September 10, 2019

Climate-Related Risk Disclosure Under U.S. Securities Laws

In light of public concern over climate change, some stakeholders have asked to what extent publicly traded companies should disclose their climate-related risks. The Securities and Exchange Commission (SEC) requires publicly traded companies to disclose financial statements and certain other relevant business information in public filings, including annual and quarterly reports. While current SEC requirements do not address climate-related risks expressly, publicly traded companies must disclose such risks if they are "material" under federal securities laws.

Financial Risks Posed by Climate Change

Numerous organizations, shareholder groups, businesses, and financial regulators have recognized financial risks that climate change may pose to companies. Such climate-related risks commonly fall into two general categories:

- **Physical risks:** These risks include direct and indirect risks arising from extreme weather events and from longer-term shifts in climate patterns, including, for example, changes in water availability and food security. Physical risks have important implications for many companies' physical facilities, operations, transportation costs, supply chains, and employees.

- **Transition risks:** These risks arise from policy, legal, technology, and market changes as the world transitions to a lower-carbon economy, with potential financial or reputational effects on businesses. For example, a company may engage in efforts to reduce greenhouse gas emissions or otherwise respond to changing consumer behavior.

Although financial regulators have not traditionally focused on climate change, some financial regulators have begun to consider the economic impact of climate-related changes. For example, the Bank of England is incorporating climate change scenarios into certain prudential regulation stress testing processes. Similarly, the Bank of Canada recently added climate change to its list of the top economic risks facing the country's financial system, as noted in its *2019 Financial System Review*. In the United States, Federal Reserve Chairman Jerome Powell has stated that climate events "have the potential to inflict serious damage on the lives of individuals and families, devastate local economies, and even temporarily affect national economic output and employment."

What Climate-Related Risk Disclosures Do the SEC Currently Require?

Federal securities law does not explicitly require publicly traded companies to disclose specific climate-related risks. Rather, publicly traded companies need to disclose climate-related risks if such risks are material to investors. In *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), the Supreme Court explained that a fact is "material" if there is a "substantial likelihood" that a reasonable shareholder would find its omission to alter the total mix of available information significantly. By requiring publicly traded companies to disclose material information, federal securities law enables shareholders to make informed investment decisions. Subject to this "principles-based" approach to disclosure, a company's management must use its judgment in complying with the "materiality" standard to determine what information must be disclosed. Under the securities laws, investors harmed by materially misleading statements or the omission of material facts can seek remedies through civil litigation.

The SEC's Regulation S-X and Regulation S-K require publicly traded companies to disclose certain information, such as financial statements and business descriptions, in their periodic filings. For example, in the Management's Discussion and Analysis, or MD&A section of SEC-mandated public reports, publicly traded companies must provide a narrative explanation of their financial statements. The MD&A section also requires disclosure of any known trends, events, or uncertainties, which are reasonably likely to have a material effect on the publicly traded company's financial condition or operating performance beyond what its reported financial statements reflect. In the Risk Factors section of SEC-mandated periodic reports, a company must disclose the most significant risk factors that would make an investment in the company speculative or risky, although the rule states that companies should not present risks that could apply generically to any security. Moreover, the SEC's Rule 12b-20 requires additional disclosure of "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."

In 2010, the SEC issued a *Commission Guidance Regarding Disclosure Related to Climate Change* to assist publicly traded companies in satisfying their disclosure obligations with respect to climate change matters. First, the SEC's guidance reviewed certain explicit disclosure requirements concerning environmental matters contained within Regulation S-K. Specifically, under Item 101 of the regulation, issuers must report their material costs of complying with environmental laws. Under Item 103, companies generally must disclose environmental litigation that is material, involves damages in excess of 10% of the company's assets, or involves a government entity.

Next, the SEC provided examples of climate-related risks that a publicly traded company would need to report (including in the business description, MD&A, or risk factors sections), if they are material:

- impacts of enacted or pending environmental legislation, regulations, or international accords that pose a specific risk or a material impact on the company's financial condition;
- indirect consequences of regulation or business trends, such as changes to demand or competition for products or services (e.g., decreased demand for goods that produce significant greenhouse gas emissions) or even relevant reputational effects; and
- significant risks and physical effects of climate-related events such as severe weather.

Although the SEC has not updated its 2010 guidance, it published a "concept release" on *Business and Financial Disclosure Required by Regulation S-K* in 2016, in which it sought public comment on whether shareholders need sustainability disclosures to understand a publicly traded company's business and financial condition or to participate in shareholder votes. The SEC's August 2019 proposal to amend Regulation S-K does not address climate-related risks.

Voluntary Climate Disclosures. In addition to mandatory disclosures, many publicly traded companies voluntarily disclose climate-related information in corporate social responsibility or sustainability reports. In making these disclosures, numerous companies use disclosure frameworks developed by standard-setting organizations. For example, in 2017, the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD), an international industry-led group, released its final recommendations report, which outlined a voluntary, standardized climate risk disclosure framework for companies. According to TCFD's June 2019 status update, more than 800 global organizations have shown support for the TCFD framework.

Proposals for Increased Climate Risk Disclosures

Legislative Proposals. Through hearings and legislative proposals, Congress has been considering possible climate-related macroeconomic impacts and environmental, social, and governance (ESG) disclosures. In the 116th Congress, two bills have been introduced that would require publicly traded companies to disclose specific climate-related information in their annual public reports to the SEC. The Climate Risk Disclosure Act of 2019 (H.R. 3623 and S. 2075), which the House Financial Services Committee ordered to be reported, would require publicly traded companies to evaluate the financial effects of climate-related risks (i.e., both physical and transition risks) and to describe their strategies to mitigate and manage those risks. The bill would require the SEC to adopt specific disclosure rules for certain industries as well as reporting standards for publicly traded companies' greenhouse gas emissions, fossil fuel related assets, and the "social cost of carbon." The bill would also require the SEC to specify a number of line-item disclosures related to greenhouse gas emissions for publicly traded companies developing fossil fuels commercially. Finally, the bill would require publicly traded companies to disclose their financial strategies under different climate scenarios.

Shareholder Activity. Some shareholders have advocated for publicly traded companies to make climate-related disclosures. Under SEC Rule 14a-8, shareholders may recommend votes on proposed company actions at annual shareholder meetings. In recent years, environmental proposals have accounted for a significant share of such shareholder proposals. However, companies often exclude such shareholder proposals from proxy ballots based on the SEC issuing a "no-action" letter recommending that no enforcement action be taken against the company for the exclusion. In addition to making Rule 14a-8 proposals, some investors—through groups such as Climate Action 100+, which represents more than 300 institutional investors—have urged large multinational corporations to make climate-related disclosures using TCFD standards, improve governance around climate change, and take other climate actions.

Should Specific Climate Change Disclosures Be Mandatory?

Some proponents of more climate-related disclosures view climate-related risks as having significant, immediate or quantifiable impacts on a publicly traded company's operations and that disclosing such risks aligns with shareholders' interests. Many of these commentators contend that imposing a standardized framework for climate-related disclosures would help publicly traded companies comply with their obligations and enable investors and regulators to compare the risks facing different companies easily. Finally, some observers have argued that enhanced climate-related disclosures could provide regulators with valuable data in monitoring financial system developments at a macroeconomic level.

Critics of increased climate-related disclosure requirements question their usefulness and whether reporting frameworks would capture the complexity of climate-related risks adequately. They also assert that providing such disclosures could increase costs for publicly traded companies—a potentially salient concern in light of the steady decline in the number of publicly traded companies since the 1990s. Some critics also argue that publicly traded companies' disclosures should be limited to information relating to financial performance, viewing additional disclosure as furthering social or political interests rather than providing necessary financial information. Finally, some stakeholders believe that the current disclosure regime (i.e., disclosing material climate-related risks) is sufficiently flexible to account for the climate-related risks publicly traded companies face.

Related Product

CRS In Focus IF11256, *SEC Securities Disclosure: Background and Policy Issues*, by Eva Su.

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IF11307