An open letter in support of the Security and Exchange Commission SEC proposal for "New Rules to Enhance and Standardize Climate-Related Disclosures for Investors"

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I write to contribute my thoughts during the comment period in support of the new "Rules to Enhance and Standardize Climate-Related Disclosures for Investors" that have been proposed by the U.S. Security and Exchange Commission.

I thought it would be productive to record as many as 8 really good reasons why including clear and consistent procedures of reporting climate risk to investors of all kinds and nationalities is a good idea even though they are enormously complicated – complication that is simply a reflection the full range of issues that must be accommodated for them to work efficiently within an evolving international system of communicating material climate risk to those who worry about financial stability. They are listed below in no particular order.

I also attach an annotated version of Gary Gensler's March 21st statement as Chair of the SEC. It displays where his understandings of the challenges involved in drafting and implementing the new Rules have informed my thinking.

Reasons for supporting the proposed new Rules:

1. The Rules clearly fit the "three-part mission" of the SEC that was first articulated in its founding legislation – the Security Exchange Act of 1934: "(i) protect investors, (ii) maintain fair, orderly, and efficient markets, and (iii) facilitate capital formation".[1]

2. Financial markets work best and minimize sources of capital market instability at a macro scale when they are supported with the best information about material risk of all kinds. Investors can use that information to manage their assets and hedge across their portfolios. Adding climate risk to the mandated risk categories will be a game changer in many ways. Perhaps most importantly, companies who rely on those

[1] Words from the SEC's coverage of its inception at the top of https://www.investor.gov/introduction-investing/investing-basics/role-sec.

markets to underwrite their physical and infrastructure investment plans are thereby led to compete with each other for investors' commitments on the basis of additional new information about their risk from climate impacts and their contributions to the problem.

3. Clear and consistent reporting protocols sustain this value of information in ways that are not possible by under the current voluntary reporting by many companies through a wide range of different reporting platforms. Side by side comparisons can be useless if they include incomparable evaluations of risk based on different criteria and different weighting structures; and this is a problem that the new Rules can significantly address.

4. Accurately informed markets are the best protection from contagion that can cause macro scale economic harm a la the mortgage crisis of 2008 that brought about the great recession of 2009. SLR is an example of how climate change could do such a thing. Language from the Nov 9, 2020 "Financial Stability Report" of the Federal Reserve Board (FED) speak to this point (Box 4 entitled "The Implications of Climate Change on Financial Security" in https://www.federalreserve.gov/publications/files/financial-stability-report-20201109.pdf. They are replicated verbatim (with modest annotation indicated with ***red italicized highlighting)*** in Appendix A. One sentence, with my emphasis, stands out:

   "With perfect information ***(about climate risk and, for present purposes, "With improved information…")***, the price of real-estate-linked assets and the valuations of claims linked to such assets—held by banks, insurers, investment funds, and nonfinancial firms—would already ***(more accurately)*** reflect these climate-related risks".

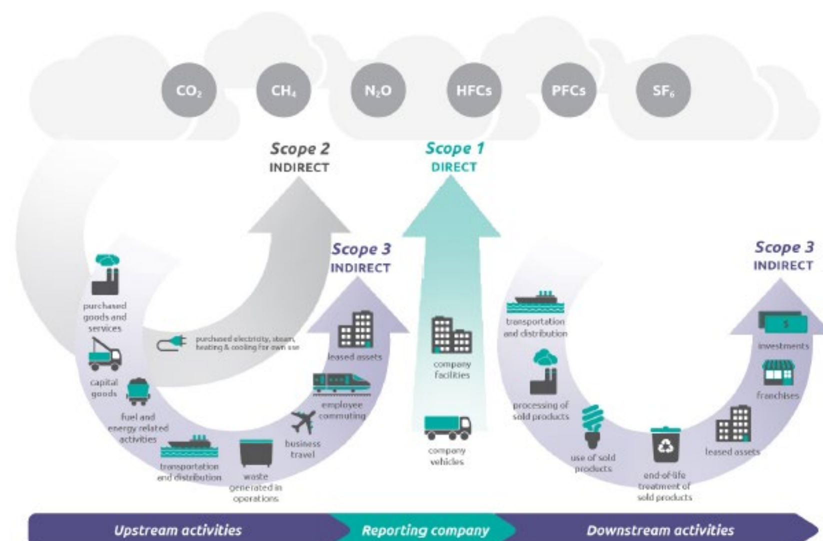
   This would surely be a profound benefit of the SEC's enacting its proposed new Rules.

5. The significance of new Rules will be amplified by their complementarity with the parallel efforts to protect financial stability against climate risk by the FED and the Federal Deposit Insurance Corporation (FDIC). Both the FED and the SEC initiatives are, for example, works in progress, but they are concrete responses to investor demand for "environmental, social, and governance" information. They are designed to promote financial stability, and their potential to abate greenhouse gas emissions and/or ameliorate climate damages are a co-benefit of enormous value.

6. The new SEC Rules brings the US into line with international efforts, so the market efficiency argument can hold globally. Without that, US companies will not compete well for investable funds with foreign companies which will be reporting their material financial risk and macroeconomic financial stability within clear and mutually consistent protocols. They, as well as the FED's new and growing interest climate risk, are the emerging products of five years of collaboration with the central banks of the European Union and the G-20 countries. All of these countries, and now the United States, are

working meticulously together to repurpose regulatory instruments like stress tests, risk-based capitalization standards, and integrated reporting protocols within existing and well-established mandates. They therefore deserve a special nod because both institutions have been excused by design from direct interference from either of the politicized branches of government. The courts can rule on perceived overreaches in design, but they cannot interfere with the implementation of accepted rules once that hurdle has been crossed.

7. Reporting emissions under Scope 1 and Scope 2 of the new Rules will promote competition on the mitigation side. The figure makes it clear that the proposed Rules do not confine reporting to carbon; that is, other heat-trapping gases like nitrous oxides, methane, chlorofluorocarbons and the like are also included because they, too, determine the pace of damaging warming. Environmentally engaged investors and management firms will use this information in making portfolio decisions, so companies should compete with one another in a second context – another reason why the proposed Rule is good climate policy specifically and good environmental policy more generally.



Source: https://compareyourfootprint.com/wp-content/uploads/2018/11/scope-1-2-3.jpg

8. Scope 3 requirements on emissions upstream (suppliers and distributors) and downstream (distributors, clients, and customers) on the value chain of companies will reveal sources of transitional risk as the economy moves from reliance on fossil fuels to widespread penetration of renewable energy.

And now, I offer two caveats:

1. Scope 3 is controversial, so please do not hold up action on everything else waiting for agreement there. The proposed new Rules already allow for delaying its implementation, so just do not prematurely fixate on a date to make a slow moving target out of the entire proposal.

2. The forward looking components of the proposed new Rules will require companies' have access to consistent climate change scenarios. That fact needs to be addressed, but you are not alone in that regard. As reported in October of 2021, this need has already been flagged for the FED at least by the Financial Stability Oversight Council (FSOC); see https://home.treasury.gov/system/files/261/FSOC-Climate-Report.pdf and https://www.crefc.org/cre/content/News/Items/advocacy-items/FSOC_Climate_Report.aspx

In sum, the proposed new Rules would be good climate policy as well as good economic policy. Unlike Executive Orders or even legislation, rules that govern SEC practices are somewhat insulated from political shenanigans. As you know, the SEC is (much like the FED) independent of executive and legislative branch demands (though it must report its actions to both); and judicial due process protects the actions of both against charges of overreach as long as it operates within approved processes and procedures.

Thank you for your consideration. I wish you all success in this critical endeavor.

Appendix A: The Implications of Climate Change on Financial Stability.
Source: directly from pp. 58-59 in https://www.federalreserve.gov/publications/files/financial-stability-report-20201109.pdf. ***The annotations are mine.***

"Features of climate change can also increase financial system vulnerabilities, as illustrated in the figure. Opacity of exposures and heterogeneous beliefs of market participants about exposures to climate risks can lead to mispricing of assets and the risk of downward price shocks. Similarly, uncertainty about the timing and intensity of severe weather events and disasters, as well as the poorly under-stood relationships between these events and economic outcomes, could lead to abrupt repricing of assets. Climate risks thus create new vulnerabilities associated with non-financial and financial leverage. In regions affected by severe events, households and businesses could become over-levered if the value of their assets or income prospects become impaired.

"……The financial system is also vulnerable to amplification effects of these damages if contracts are incomplete and do not capture all damages and if ***poorly understood financial exposures*** cause spillover effects or financial contagion.

“One example of how climate change is likely to increase financial stability risks is through real estate exposures ***(much like the 2008 road to severe recession).*** Some residential and commercial properties will be subject to acute hazards such as storm surges associated with rising sea levels and more intense and frequent hurricanes. Continued productive use of these properties would require investment and adaptation. As inundations or storm surges become more frequent, the expected value of exposed real estate may decrease, which may in turn pose risks to real estate loans, mortgage-backed securities, the holders of these loans and securities, and the profitability of nonfinancial firms using such properties.

“With perfect information ***(improved information about climate risk)***, the price of real-estate-linked assets and the valuations of claims linked to such assets—held by banks, insurers, investment funds, and nonfinancial firms—would already ***(more accurately)*** reflect these climate-related risks. However, given the uncertain timing and severity of future climate-related flooding and the associated opacity of asset exposures, investors in real-estate-linked assets may react abruptly to new information about a region’s exposure to climate-related financial risks. A sharp repricing, in turn, could create incentives to fire sale such assets by leveraged financial and nonfinancial fi rms. These asset valuation changes would be amplified by financial and nonfinancial leverage, funding risks, and interconnections across holders of the collateral-based assets, thereby creating risks to financial stability.

Gary W. Yohe[a]

[a] Gary W. Yohe is the author of nearly 190 scholarly articles as well as several books and many contributions to media coverage of climate issues. Since 1982, he has focused frequently focused his research how we should apply a risk management approach to thinking acting to combat climate change in an uncertain world wherein extreme climate events are not only increasing dramatically in both intensity and frequency but also changing radically in both character and behavior. Involved since the early 1990’s with the United Nations Intergovernmental Panel on Climate Change (IPCC), he received a share of the 2007 Nobel Peace Prize as a senior member. Professor Yohe was also Vice Chair of the 2014 Third National Climate Assessment in the Obama Administration, and has been a member of the New York (City) Panel on Climate from 2008 through 2018. In addition, Yohe has served on many panels for the National Academies of Sciences, Engineering and Medicine, has testified before both the United States Senate and House of Representatives on climate issues, and has given numerous public presentations about climate risk. He currently serves as Co-editor-in-Chief, along with Michael Oppenheimer, of *Climatic Change* where he helps process new submissions that now number more than 1200 per year alongside 600 or so that are in various stages of revision.

Statement *(by SEC chair)* on Proposed Mandatory Climate Risk Disclosures

Chair Gary Gensler

https://www.sec.gov/news/statement/gensler-climate-disclosure-20220321 March 21, 2022

Today, the Commission is considering a proposal to mandate climate-risk disclosures by public companies. I am pleased to support today's proposal because, if adopted, it would provide investors with consistent, comparable, and decision-useful information for making their investment decisions and would provide consistent and clear reporting obligations for issuers. *(make for better informed investors with comparable reports across public companies based on consistent application of clear reporting protocols)*

Over the generations, the SEC has stepped in when there's significant need for the disclosure of information relevant to investors' decisions. Our core bargain from the 1930s is that investors get to decide which risks to take, as long as public companies provide full and fair disclosure and are truthful in those disclosures. That principle applies equally to our environmental-related disclosures, which date back to the 1970s. *(Important point – this is not new for the SEC. This was one of their aims from day one of the institution, and the reporting protocols have included environmental risks over the past 50 years.)*

Today, investors representing literally tens of trillions of dollars support climate-related disclosures because they recognize that climate risks can pose significant financial risks to companies, and investors need reliable information about climate risks to make informed investment decisions. For example, investors with $130 trillion in assets under management have requested that companies disclose their climate risks.[1] Further, the 4,000-plus signatories to the UN Principles for Responsible Investment—a group with a core goal of helping investors protect their portfolios from climate-related risks—manage more than $120 trillion as of July 2021.[2] *(Investors who manage more than $125 trillion in assets are, themselves,* ***asking for this*** *in the United States.)*

Today's proposal would help issuers more efficiently and effectively disclose these risks and meet investor demand, as many issuers already seek to do. One report found that nearly two-thirds of companies in the Russell 1000 Index, and 90 percent of the 500 largest companies in that index, published sustainability reports in 2019 using various third-party standards, which include information about climate risks.[3] SEC staff, in reviewing nearly 7,000 annual reports submitted in 2019 and 2020, found that a third included some disclosure related to climate change. *(Many companies large and small are already reporting information about climate risk to meet this demand. They work with standards provided by third parties – plural – so inter-comparison across these responsible companies is difficult. It nonetheless suggest that honesty with respond to material climate risk is a tool for matching up favorably with non-participating competitors across the diversity of offerings in the world's financial markets. It follows that*

comparability of reports across respondents is an advantage of the SEC proposal over the status quo – in addition to enlarged coverage)

Companies and investors alike would benefit from the clear rules of the road proposed in this release. I believe the SEC has a role to play when there's this level of demand for consistent and comparable information that may affect financial performance. Today's proposal thus is driven by the needs of investors and issuers. *Comparability of reports across respondents is an advantage of the SEC proposal over the status quo seen even by those who would have to live with the new rules)*

In making decisions about disclosure requirements under the federal securities laws—including decisions about today's climate-related disclosures—I am guided by the concept of materiality. As the Supreme Court has explained, information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment or voting decision, or if it would have "significantly altered the total mix of information made available."[4] *This is the source of support from investors – climate risk **is** material risk that meets both criteria – information that rational investors would, in fact, covet as well as altering the total mix of information by making its coverage more complete.*

The proposed rules would require disclosures on Form 10-K about a company's governance, risk management, and strategy with respect to climate-related risks. Moreover, the proposal would require disclosure of any targets or commitments made by a company, as well as its plan to achieve those targets and its transition plan, if it has them. *"If it has them" is an important clause. The absence of such plans would be a flag for investments who understand the materiality of risk born of not preparing for a future that will be dominated by a changing climate.*

To the extent that the proposed disclosures would include some forward-looking statements, such as projections of future risks or plans related to targets or transitions, the forward-looking statement safe harbors pursuant to the Private Securities Litigation Reform Act would apply, assuming certain conditions were met.

The proposed rules also would require a company to disclose "certain disaggregated climate-related financial statement metrics that are mainly derived from existing financial statement line items" in a note to its financial statements. This would include the impact of the climate-related events and transition activities on the company's consolidated financial statements. *This means that the new rules will not create add-ons to be laid beside traditional risk reporting; instead, material climate risk is to be integrated in companies' "consolidate financial statements" – the core of the information that investors use to make their plans or advise their clients.*

The proposal also addresses disclosure of greenhouse gas emissions. Greenhouse gas emissions data are increasingly being used as a quantitative metric to assess a company's exposure to—and the potential financial effects of—climate-related transition risks. Those risks could include regulatory, technological, and market risks driven by a transition to a lower greenhouse gas emissions economy, with potential financial impacts on revenues, expenditures, and capital outlays. *(The transition is, by virtue of policies and public opinion, another source of planning*

uncertainty and therefore material risk.) Filers would disclose their Scope 1 and Scope 2 greenhouse gas emissions—emissions that "result directly *(1)* or indirectly *(2)* from facilities owned or activities controlled by a registrant." Thus, these data should be reasonably available to issuers. *(This should not be difficult.)*

Under the proposed rules, some registrants also would be required to disclose Scope 3 emissions—the emissions from upstream and downstream activities in *(up and down)* a company's value chain—if such emissions were material to investors or if the company had made a commitment that included reference to Scope 3 emissions. As the release notes, Scope 3 disclosure "may be necessary to present investors a complete picture of the climate-related risks—particularly transition risks—that a registrant faces and how [greenhouse gas] emissions from sources in its value chain … may materially impact a registrant's business operations and associated financial performance." ***Scope 3 is controversial. It brings customers', clients' and suppliers' material risk to climate change and transitional pressures on companies who relative financial security matters for the respondent's financial security.***

Moreover, the proposal would phase in Scope 3 disclosures after Scopes 1 and 2; a new safe harbor would be available for Scope 3 disclosures; and smaller reporting companies would be exempt from Scope 3 disclosures.

The disclosures themselves would be provided to investors in a comparable manner, via structured data. The core elements of today's proposal also would apply to international filers on Form 20-F.

Today's proposal draws on our existing rules and guidance governing climate-related disclosures, ***(Not overstepping with something new and outside of purview.)*** as well as from the Task Force on Climate-related Financial Disclosures, an international framework that many companies and countries already have started to adopt, including Brazil, the European Union, Hong Kong, Japan, New Zealand, Singapore, Switzerland, and the United Kingdom. ***(Catching up to the much of the developed world economies; not doing so would mean losing a competitive position vis a vis climate risk and attracting international investors.)***

I encourage issuers and investors to weigh in on each of these potential disclosures. ***(That's a call for us.)*** Approximately 600 unique comment letters were submitted in response to then-Acting Chair Allison Herren Lee's statement on climate disclosures in March 2021. We benefited greatly from those letters, and I know we will continue to learn from comments from issuers and investors.