Speech

Remarks at the "SEC Speaks" Conference 2024

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Thank you, Erik [Gerding], for the introduction and for co-chairing this event with Gurbir Grewal. SEC Speaks provides the Commission and its staff an opportunity to share information and insights directly with members of the public. I am pleased that the program has returned to its traditional springtime spot, even if it is in a different venue.

The Practising Law Institute ("PLI"), an organization dedicated to keeping attorneys at the forefront of legal knowledge and expertise, was founded in 1933,[1] the same year that the Securities Act of 1933 ("Securities Act") became law.[2] The following year, President Roosevelt signed into law the Securities Exchange Act of 1934 ("Exchange Act"),[3] thereby creating the Commission to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.[4] Despite the passage of time, the Commission and the PLI remain steadfastly committed to their respective missions.

In 1984, Chairman John Shad reflected on the Commission's "illustrious history over the past half century."[5] He credited the agency's success to "generations of exceptional and dedicated individuals who have served in a wide variety of capacities."[6] Subsequent generations have come and gone, but the need for high-quality, dedicated individuals remains unchanged.

Now approaching its 90th year, the Commission's reputation for excellence depends on its ability to adhere to its mission. But we cannot take that for granted. The Commission should remain focused on its narrow mission, even when political activists would seek to transform the agency's authority to achieve policy objectives that are outside of its statutory mandate. Today I will discuss my concerns that the Commission has gone astray. My remarks reflect my views as an individual Commissioner and do not necessarily reflect the views of the full Commission or my fellow Commissioners.

The Commission's Climate Rule

Last month, the Commission adopted amendments to Rule 605 under the Exchange Act, which updated the disclosure requirements for order executions in national market system (NMS) stocks.[7] On the same day, the Commission adopted amendments to require issuers to disclose certain climate-related information.[8] One of these rules will provide information that will better serve investors. The other rule is designed to alter the behavior of public companies in a manner that serves political interests that have otherwise failed to achieve such change through the legislative process.

The climate rule's fundamental flaw is that it mandates disclosures not financially material to investors. Absent financial materiality, the Commission lacks the authority to broadly regulate the operating activities of public

companies under the pretext of disclosure requirements. Issues of national economic or political policy beyond the Commission's narrow statutory remit should be addressed by Congress, not financial regulators.[9]

In the adopting release, the Commission takes great lengths to mask the climate rule's intent with superficial references to financial materiality, suggesting that nothing in the climate rule is inconsistent with historical disclosure practice. However, as securities law practitioners, you know to focus on the rule text, not the accompanying spin set forth in speeches and press releases. Unlike *Star Trek: The Next Generation*, merely because Captain Jean-Luc Picard says "make it so,"[10] it isn't necessarily so.

Materiality Requirement for Mandated Disclosures

The advocacy leading to the climate rule demonstrates how the bedrock principle of materiality is under attack. For example, one proponent claims that "nowhere in the statutes or legislative history is the [Commission's] authority to require disclosures limited to materiality."[11] This proponent argues that public company disclosures serve not only investors, but also other economic actors, such as lenders, suppliers, and customers who are deciding how to spend their money.[12] However, that view is inconsistent with the Commission's historical approach.

As the Commission outlined in 1972:

> "A basic purpose of the Federal securities laws is to provide disclosure of material financial and other information on companies seeking to raise capital through the public offering of their securities, as well as companies whose securities are already publicly held. This aims at enabling investors to evaluate the securities of these companies on an informed and realistic basis."[13]

In other words, public company disclosures are intended for *investors*, and those disclosures should be *material* to those investors.

In this regard, while the federal securities laws may not explicitly address whether the Commission's disclosure rules are limited by materiality, federal statutes and judicial precedent establish that materiality is an important principle. For example, Section 17(a)(2) of the Securities Act makes it unlawful for a person – in the offer or sale of any securities – to obtain money by means of any untrue statement of a *material* fact or omission of a *material* fact when such omission would make a statement misleading.[14] Section 18(a) of the Exchange Act imposes liability on any person who makes a false or misleading statement with respect to any *material* fact in a document filed with the Commission.[15] If liability for an omission under the Securities Act and the Exchange Act requires that the omitted information be material – should the Commission be adopting rules that require disclosure of information that is *not* material? That result would be odd.

Separately, a materiality requirement for mandated disclosures flows from the Administrative Procedure Act ("APA"), which requires an agency to act in a manner that is not arbitrary or capricious.[16] In particular, the U.S. Court of Appeals for the D.C. Circuit has interpreted this requirement in the context of Commission rulemaking under the Securities Act and the Exchange Act, which require the Commission to consider a rule's effect on efficiency, competition, and capital formation.[17] The D.C. Circuit held that if the Commission fails to consider a rule's economic consequences, then the adoption of the rule is arbitrary and capricious.[18] In light of these requirements, the Commission's internal guidance provides that "[r]ulewriting staff should work with [the agency's] economists to identify relevant potential benefits and costs of [a] proposed rule…"[19]

The Commission's obligation to conduct a cost-benefit analysis when engaging in rulemaking provides an independent requirement to satisfy a materiality threshold for mandating disclosures. If information were not material to investors, the costs imposed by requiring those disclosures would likely render the rule arbitrary and capricious under the law.

Materiality Defined

Since the Commission's rulemaking authority regarding required disclosures is shaped by the materiality standard, it is important to understand exactly what materiality means. The U.S. Supreme Court has weighed in on this issue. In *TSC Industries v. Northway*, Justice Thurgood Marshall wrote that "the disclosure policy embodied in the proxy regulations is not without limit…Some information is of such dubious significance that

insistence on its disclosure may accomplish more harm than good."[20] The Court articulated the general standard of materiality as being whether "there is a substantial likelihood that a reasonable shareholder would consider [an omitted fact] important in deciding how to vote."[21] According to the Court, to fulfill this materiality requirement, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[22]

The context of *TSC Industries* is important. The proxy vote did not involve a non-binding shareholder proposal or the election of a single director. Rather, it was a proposal to liquidate and sell all of TSC's assets to National Industries. In effect, the proposal was to provide for the exchange of TSC common and Series 1 preferred stock for National Series B preferred stock and warrants. Viewed objectively, the voting decision – whether to liquidate and sell off all of the assets – was important from a financial perspective of a TSC shareholder.

Twelve years later, the Supreme Court adopted this standard of materiality for purposes of Section 10(b) of the Exchange Act[23] and Rule 10b-5 thereunder, which make it unlawful to "make any untrue statement of a material fact or to omit to state a material fact" when such omission would make a statement misleading.[24]

The Supreme Court's recitation of the materiality standard is embedded in the Commission's own rules, which provide that "[t]he term material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered."[25]

An Attempt to Retreat to Materiality

The proposed climate rule strayed so far from any concept of materiality that the final rule stripped out the proposal's boldest provision – the requirement for a public company to disclose its Scope 3 emissions.[26] The final rule also added a materiality threshold to the requirement for certain companies to disclose Scope 1 and Scope 2 emissions.[27] These and other changes followed threats by various groups to challenge the final rule if it largely resembled the proposal.[28] The significant changes in the final rule reflect a recognition that no disclosure rule that veers from materiality is likely to survive a court challenge. Indeed, the Commission describes its rule as being designed to "assist investors in making decisions to buy, hold, sell, or vote securities in their portfolio."[29]

However, the Commission's problem is twofold. First, changes to selected portions of the rule text intended to mitigate legal risk do not necessarily convert a climate change activism rule to a material risk disclosure rule. Second, because the changes are so significant, the failure to repropose the rule is likely a failure to provide sufficient notice of the terms or substance of the rule as required by the Administrative Procedure Act.[30]

The rule's invocation of the term "material" is a red herring. Companies face a plethora of material risks that impact their financial statements and operations. However, the granularity with which the climate rule requires companies to disclose certain climate risks, their considerations, oversight, and plans for climate risk, and the elevated treatment of the financial impact of those climate risks in a company's financial statements, reveals the rule's true purpose to pressure companies into making operational changes to reduce greenhouse gas emissions.

Put simply, the rule elevates one potential factor impacting a company's financial condition above all others. Therefore, even if climate risks are "material" under certain circumstances, the climate rule uses the materiality standard as a shield to advance a very different agenda. As one proponent of the rule wrote after it was proposed, the rule is a "powerful regulatory lever" that can "put the [United States] on a climate-safe trajectory."[31]

Broad policy and economic decisions of this nature do not – and should not – rest with the Commission. Claims of materiality designed to survive judicial review cannot save a rule that has veered far beyond the Commission's jurisdiction.

A Cautionary Tale

At times, Congress has mandated that the Commission require non-material disclosures. In 2012, the Commission adopted a rule requiring companies to publicly disclose their use of conflict minerals that originate

in the Democratic Republic of the Congo ("DRC") or an adjoining country.[32] This action was mandated by Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[33]

Then-Chair Mary Jo White observed that these types of Congressional mandates "seem more directed at exerting societal pressure on companies to change behavior, rather than to disclose financial information that primarily informs investment decisions."[34] While Chair White acknowledged that these mandates might be in service of worthy goals, she questioned, "as a policy matter, using the federal securities laws and the [Commission's] powers of mandatory disclosure to accomplish these goals."[35]

One thing that we should have learned from the conflict minerals rule is that SEC-mandated disclosures are not particularly well-suited to implement broad social policy decisions, especially because these types of issues are constantly evolving. Have any of these disclosures made a difference? Unlikely. The Government Accountability Office reported in 2023 that violence in the DRC has persisted and "that overall peace and security in the region has not improved."[36]

Conflict minerals covered by the rule are tin, tungsten, tantalum, and gold.[37] Yet, merely twelve years since the adoption of the conflict minerals rule, human rights groups have been sounding the alarm about cobalt and copper mining in the DRC. Cobalt is used to make lithium-ion batteries in electric vehicles, and copper is also used in electric vehicles and other so-called "green" products. A recent report from Amnesty International found that "[t]he expansion of industrial-scale cobalt and copper mines in the [DRC] has led to the forced eviction of entire communities and grievous human rights abuses including sexual assault, arson and beatings."[38]

However, the conflict mineral rule does not require disclosures regarding cobalt or copper while demand for these minerals has grown in the years *after* the rule's adoption. If the goal of Section 1502 was to affect positive changes to human rights in the DRC, then one can reasonably conclude that the rule has failed. Some might argue that the effectiveness of the rule was impaired by unfavorable rulings in the court.[39] I find that alternative narrative doubtful given the current role of cobalt and copper in the DRC. Thus, public companies and investors are stuck with a mandatory disclosure rule that deviates from financial materiality but fails to resolve the social purpose for which it was adopted.

It is not hard to imagine the climate rule facing similar challenges. Prescriptive disclosure requirements lend themselves to predictable behavioral outcomes. Perhaps companies will outsource certain functions that otherwise would have been performed internally to avoid generating emissions that would trigger climate disclosures. Perhaps companies will not commit to any emissions reduction targets to avoid making costly disclosure requirements with attendant liabilities under the federal securities laws. Perhaps new technology will emerge to mitigate the effect of greenhouse gas emissions and these rules – such as the "severe weather events and other natural conditions" provision in Regulation S-X – will continue to impose significant compliance costs without providing any real value to investors.

Unlike the conflict minerals rule, which was mandated by Congress, the Commission has acted on its own volition to adopt a climate disclosure rule that seeks to exert societal pressure on companies to change their behavior. It is the Commission that determined to delve into matters beyond its jurisdiction and expertise. In my view, this action deviates from the Commission's mission and contravenes established law.

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Thank you for providing me with an opportunity to speak with you this afternoon. I would also like to thank the many members of the Commission's staff who are presenting to you over the course of this two-day program. Their dedication to the Commission's mission helps to maintain the robust capital markets that afford opportunities to all investors. While leadership of the Commission might disagree as to certain policies, the Commission's staff is consistently unwavering in its commitment to serving the American public.

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[1] *See Practising Law Institute*, About PLI, available at https://www.pli.edu/about.

[2] *See Statement on Signing the Securities Bill*, Franklin D. Roosevelt (May 27, 1933), available at https://www.presidency.ucsb.edu/documents/statement-signing-the-securities-bill.

[3] *See Signing of the Securities Exchange Act of 1934*, Library of Congress, available at https://guides.loc.gov/this-month-in-business-history/june/signing-securities-exchange-act-1934.

[4] *See*, *Securities and Exchange Commission*, Mission, available at https://www.sec.gov/about/mission.

[5] *See* Securities and Exchange Commission, 50th Annual Report (1984), available at https://www.sec.gov/about/annual_report/1984.pdf.

[6] *Id.*

[7] *See* Disclosure of Order Execution Information, Release No. 34-99679 (Mar. 6, 2024), available at https://www.sec.gov/files/rules/final/2024/34-99679.pdf.

[8] *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, Release No. 33-11275 (Mar. 6, 2024) ("Climate Rule Adopting Release"), available at https://www.sec.gov/files/rules/final/2024/33-11275.pdf.

[9] *See West Virginia v. Environmental Protection Agency*, 597 U.S. 697 (2022), available at https://www.supremecourt.gov/opinions/21pdf/20-1530_n758.pdf.

[10] *See, e.g.,* Star Trek: The Next Generation, *Encounter at Farpoint* (Sept. 28, 1987).

[11] *See The SEC Has Broad Authority To Require Climate and Other ESG Disclosures*, Center for American Progress (June 10, 2021), available at https://www.americanprogress.org/article/sec-broad-authority-require-climate-esg-disclosures/. The article argues in the alternative that climate disclosures *should* be considered material. However, it begins by arguing that materiality is not a limitation on disclosure mandates in the first place.

[12] *Id.*

[13] *See* Securities and Exchange Commission, 38th Annual Report (1972), at 23, available at https://www.sec.gov/about/annual_report/1984.pdf.

[14] *See* 15 U.S.C. § 77q(a)(2).

[15] *See* 15 U.S.C. § 78r(a).

[16] *See* 5 U.S.C. § 706(2)(A).

[17] *See* 15 U.S.C. §§ 78c(f), 78w(a)(2). *See also* 15 U.S.C. §80a-2(c).

[18] *See, e.g., Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011), available at https://casetext.com/case/business-rountble-v-sectis-ex-comm-10-1305-dc-cir-7-22-2011.

[19] *See* Memorandum from the Div. of Risk, Strategy, and Fin. Innovation (RFSI) and the Office of Gen. Counsel, Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16, 2012), available at https://www.sec.gov/divisions/riskfin/rsfi-guidance-econ-analy-secrulemaking.pdf.

[20] *See TSC Industries, Inc. v. Northway, Inc.,* 426 U.S. 438 (1976), available at https://supreme.justia.com/cases/federal/us/426/438/. (Internal citations omitted.)

[21] *Id.*

[22] *Id.*

[23] *See* 15 U.S.C. § 78j(b).

[24] *See* 17 CFR § 240.10b-5(b). *See also Basic, Inc. v. Levinson,* 485 U.S. 224 (1988), available at https://supreme.justia.com/cases/federal/us/485/224/.

[25] *See* 17 CFR § 230.405.

[26] *See* Climate Rule Adopting Release, *supra* note 8, at 31.

[27] *Id.*

[28] *See, e.g., Gensler to U.S. Chamber on SEC Climate Disclosure Rulemaking: 'Wait, are you already suing us?'*, Thomson Reuters – Tax and Accounting (Oct. 30, 2023), available at https://tax.thomsonreuters.com/news/gensler-to-u-s-chamber-on-sec-climate-disclosure-rulemaking-wait-are-you-already-suing-us/.

[29] *See* Climate Rule Adopting Release, *supra* note 8, at 11.

[30] *See* 5 U.S.C. § 553(b).

[31] *See* What Are the SEC Climate Rules? Financial regulators are hoping to force big companies and investment managers to disclose climate information, Sierra – The Magazine of the Sierra Club (Aug. 1, 2022), available at https://www.sierraclub.org/sierra/what-are-sec-climate-rules. While the article goes on to claim that the climate rule is designed to require financial disclosures, it examines the rule through the lens of whether or not the rule will "advance a climate agenda." *Id.*

[32] *See* Conflict Minerals, Release No. 34-67716 (Aug. 22, 2012) [77 FR 56274 (Sept. 12, 2012)], available at https://www.govinfo.gov/content/pkg/FR-2012-09-12/pdf/2012-21153.pdf.

[33] Public Law 111–203, 124 Stat. 1376 (July 21, 2010).

[34] *See The Importance of Independence, Remarks at the 14th Annual A.A. Sommer, Jr. Corporate Securities and Financial Law Lecture*, Chair Mary Jo White (Oct. 13, 2013), available at https://www.sec.gov/news/speech/spch100113mjw.

[35] *Id.*

[36] *CONFLICT MINERALS: 2022 Company Reports on Mineral Sources Were Similar to Those Filed in Prior Years*, U.S. Government Accountability Office (July 2023), at 1, available at https://www.gao.gov/assets/gao-23-106295.pdf.

[37] *See* 17 CFR § 249b.400 - Form SD, specialized disclosure report, available at https://www.sec.gov/files/formsd.pdf.

[38] *See Democratic Republic of the Congo: Industrial mining of cobalt and copper for rechargeable batteries is leading to grievous human rights abuses*, Amnesty International (Sept. 12, 2023), available at https://www.amnesty.org/en/latest/news/2023/09/drc-cobalt-and-copper-mining-for-batteries-leading-to-human-rights-abuses/.

[39] *National Association of Manufacturers, et al. v. SEC*, 800 F3.d 518 (D.C. Cir. 2015), available at https://casetext.com/case/natl-assn-of-mfrs-v-sec-amp-exch-commn.