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ESG, the SEC Climate Rule, and the Limits of Securities Regulation

By Kenneth M. Rosen

ESG, the denotation of the movement to evaluate enterprises on their adherence to certain environmental, social, and corporate governance goals, garners significant attention – both positive and negative – from the business community. While some might view the focus on ESG as a recent phenomenon, concentration on the relationship of corporations to social change is more long-standing. This attention includes that of government actors, who evaluate and affect that relationship.

Among those currently experimenting in this area is the United States Securities and Exchange Commission (SEC) with its recently finalized climate rule.[1] And, this federal agency is not the only public actor seeking space in the area. This regulatory activity raises questions about the appropriateness and wisdom of the use of different regulatory schemes to address ESG issues. Accordingly, lawyers representing businesses should be interested in both the short-term and long-term implications of such activities for their clients and the U.S. economy as those activities are undertaken by securities regulators.

ESG and Its Predecessors

Scrutiny of the relationships among corporations, their shareholders, and society is hardly new. While the term "ESG" may be more recently minted, the legal focus on those relationships is not. A classic academic dialogue between E. Merrick Dodd, Jr. and A.A. Berle, Jr., evidencing different perspectives on shareholder primacy and to whom key corporate players owe a responsibility, played out in the pages of the *Harvard Law Review* in the early 1930s.[2] You even might remember cases from your introductory business organizations course that further illustrate this early attention. For instance, in *Dodge v. Ford Motor Company*, some shareholders objected to automaker Henry Ford's and his company's perceived emphasis on labor and social development over shareholder profits. The court in *Dodge* famously was reluctant to declare such considerations impermissible, employing an early version of a deferential, business judgment rule type analysis.[3]

Some states' "other constituency" statutes that affirmatively protect from liability directors considering other societal groups during decision-making seem consistent with the result in the *Dodge* case.[4] However, some have cautioned that codification of such matters in these statutes might have drawbacks.[5] In more recent times, some businesses have sought to advertise their emphasis on community-minded efforts in identifying with the corporate social responsibility (CSR) movement. In many ways, ESG appears to be another iteration of this phenomenon by a different name.

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Other government actors, such as the SEC, certainly have started to add their imprimatur to corporations' socially conscious acts related to specific issues. For example, in 2012, the SEC adopted a rule requiring disclosure of activities related to conflict minerals.[6] More recently, the Commission's efforts in this area seemed to broaden with its proposed rule for disclosure related to climate change that is closely linked to the environmental component of ESG.[7] That proposal was met with pushback, leaving it in limbo for numerous months rather than moving toward prompt adoption.[8] However, the SEC kept working toward a final rule,[9] and on March 6, 2024, the Commission voted to adopt a scaled-back version of the rule that still required certain disclosures.[10] Such efforts seem to illustrate the SEC's willingness to at least consider regulatory requirements of disclosure related to ESG that go beyond purely voluntary corporate action. The potential legal consequences deserve close attention by the bar.

Possible Immediate Concerns for Practitioners

In the short term, practitioners will need to carefully monitor both how the SEC climate rule will, and how other similar federal regulations might, impact their corporate clients. The SEC climate rule, as initially proposed, placed specific burdens on companies. The proposal contemplated detailed disclosures on a variety of climate-related issues.[11] Compliance with even the scaled-back version of the rule – a rule which still requires certain disclosures – undoubtedly will cause some companies to incur significant costs, including legal ones.

Moreover, a practitioner's attention should not only focus on federal regulation. Remember that while the federal government effectively preempts certain state securities regulation,[12] states remain active in some areas of securities law. Alabama features its own securities regulator, the Alabama Securities Commission (ASC).[13] And while the ASC may not dive into the climate arena as much as other states' public actors, Alabama businesses, depending on the nature

and geographical scope of their operations, might face scrutiny from other states' regulators seeking to impose themselves in this area. A case in point: California legislation which has already been enacted, if fully implemented, would require disclosures related to the environment by certain companies doing business in the state.[14] Like the SEC Rule, the California law is not without detractors, and it prompted immediate legal challenge after enactment.[15]

Some companies might even need to look beyond national borders to satisfy regulatory requirements. For example, the European Union's Corporate Sustainability Reporting Directive from January 2023 requires member states to move forward on national legislation prescribed by the Directive.[16] These are only examples of some state and international climate regulatory efforts. Lawyers wanting to stay informed should continue to monitor legal requirements in non-EU countries as well as additional U.S. states.

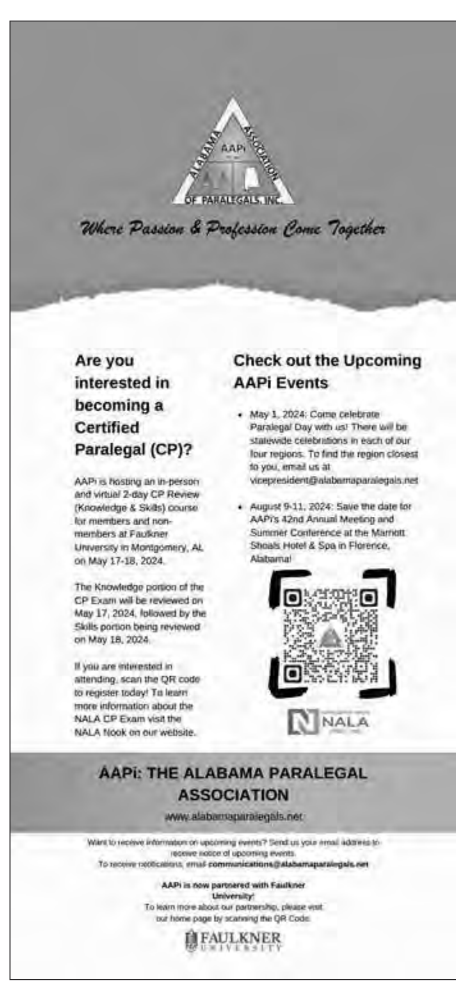
Additional Longer-Term, Systemic Concerns

Lawyers' interest in potential ESG related compliance issues under securities laws, especially as implemented by government authorities, should go beyond the short-term. Implementation of social goals through business compliance with securities law requirements raises possible concerns, including the efficacy of the market regulation system.

Critical to the success of the U.S. economy is the presence of robust capital markets that provide U.S. businesses with access to financial resources to help bolster their growth.[17] It is no coincidence that the current strength of those markets is accompanied by a capital market regulator, the SEC, with nearly a century of experience and that is recognized as one of the most effective in the world. While adjusting to new challenges, the Commission traditionally adheres to a core mission of investor protection; maintenance of market fairness, order, and efficiency; and facilitation of the formation of capital.[18] To the extent the SEC climate rule represents movement away from the Commission's traditional, core mission, lawyers should consider several questions.

First, are securities regulators best situated to address societal issues such as climate change as compared to other regulators? The climate rule presumably seeks to minimize behavior negatively affecting the climate through pressure brought via public disclosure; this might make the rule popular with environmental activists. Whether one supports such a behavioral change or not, utilizing the Commission as a tool to achieve such ends appears to be a classic second-best solution.[19] Put another way, other regulators, such as the Environmental Protection Agency, would seem to have more expertise and direct interest on activities with hazardous environmental impacts than the SEC. An open, transparent debate on climate change, accounting for all arguments about the nature of climate change and the best way to address it, would seem best suited for the forum of a regulator with expertise in the field and more direct (and statutorily authorized) responsibility to oversee such issues. Forcing the SEC to become more of an expert on a potentially limitless range of social issues runs the risk of transforming the agency into a jack of all trades and the master of none.

Second, what is the cost of redirecting the SEC away from its core mission? Unfortunately, the Commission, like other federal agencies, does not possess unlimited resources. Accordingly, use of those limited resources for new rulemakings on a potentially large variety of ESG issues likely could come at the expense of important, traditional SEC activities. Wise regulators and those calling for



new regulations should always ask if resources are more efficiently spent enforcing existing laws or promulgating new ones. And, the potential resource drain is not only in the new rules' promulgation, but also in their enforcement.[20] If regulation exists not only to punish violations, but to encourage proactively the regulated parties from violating the law in the first instance, it is fair to assess the cost to such deterrence in a world where potential violators see no likelihood of prosecution related to violations. Moreover, fewer resources for market integrity run the risk of harming investor confidence and capital market strength.

Third, will those the SEC traditionally seeks to help possibly be harmed by a new focus for its regulations? As noted, investor protection is at the top of the list of important priorities in the Commission's core mission. Insufficient information can harm investor decision-making, but so too might an overabundance of data. Flooding of the markets with large quantities of new figures on ESG issues might confuse investors with informational "noise" that distracts them from other disclosed issues – issues perhaps more vital to the success of their investments and personal livelihoods. Disclosure should always strike a balance: It should not only account for the cost of businesses gathering and disseminating information, but also the usefulness of that information to investors. Moreover, given investors' hard-earned trust of the SEC, the Commission does not want to inadvertently put its finger on the scale and signal some subjects of disclosure are more important than others.

Fourth, will entry into areas viewed as social reform increase legal attacks on the SEC? Of late, the SEC has been under scrutiny in cases questioning its operations and authority to regulate in certain areas. For example, its authority to promulgate its recent rules related to the private funds industry were quickly challenged.[21] Resulting litigation against the Commission based on its entry into novel areas risks potential losses in court that might generally decrease the credibility of the Commission and affect its other work. New litigation against the SEC also would occur in an environment seemingly less amenable to government actors, where some seek to afford less deference to federal agency work under doctrine previously established in cases like *Chevron*, the fate of which hangs in the balance even as this piece goes to press.[22] Of note, on the same day as the climate rule's adoption, multiple states seem to be gearing up for a legal challenge.[23]

Better lawyers, whether in favor or against such efforts, will contemplate utilizing such knowledge to engage proactively *during* the policy-making process.

Conclusion

Businesses are sometimes accused of wanting no regulation. A more nuanced view recognizes that what businesses often seek is greater legal certainty associated with applicable regulations. When operating effectively, the SEC can be as much the ally of businesses as investors in that investor confidence and robust capital markets also help businesses. Accordingly, those who work with companies should be keenly aware of any evolution of the Commission's core work. Undoubtedly, they will want to consider whether movement of regulatory efforts by the SEC in new directions might expose the Commission to changes based on political priorities or on whims of the moment during changing administrations. Flux in this regard may spawn more undesirable legal uncertainty.

In addition, lawyers need to educate themselves on rules when they are passed. Better lawyers, whether in favor or against such efforts, will contemplate utilizing such knowledge to engage proactively *during* the policy-making process. They can do so by offering comments on proposed rules' benefits and drawbacks, in coordination with each other and clients, as those rules are considered. This provides policymakers like the SEC with a more comprehensive view of those rules' potential economic and other impacts and, it is hoped, this will result in more optimum regulation. Through such dialogue, the SEC can more thoughtfully consider the advisable limits of securities regulation. ▲

Endnotes

1. *See* Press Release 2024-31, SEC, SEC Adopts Rules to Enhance and Standardize Climate-Related Disclosures for Investors (Mar. 6, 2024).
2. *See* A.A. Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931).
3. *See* 170 N.W. 668 (MI 1919).
4. *See* Charles Hansen, *Other Constituency Statutes: A Search for Perspective*, 46 BUS. LAW. 1355 (1991).
5. *See* American Bar Association Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990) (noting Committee declined to amend Model Business Corporation Act despite such statutes).
6. *See* Press Release 2012-163, SEC, SEC Adopts Rule for Disclosing Use of Conflict Minerals*,* (Aug. 22, 2012).
7. *See* Press Release 2022-46, SEC, SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors (Mar. 21, 2022).
8. *See* Samantha Delouya, CNN, Dec. 30, 2023, *available at https://www.cnn.com/2023/12/30/business/sec-climate-change-rule-2024/index.html*.
9. *See* Douglas Gillison, *US SEC to Vote on Long-Awaited Climate Disclosure Rule, Notice Says*, REUTERS, Feb 29, 2024.
10. *See* SEC Final Rules, The Enhancement and Standardization of Climate-Related Disclosures for Investors, Securities Act Rel. No. 33-11275, and Securities Exchange Act Rel. No. 34-99678, *available at https://www.sec.gov/files/rules/final/2024/33-11275.pdf* (Mar. 6, 2024).
11. *See* SEC Proposed Rule, The Enhancement and Standardization of Climate-Related Disclosures for Investors, Securities Act Rel. No. 33-11042, 87 Fed. Reg. 21334 (Apr. 11, 2022).
12. *See* National Securities Markets Improvement Act of 1996.
13. *See* Alabama Securities Commission, *https://asc.alabama.gov/*.
14. *See* Jordan Wolman, *Newman Signs First-in-the-Nation Corporate Climate Disclosure Bills*, POLITICO, Oct. 7, 2023.
15. *See* Clark Mindock, *California's Landmark Climate Disclosure Laws Challenged by Business Groups*, REUTERS, Jan. 30, 2024.
16. *See* European Commission, *Corporate Sustainability Reporting*, *https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en*.
17. *See generally*, SIFMA, 2023 Capital Markets Fact Book, *https://www.sifma.org/wp-content/uploads/2022/07/2023-SIFMA-Capital-Markets-Factbook.pdf*.
18. *See* SEC, *Mission*, *https://www.sec.gov/about/mission*.
19. *Cf.* Kenneth M. Rosen, *Limits on Exporting Corporate Social Responsibility*, 12 S.C. J. INTL. LAW & BUS. 41, 62-63 (2015); Kenneth M. Rosen, *"Who Killed Katie Couric?" and Other Tales from the World of Executive Compensation Reform,* 76 FORDHAM L. REV. 2907, 2931 (2008); Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097, 1122-31 (2003).
20. *See* Kenneth M. Rosen, *Examining the Role of Settlements in the Enforcement Process by Financial Regulators: The Example of the United States Securities and Exchange Commission,* Testimony before the Committee on Financial Services of the United States House of Representatives, *published in* H. Rpt. 112-128 (2012) (noting need to allocate limited resources.)
21. *See* Carolina Mandl, *US Private Funds Industry Sues Securities Regulator Over New Rules*, REUTERS, Sept. 1, 2023.
22. *See* Mark Walsh, *Supreme Court Will Consider Overruling Landmark Chevron Deference Decision in a Fishy Case*, ABA J. (Jan. 11, 2024), *available at https://www.abajournal.com/web/article/supreme-court-to-consider-overruling-landmark-chevron-deference-decision-in-a-fishy-case*.
23. *See* Taylor Giorno, *10 States File Legal Challenge to SEC Climate Disclosure Rule*, THE HILL (Mar. 6, 2024).

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