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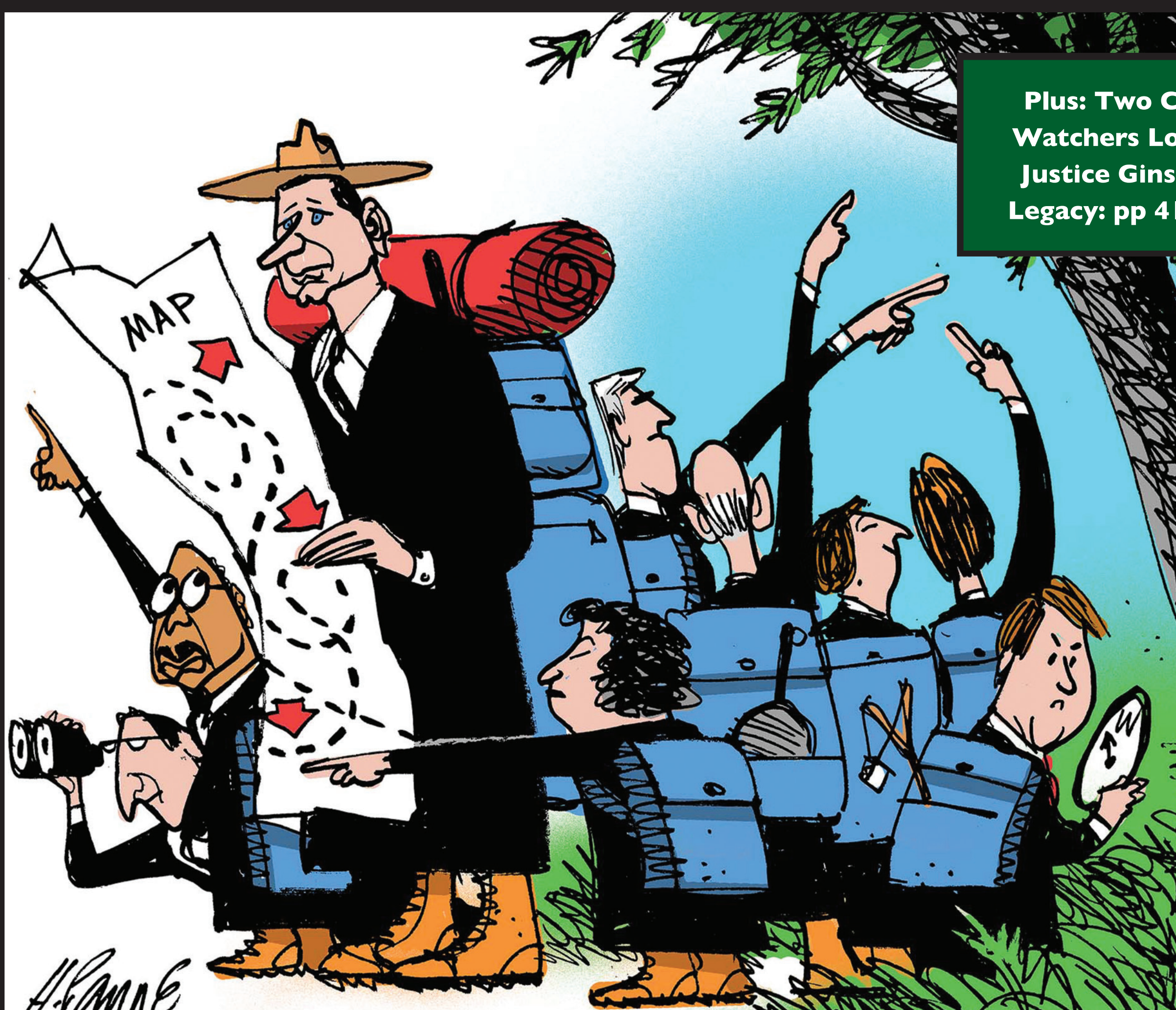

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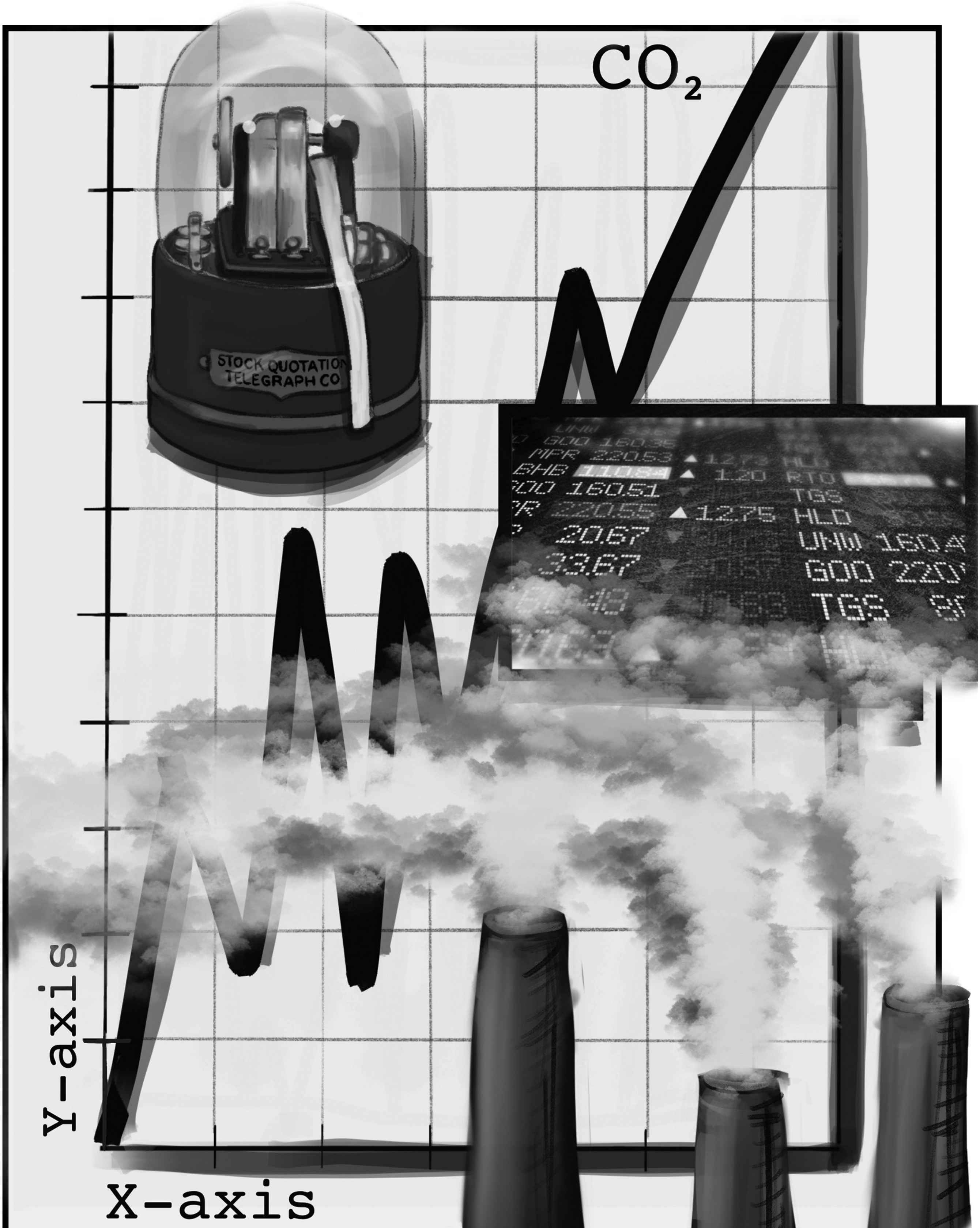
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The Uncertainty Principles

The Securities and Exchange Commission is leaving corporate managers with a murky view of how they should consider climate-related information and without guidance on how best to navigate differing opinions from investors and advocacy organizations

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Climate change is impacting how we live our lives and how companies do business. When that happens, it impacts the law. A prime example is the resilience policymakers tout to combat the inevitable shifts ahead. But resilience in the face of change requires transparency — companies and financial entities need to account for these impacts openly and honestly. Investors' interest in climate-related risks and opportunities has grown rapidly in the last five years, leading to better corporate disclosure practices. Yet despite pressure to act accordingly, U.S. regulatory bodies have not taken significant direct actions to address climate change risks. Reticence to do so may ultimately give them less input into how legal standards evolve. Standards grounded in malleable concepts that can improve as the nature of investing changes, such as the materiality standard grounded in the needs of the "reasonable investor," can shift expectations even absent regulatory action.

Our regulatory bodies appear to be of two minds about directly addressing climate change risks. The Securities and Exchange Commission has resisted calls to incorporate explicit disclosure obligations into its regulatory structure, and the Department of Labor's Employee Benefits Security Administration (EBSA) has proposed new regulations that indicate substantial skepticism about environmental, social, and governance factors' connection to financial outcomes in investing. In contrast, the Commodities Future Trading Commission (CFTC) and Federal Reserve are actively exploring climate-related impacts on the financial system.

Existing regulatory guidance from the SEC does not fully address the rapidly changing climate discussion, its importance to investors, and the certainty of climate-related impacts. The SEC released guidance on the materiality of climate-related information in 2010, after investors, environmental groups, and the New York attorney general petitioned the commission. The release also followed a series of investigations into power company disclosures by the New York AG, leading to settlements that required disclosure of certain climate-related information in companies' SEC filings. But the 2010 guidance largely sidestepped the question of how companies should handle climate-related information in materiality analyses. The commission listed examples of such information that could be material but did not fully explain what it expected of corporate management. It emphasized that firms should limit disclosure to financially material information, but not limit the information considered in making that determination. The SEC also failed to follow the guidance with substantive enforcement efforts. Reviews of corporate disclosures in the following years reveal little significant change. An effort to go behind the disclosures and evaluate how companies made their materiality determinations could have more precisely defined when climate-related information is material and encouraged more substantive corporate evaluations.

Despite opening a door to new guidance or regulation on climate-related and ESG issues in a 2016 concept release, the SEC has remained on the sidelines, leaving companies and investors to spar over how expansive climate-related disclosures should be, and on what topics and in what form. Last May, the commission's Investor Advisory Committee recommended the SEC update reporting requirements to include "material, decision-useful ESG factors" and specifically referenced climate-related information.

In early 2020, State Street Global Advisors, BlackRock, and other investment firms announced new plans for persuading companies to address financially material ESG issues. The high-profile announcements followed moves in recent years by Wellington Management, CalPERS, and other institutional investors to integrate climate-related data into their processes and increase the pressure on companies to more deeply consider climate change risks and disclose how they are accounting for those risks in their operations. Companies have responded with a steady stream of climate-related goals, commitments to disclose in line with the international Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) recommendations, and climate reports in addition to sustainability reports and other annual reports.

Adding to pressure from advocates and investors, academics have proposed various approaches to revising SEC disclosure requirements to expand discussion of sustainability issues, including climate. In 2016, Robert Eccles and Timothy Youmans suggested in the *Journal of Applied Corporate Finance* requiring a statement of significant audiences and materiality to better define what ESG issues boards consider material and the specific stakeholders to which they relate. Last year, Jill Fisch proposed in the *Georgetown Law Journal* creating a new sustainability, disclosure, and analysis section of SEC filings, modeled after the management discussion and analysis section. Her idea was that companies could then identify and explain their choice of the three sustainability issues most significant to their operations. Also last year, Dan Esty and Quentin Karpilow suggested a three-tiered mandatory ESG reporting regime in the *Yale Journal on Regulation.* These proposals would likely require additional SEC guidance on their applicability to climate-related topics.

U**nfortunately, recent statements by SEC** commissioners have pushed back on calls for new guidance or requirements, focusing on the "amorphous nature" of ESG. Relying on the old mantra that U.S. disclosure requirements are principle based, their view is that ESG or climate change-specific disclosure requirements are unnecessary because companies already disclose material information once it becomes material, whether it is climate-related or not. However, this largely misses the point that companies need help determining how to properly disclose risks that are rapidly becoming financially material but are distinct from the types of information they have typically worked into their analyses. By failing to provide additional guidance, the SEC leaves corporate managers with a murky view of how they should consider climate-related information and without enlightenment as to how best to navigate differing opinions from investors and advocacy organizations.

The Trump administration is unlikely to support efforts to more specifically address climate change risks in disclosures. President Trump issued a directive to the Department of Labor in 2019 to review data on Employee Retirement Income Security Act (ERISA) plans, identify trends in investments in the energy sector, and review guidance on fiduciary responsibilities for proxy voting. Last June, EBSA released proposed amendments to the investment duties regulation under ERISA. The proposal discourages considering ESG factors in ERISA-covered plans, emphasizing financial outcomes above all else, and restricts the ability of fiduciaries to offer ESG-themed funds as default options. It also departs from previous guidance by requiring potentially burdensome documentation of equal economic returns and risks for investment choices partially based on an ESG factor.

The justification requirements and other aspects of the proposal may dampen recent enthusiasm for ESG-focused investments. It may discourage integration of the many topics, such as climate change, that live under ESG as factors in investment decisions but does not preclude such integration. The proposal explicitly recognizes the potential financial materiality of ESG factors. EBSA's skepticism that such investments can have equal or better financial outcomes and focus on documentation heightens the importance of disclosure that better details financial aspects of climate-related risks and opportunities.

Concern over climate change risk goes beyond investors and firm-level corporate disclosure. Banks are revising lending policies to limit lending in certain extractive industries. They are also increasingly disclosing their own exposures to climate-related risks, with reports guided by TCFD on climate-related risks in their assets and estimates of the environmental and climate impacts of their lending practices.

Financial and bank regulators, with substantial independence from the White House, are considering whether climate change poses systemic risks to the

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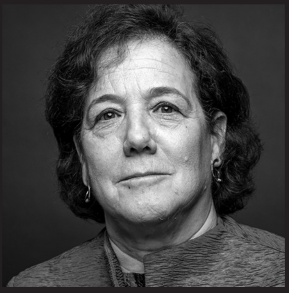
SIDEBAR

We Need a Federal Climate Risk System



Mindy Lubber
CEO
Ceres

"The Commodities Futures Trading Corporation's experts, representing financial institutions, banks, insurance companies, data service providers, and environmental and sustainability organizations, issued a clarion call in September to financial regulators based on the real-world impacts and risks of climate change."

The systemic risks posed by climate change are not partisan, or even political. They are financial. They are real, material, systemic risks for Wall Street, Main Street, and everywhere in between. Integrating climate risks into our federal financial system is about ensuring the stability and security of our economy.

Financial markets have a critical role to play in addressing climate change. Financial regulators like the Federal Reserve and the Securities and Exchange Commission must heed the calls of capital market leaders. They must listen to the scientists, listen to the economists, and listen to the financial experts sounding the alarm bells.

In early September, for the first time ever, an expert subcommittee of a federal financial regulatory agency issued a major report on climate risk, recommending that the Commodity Futures Trading Commission, the Fed, the SEC and other financial regulators act swiftly to address climate change as a systemic financial risk.

The report, "Managing Climate Risk in the U.S. Financial System," was produced by the Climate-Related Market Risk Subcommittee of the CFTC, on which I serve. It issues recommendations for action, including putting a price on carbon, strengthening climate risk disclosure, and conducting stress tests to see how financial institutions like banks might fare in a carbon-constrained, rapidly warming world.

And it doesn't stand alone. A movement is building — with more and more capital market leaders calling for action from our financial regulators by the day. It's time our financial regulatory agencies listen to this increasing number of calls for action, learn from them and then act.

In June, the Ceres Accelerator for Sustainable Capital Markets issued its own report outlining the systemic threat climate change poses to capital markets, along with more than 50 recommendations financial regulators should take to combat this threat.

In July, investors with a collective $1 trillion in assets under management joined with former members of Congress from both major political parties to demand that financial regulators heed the report's recommendations and address climate change as a systemic financial risk.

"The adverse impacts of climate change are already stressing key sectors of our economy," David Jenkins, president of Conservatives for Responsible Stewardship, said in an endorsement of the June report. "The risks are real," former Representative Carlos Curbelo (R-FL) told the *New York Times.* "We need leadership from every U.S. financial regulator to transition to a resilient, sustainable, low-carbon economy and avoid a climate-fueled financial collapse," California Comptroller Betty Yee wrote in *Barron's*.

In August, Senator Elizabeth Warren (D-MA) sent a letter to SEC Chairman Jay Clayton, urging him to act on climate change as a systemic risk and to require that publicly traded companies provide climate risk disclosure, among other recommendations.

Her colleagues in the Senate issued a major climate report, with significant emphasis on the role financial regulators must play in avoiding severe climate risks to the U.S. economy. They, too, called for mandatory climate risk disclosure, stress tests for banks, and cooperation from U.S. financial regulators with their global counterparts who are already engaging on climate.

We're nearing an inflection point. The CFTC subcommittee, made up of experts representing financial institutions, banks, insurance companies, data service providers, and environmental and sustainability organizations, issued a clarion call in September to financial regulators based on the real-world impacts and risks of climate change.

That this recommendation for financial regulatory action has come from across the spectrum is a testament to the leadership of CFTC Commissioner Rostin Behnam, sponsor of the subcommittee, and Chair Bob Litterman. But it also shows just how extensive and serious a financial issue climate change is to our economy and our society — and that we urgently need action from our financial regulators.

financial system. While U.S. regulators are generally behind their European counterparts in grappling with how to address climate risks in their supervisory and regulatory capacities, they are not ignoring the issue. The CFTC's Market Risk Advisory Committee commissioned a report on climate-related systemic risk expected this fall. Federal Reserve Chair Jerome Powell said in January that the Fed has a role to play "to ensure that the financial system is resilient and robust against the risks of climate change" and is working to understand how to do so. Powell has also indicated a willingness to join the Network of Central Banks and Supervisors for Greening the Financial System and has sent representatives to participate in its meetings. The Federal Reserve Bank of San Francisco hosted a conference on climate change in 2019, commissioning a series of papers. The executive vice president of the Federal Reserve Bank of New York, Kevin Stiroh, delivered remarks on climate change and risk management in bank supervision at an event at Harvard Business School earlier this year. Stiroh is serving as the co-chair of the Basel Committee on Banking Supervision's high-level Task Force on Climate-Related Financial Risks and has said that the Federal Reserve is devoting "a lot of resources" to climate change risk research. The Fed is closely following central banks and regulators in other countries who are developing stress testing and additional disclosure requirements.

Even absent new regulation, legal standards for corporate disclosure and risk management will change. The rise in firms looking to partner with climate data providers marks a shift from talking about climate change as something that will eventually impact financial markets and corporate well-being to considering how and when that will happen. The flurry of investor commitments on portfolio management and voting practices indicates a key component of materiality — who is a reasonable investor — is evolving as it relates to climate-related information.

Securities law requires companies to disclose certain information to investors, and imposes liability for untrue or misleading statements and omitting financially material information. Management and boards decide what to disclose, but they must consider the shareholder's viewpoint. The reasonable investors' evolving view of climate-related information means companies can no longer make materiality determinations as they always have. As investors take concrete actions to incorporate climate-related information into their analyses and make specific decisions dependent on that information, it becomes material for the purposes of disclosure. Investors' recent moves increase the pressure on companies to more deeply consider climate change risks to their operations and how they disclose them.

Corporate actors have already begun to shift their approach to managing and disclosing climate change risks and opportunities — increasingly recognizing the climate-related impacts on their business. Nongovernmental organizations have stepped into the void to referee this process. The Financial Stability Board's Task Force on Climate-Related Financial Disclosures galvanized these efforts and brought together a broad coalition of companies and investors to agree on a general framework for climate-related disclosures — heavily influencing the conversation, providing heft to the effort, and solidifying buy-in from industry players. Other organizations such as Ceres have long made enhanced disclosure a priority, providing guidance on specific metrics and working directly with companies on improving disclosures. The Sustainability Accounting Standards Board (SASB) has developed industry-specific guidance on when ESG issues, including climate-related topics, may become material under U.S. securities law. Industry standards organizations are also entering this space. Earlier this year, the American Petroleum Institute and International Association of Oil & Gas Producers collaborated with the International Petroleum Industry Environmental Conservation Association to release updated sustainability reporting guidance for the oil and gas industry that specifically addresses climate change risks and opportunities.

As investors gain a more sophisticated understanding of climate change information and comfort using it to inform their decisions, courts are more likely to consider climate-related information material. When, how, and whether certain topics become material depend on case specifics. A court considers the totality of the information the investor considers and how the information at issue in the case fits within that context. There is no bright-line rule on when something is material, and courts are understandably wary of setting the threshold too low. The reasonable investor standard is ostensibly objective, measured by the views of the mainstream market as a whole in which the reasonable investor is neither the worst nor best informed. A reasonable investor must exercise care in considering information, takes into account publicly available information and relevant industry customs, but is not necessarily an expert. Despite prominence

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An Approach for Investors, Companies

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"A prescriptive regulatory approach to climate risk analysis and disclosure has the potential to stifle needed creativity."

For whom is climate disclosure intended? This simple, unanswered question is central to evaluating the role of the SEC in further regulating climate disclosures. Some investors are calling for standardization of disclosures so they can compare risk across companies. However, a countervailing view is that climate disclosures are intended as risk assessment tools for the companies — a goal that could be undercut by regulatory requirements to use standard procedures.

With the publication of the final report of the Task Force on Climate-Related Financial Disclosure in 2017, many investor efforts came in the form of shareholder resolutions or letters asking companies to engage in scenario analysis to examine the impacts of steep emissions cuts required to achieve the goals of the Paris Agreement.

While TCFD aims to facilitate enhanced capital allocation by providing information to allow for pricing climate risk, its framework does not specify methodologies for the scenario analysis. The result has been that there is wide variation both in the actual assumptions that companies are making in projecting climate futures and the information they are disclosing. This has led to a patchwork of disclosures that are difficult for investors to compare.

As the SEC's Asset Management Advisory Committee's ESG Subcommittee recently noted, drawing a connection between corporate financial performance and environmental-social-governance policies (including climate) requires more robust frameworks, including the use of benchmarks and independent validation of ESG performance. Therefore, to the extent that the goal of climate reporting is to facilitate market transparency, the SEC's role in developing a more consistent, robust disclosure framework for climate risk is essential.

However, an alternative view is that climate scenario analysis should be a tool to enhance corporate resilience. Many companies engaging in TCFD-style analyses benefit from evaluating their governance, internal organization, and business opportunities that emerge from the energy transition. From this perspective, the climate scenario analysis should be a tool for imagination. If the enhancement of organizational resilience is the goal, then companies should be encouraged to evaluate a variety of orderly and disorderly energy transition scenarios to plan for the climate future and disclose results as appropriate. A prescriptive regulatory approach to climate risk analysis and disclosure has the potential to stifle this kind of creativity.

Consider the following example. With the encouragement of investors seeking standardization, oil and gas companies have mostly adopted the practice of basing their scenario analyses on the International Energy Agency's demand projections, which assume an orderly energy transition with robust natural gas demand through 2040. However, reliance on IEA scenarios neither provided companies with tools to evaluate short-term market shocks nor the potential for a sudden, lasting change in demand. There is nothing in the IEA scenarios that allows companies to test for the impact of the sudden drop in demand caused by COVID-19 and the collapse of OPEC+.

Given this, are energy companies better off with standardized scenario analysis that provides investors with clearly comparable information premised on an orderly energy transition? Or should we encourage the imagination that comes with the development of a range of short- and long-term scenarios to enhance corporate resilience and preserve long-term value?

No matter where you come out on these questions, there is value in enhanced transparency around climate disclosures. As such, the SEC could play a role in mandating a standardized method for disclosing the types of climate risk evaluations companies are undertaking, the assumptions underlying them, and what actions are being taken to mitigate any identified risks. This type of a framework could both encourage continued corporate imagination to build resilience and provide investors with enough information to compare the climate risk profiles of companies.

in the definition of materiality, investors are not directly involved in disclosure decisions, making court review all the more important.

The positions of the Big Three investment firms (BlackRock, State Street, and Vanguard) play an outsized role in influencing corporate actions. All three have made waves on the topic of climate-related information. They are taking a more proactive approach to engaging with corporate management on climate-related issues and showing a willingness to vote against the company on shareholder proposals. They may also play an outsized role in influencing the direction of legal interpretation. They have significant market pull that can help define an industry standard for reporting frameworks. By naming SASB and TCFD as their preferred guidelines they shape corporate decisions about what reporting guidance to follow. Their policies and practices regarding climate-related information could become the reasonable investor's position. While they may be the most influential, efforts to gather, consider, and incorporate climate-related information into portfolio management expands well beyond the Big Three.

In cases involving environmental information, materiality findings generally coincide with acute events, such as spills or accidents, or substantial noncompliance with environmental regulations. Very few cases have raised questions of materiality specific to climate change-related information. But as investors engage more with such information, more allegations of misleading disclosures are likely to make their way to the courts and require a determination of materiality. At a minimum, courts can no longer dismiss climate-related information as a niche interest of impact investors.

Two cases directly addressing climate disclosures have resulted in significant opinions, both involving the same basic facts. The first case to make it to the courtroom was a shareholder suit against ExxonMobil. The *Ramirez v. ExxonMobil* court partially granted a motion to dismiss that acknowledged the potential for information on climate risks to be material to reasonable investors, but it did not review the merits of the arguments in full. In *New York v. ExxonMobil*, the court considered the merits of the claim that the firm misled investors in disclosures about how future climate policies could impact product demand and how it incorporated this information into its project-level business planning.

Plaintiffs failed to convince the court of the materiality of the company's statements and supposed omissions. The court found plaintiffs' experts unpersuasive and found no evidence of impact on investors' analyses or decisions during the relevant time frame. These cases acknowledged the potential materiality of climate-related information but did not ultimately find future cost estimates of an energy transition material to a reasonable investor's decisions. The discussions of how to treat climate-related information in these cases may help shape corporate materiality determinations in the near future but do not provide a clear path for how the law will develop.

Although at first glance the *New York* opinion may seem to run counter to the argument that courts are increasingly likely to find climate-related information material for disclosure purposes, a closer reading results in a more nuanced assessment. The opinion shows companies have significant leeway in how they consider future transition risks as long as discussions of their evaluation and incorporation of those risks are not misleading. Of particular importance is how the judge discussed the way a reasonable investor would view cost assumptions that feed into modeling and projections for future costs and demand. The court's declaration that "no reasonable investor" would make investment decisions in the near term based on "speculative assumptions of costs that may be incurred 20+ or 30+ years in the future with respect to unidentified future projects" may not hold in a different context.

The case focused on whether the company did one thing and said another within a narrow time frame, 2013-16. Investors are now actively evaluating firms' views of potential future demand and costs and calling for more disclosure on how companies make these evaluations. Investors may not make decisions based on that type of a future-scenario projection alone, but they might make a decision based on how well the company is prepared to adjust to the possibility of that future and whether the business is making a good-faith effort to grapple with plausible scenarios.

The *New York* case should give solace to companies trying to assess future transition risks and provide shareholders with an understanding of their assessments without elevated liability risk. It should also encourage them to more fully explain their analyses. The case focused on differences between the company's estimates of how future policy decisions might impact the cost of CO_2 described in its public-facing "Outlook for Energy" report and nearer-term, project-level cost projections for internal budgeting and planning purposes found in its annual "Corporate Plan DataGuide."

The data guide was used to prepare annual planning budgets at the business-unit level. It provided default assumptions of costs as a starting point. Planners were expected to adjust these default cost numbers based on more detailed, project-level information about expenses specific to their project's locality and within relevant time frames. The guide did not represent all potential future costs of the full suite of climate-related policies available, and its information was not public nor intended for investors. The price assigned for the purpose of the outlook document served as a stand-in for the possible costs of a suite of potential future policies and fed into modeling used to consider future changes in product demand and supply and technology uptake. It did not represent a specific carbon price or project-level cost the company might expect to see directly applied to its operations and thus incorporated into its budget planning process (which is what the data guide's internal numbers were designed to help project). To understand this difference and why it matters requires some understanding of climate economy models, scenarios, and analyses.

The *New York* case should show stakeholders the importance of understanding the tools industry uses to imagine and plan for the future. Investors are increasingly interested in how companies model future costs of climate policies, how climate change projections impact corporate project planning, and to what extent companies are prepared to adjust to the physical and transitional impacts of climate change — pressuring firms to disclose more about their scenario-analysis efforts. But they also need to better understand how these tools work — what they can do, and what they can't. The *New York* outcome does not mean climate-related information is immaterial. The investor relationship to climate-related information has shifted since the period at issue in the case, changing even more rapidly in the last year, a trend likely to continue and one that could impact a court's analysis.

E**xxon faces another lawsuit based on the** same facts, filed by Massachusetts Attorney General Maura Healey last year. That case includes claims of misleading investors familiar to followers of the *New York* litigation while also raising consumer protection claims. Other shareholder suits have also emerged. But more interesting will be future cases addressing the adequacy of climate disclosures that investors are just now beginning to incorporate into their decisionmaking. As investors find new ways to incorporate climate-related information into their portfolio management practices, evidence grows to support finding such information material.

The cases to date have dealt entirely with transition risk climate-related information, meaning information on risks associated with a change to a low-carbon economy. Corporate disclosures around the physical risks of climate change may cross the materiality threshold even sooner than modeling of future drops in demand or price shifts from an uncertain path to lower carbon emissions. As investors better understand the current and near-term physical impacts of our changing climate it may be even easier to show the financial importance of such information. Increased investor use of climate information increases the likelihood of future cases addressing different types of climate-related information in different time frames, contributing to evolving case law and increasing the likelihood of different outcomes.

While the energy sector gets much of the limelight when it comes to climate change impacts, other industries are recognizing physical and transition risks. Infrastructure development, real estate, and insurance sectors have had to adjust to very real climate-related impacts. Recent research calls into question the future of the conventional 30-year mortgage in some areas of the country. The FEMA flood maps that insurers, developers, and local governments rely on for planning purposes and pricing risk do not fully reflect expected climate risk, creating a demand for sea-level rise and flooding data with more up-to-date climate science and projections, and leading some jurisdictions and private sector entities to develop their own data.

The debate about whether ESG factors should be considered by investors and plan managers, corporate disclosure practices, and financial risk management is fast becoming obsolete for issues like climate change. As warming impacts businesses and their supply chains, and our communities and their governments are forced to more directly respond, the materiality of climate-related issues will only become more apparent for many sectors. As they do, the existing law will require changes to disclosure practices regardless of whether new regulatory requirements have been imposed.

These trends highlight the importance of companies clearly explaining how they evaluate and consider climate-related information. Right now they are left to do so without the benefit of regulatory guidance, making that task more challenging. Regulators and courts will ultimately have to grapple with the materiality question even if they are not interested in encouraging increased focus on climate change. **TEF**