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Expanded Liability for Companies under the SEC's Proposed Climate Disclosure Rule

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On March 21, the Securities and Exchange Commission released its much-anticipated proposed climate disclosure rule that would require public issuers to provide certain climate-related information in their public filings. The enforcement implications of such a rule could be far-reaching as companies could now be required to report several new categories of detailed climate-related information, expanding the scope of liability for potential SEC investigations and shareholder litigation.

The proposed rule, titled the Enhancement and Standardization of Climate-Related Disclosures for Investors, would enhance disclosure requirements for registration statements, periodic reports, financial statements, Inline XBRL and attestation reports. Specifically, the proposed rule adds a new subpart to Regulation S-K requiring the disclosures modeled on the Task Force on Climate-Related Financial Disclosures framework and a new subpart to Regulation S-X to require the disclosure of "disaggregated climate-related impacts on existing financial statement line items."

The comment period on the proposed rule is now open and will close on the latter of May 20 (60 days after issuance) or 30 days after publication in the Federal Register. The SEC has indicated that it hopes to finalize the rule by the end of 2022.

It is difficult to overstate the sweeping nature of this proposed rule and the amount of resources and effort that will be necessary for issuers to develop the required information and include it in their Exchange Act reports. If the proposed rule is finalized, a registrant would be required to disclose or include:

- Governance of climate-related risks (board and management oversight);
- Material climate-related impacts on its strategy, outlook and business model;
- Management of climate-related risks, including the identification, assessment and adoption of any transition plan;
- Disclosure of greenhouse gas (GHG) emissions emitted directly as a result of its own operations (Scope 1), emitted from generating the electricity it consumers (Scope 2) and emitted by its suppliers and customers (Scope 3);
- Any climate-related targets (e.g., reduction of GHG emissions, conservation, energy usage, water usage, etc.);
- Attestation reports from a GHG emissions attestation provider with respect to its Scope 1 and 2 emissions for large and accelerated filers.

Liability Implications

With more disclosure requirements comes increased potential for liability. As a threshold matter, while materiality is generally a starting point of an SEC enforcement analysis, the new proposed climate rule may require the disclosure of climate-related information that is quantitively immaterial for certain individual companies. Whether the SEC could assign liability for such a misstatement or omission remains an open question. Commissioner Allison Lee has pointed out in a recent speech that materiality is "not a legal limitation on disclosure rulemaking by the SEC." However, courts have held that materiality is required for scienter-based anti-fraud rules such as Rules 10b-5 and 14a-9 under the Exchange Act.

Should the proposed rule be finalized, companies who fail to include the newly required disclosures will be subject to liability for reporting violations under Exchange Act Section 13 and related rules. Companies should also evaluate their Disclosure Controls and Procedures to ensure their controls address the new requirements to avoid potential liability under Rules 13a-15(a)-(c). Additionally, under the proposed rule, all of the required climate-related disclosures would be treated as "filed" and therefore subject to the Exchange Act Section 18 and Securities Act Section 11.

More broadly, the proposed rule's disclosure requirement for Scope 3 emissions creates expanded liability in and of itself. Scope 3 disclosure would require registrants to disclose emissions data from every partner on their supply chains. Granted, Scope 3 emissions must be disclosed only if material or if a company included these emissions in its GHG reduction goal. But determining what is material will be an intensive fact-specific inquiry that could invite questions from regulators. Fortunately, the proposed rule includes a new safe harbor for Scope 3 disclosures: These disclosures by or on behalf of the registrant would be deemed not a fraudulent statement unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith.

Companies that have already made big promises about climate-initiatives need to be most careful with their disclosures in light of the proposed rule. If approved, companies that have disclosed climate change targets would now be required to describe details about their plans for achieving them, including financial impacts and status updates. For companies that use analytical tools to access the impact of climate-related risks on operations, the proposed rule would require disclosure of information of concerning “parameters, assumptions, and analytical choices, and the projected principal financial impacts on the registrant’s business strategy under each scenario.” Further, if a registrant uses an internal carbon price to assess climate-related risks, the proposed rule would require disclosure of such price. Each of these requirements presents additional liability risk.

If the proposed rule is finalized, expanded liability would not come from SEC enforcement actions alone. Should a company be subject to an SEC investigation, disclosure of such investigation could lead to a shareholder class action or derivative action against the company. Even without being subject to an SEC investigation, the required disclosures may reveal information not previously known to shareholders and provide the basis for shareholder actions about mismanagement due to climate impact. In addition, the proposed rule’s Scope 3 emissions disclosures could cause an increase in breach of contract litigation, as companies may want to cut ties with supply chain vendors with significant emissions and vendors who are unable to sufficiently disclose the extent of their emissions.

It is expected that market participants will challenge the final rule once adopted. Nonetheless, companies should start evaluating their climate-related disclosures and their disclosure controls and procedures with an eye towards the evolving qualitative materiality of those disclosures and the potential liability that will accompany them.

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