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Vanessa A. Countryman, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: The Enhancement and Standardization of Climate-Related Disclosures for Investors (S7-10-22)

Dear Ms. Countryman,

I welcome the opportunity to provide my views on the Commission's proposal to enhance and standardize climate-related disclosures for investors (the "Proposed Rule").[1] For identification purposes, I note that I serve as an Associate Professor of Law at Boston University, however the views expressed in this letter (the "Letter") are my own, and not those of Boston University.

I suggest a simple, but far reaching, change to the Proposed Rule: The Commission should let investors in a registrant decide which of the disclosure obligations in the Proposed Rule apply to the registrant.[2] More specifically, the Commission should allow a registrant to opt-out of particular disclosure obligations, if such an opt-out has been approved by a vote of the registrant's investors. Below I suggest further details on how the opt-out should be structured. I refer to this as an "investor-optional" disclosure rule, in contrast to the Commission's proposed mandatory disclosure rule.

As I explain further below, the Commission should make the Proposed Rule investor-optional for four main reasons:

1. Investor-optionality is consistent *both* with the claims of the Commission supporting the Proposed Rule—that investors demand climate disclosure—and those of the Proposed Rule's critics—that investors do not want climate disclosure, because it would impose additional costs on them, and current disclosure is sufficient for their needs. Letting investors decide whether climate disclosure is appropriate for their protection is the only way to resolve the tension between these two claims.
2. Making the Proposed Rule investor optional would nullify the strongest attacks on the validity of the Proposed Rule. If these apply at all, they apply only to a mandatory rule. By

[1] *The Enhancement and Standardization of Climate-Related Disclosures for Investors*, 87 FED. REG. 21334 (2022).

[2] Henceforth, I use the terms "registrant," "issuer," "company," and "corporation" interchangeably to refer to registrants.

substantially reducing the likelihood of the Proposed Rule being invalidated, investor-optionality would increase the expected benefit from the Proposed Rule.

3. Investor-optional climate disclosure would be *better for investors* than a mandatory rule. In no plausible state of the world would it be worse for investors than a mandatory rule, and in most plausible states of the world it would be better.

4. Failure to make the Proposed Rule investor-optional would be potential grounds for its invalidation. At a minimum, because investor-optionality is a reasonable alternative, the Administrative Procedure Act requires the Commission to consider it. And because investor-optionality is likely to be better for investors than a mandatory rule, it will be extremely difficult for the Commission to justify implementing a mandatory rule rather than an investor-optional rule. If the Commission did so without adequate justification, its decision would be arbitrary and capricious, and therefore subject to invalidation.

My suggestion responds most closely to two questions in Commission's release, (1) "Are there certain registration statements or annual reports that should be excluded from the scope of the proposed climate-related disclosure rules?";[3] and (2) "Are there any other alternative approaches to improving climate-related disclosure that we should consider? If so, what are they and what would be the associated costs or benefits of these alternative approaches?".[4]

Sections I to IV of this Letter expand, respectively, on the analysis supporting each of the four reasons above why the Commission should make the Proposed Rule investor-optional. Section V considers the validity of two assumptions on which this reasoning is based, as well as other potential objections to this reasoning. Section VI explains that, in order for investor-optional disclosure to be better for investors than mandatory disclosure, the opt-out process must include two critical features: (1) the vote must be of investors holding at least a majority of shares *that are unaffiliated with the directors, executives, or controlling shareholders* of the registrant; and (2) the vote must be held *after* the registrant has gone public. Section VI also suggests several other design features that the Commission should include in the Proposed Rule.

This letter is adapted from a draft of a forthcoming working paper (the "Working Paper"). I expect to update the Working Paper to incorporate and respond to any comments regarding the investor-optionality proposal I make in this Letter, which I welcome. Future drafts of the Working Paper incorporating these responses will be available at https://ssrn.com/abstract=4134822.

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[3] Securities and Exchange Commission, *supra* note 1 at 21409.
[4] *Id.* at 21452.

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I. Investor-Optionality is Consistent with the Claims of both the Commission and its Critics

The Commission's rationale for promulgating the Proposed Rule is focused on investors' need for disclosure of emissions and climate-related risks,[5] and the Release is replete with references to "investor demand" for that information. But the investor demand rationale is also entirely consistent with investor-optional disclosure: If investors need, or demand, climate-related disclosure, they will not opt-out of a rule obligating the company to produce it. The Commissions' goals in standardizing climate disclosure across registrants, and centralizing it in the same part of registrants' filings with the Commission, will also be met.

Critics of the Commission's Proposed Rule have argued that registrants already disclose climate-related information to the extent that investors require it, and therefore there is no unmet investor

[5] *See, e.g., id.* at 21335. ("Investor need information about climate-related risks …").

demand for additional disclosure.[6] They also argue that "one-size-does-not-fit-all"—that for some companies, climate disclosure is not as important to the investors in those companies, and not sufficiently valuable to justify the cost of producing it.[7] Investor optionality is consistent with both of these claims, in a way that a mandatory rule is not. Under an investor-optional rule, if investors do not actually require or demand all or part of the climate disclosure in the Proposed Rule, and if they believe the production of that disclosure will be more costly to them than the value it would provide, the company could opt-out of the obligation to disclose such information.

The claims of the Commission and the critics of the Proposed Rule are in tension, on the central question of whether investors actually demand additional climate disclosure. Letting investors decide the matter for themselves is the only way to reconcile these competing claims, and to determine the *actual* level of investor demand. As the remainder of this Letter explains, this would not be a compromise; rather, it would make the Proposed Rule better by the standards of both the Commission and its critics. Because investor-optionality would be consistent with the claims of critics, it is possible that it would lead many of them to drop their opposition to the Proposed Rule.

II. Investor-Optionality Would Nullify the Attacks on the Validity of Climate Disclosure

Many groups and individuals have argued that if the Commission adopted the Proposed rule it would be invalid. These include one of the Commission's own Commissioners, as well as members of Congress, state governors and attorneys general, industry groups, lawyers, academics, and many others.[8] Commentators have suggested that a challenge to the validity of the Proposed Rule in federal court is highly likely.[9]

Below I summarize the most important claims that the Proposed Rule would be invalid. I note that several commenters have argued that many of these claims are inaccurate.[10] I take no position on

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[6] *See, e.g.,* Lawrence A. Cunningham et al., *Comment Letter Regarding Proposal on Climate-Related Disclosures for Investors* 8–11 (2022), https://www.sec.gov/comments/s7-10-22/s71022-20126528-287180.pdf (describing the "ample supply of climate disclosure").

[7] *See, e.g.,* National Association of Manufacturers, *Letter Regarding The Enhancement and Standardization of Climate-Related Disclosures for Investors* 24 (2022), https://www.sec.gov/comments/s7-10-22/s71022-20130306-296969.pdf (arguing for more lenient treatment of small, newly public, mid-size, and recently acquired issuers); *id.* at 32. (arguing against a one-size-fits-all threshold for disclosure).

[8] *See, e.g.,* Hester M. Peirce, *We are Not the Securities and Environment Commission—At Least Not Yet* (2022), https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321; Joint Governors' Comment on SEC Release Nos. 33-11042 & 34-94478, The Enhancement and Standardization of Climate-Related Disclosures for Investors, (2022), https://www.sec.gov/comments/s7-10-22/s71022-20129962-296336.pdf; West Virginia Office of the Attorney General, *Letter Regarding Climate Change Disclosure* (2021), https://www.sec.gov/comments/climate-disclosure/cll12-8915606-244835.pdf; National Association of Manufacturers, *supra* note 7; Cunningham et al., *supra* note 6; Sean J. Griffith, *Letter Regarding Proposal on Climate-Related Disclosures for Investors* (2022), https://www.sec.gov/comments/s7-10-22/s71022-20130040-296591.pdf.

[9] *See, e.g.,* Jacqueline Vallette & Kathryne Gray, *SEC's Climate Risk Disclosure Proposal Likely to Face Legal Challenges*, HARV. L. SCH. FORUM ON CORP. GOV. (2022), https://corpgov.law.harvard.edu/2022/05/10/secs-climate-risk-disclosure-proposal-likely-to-face-legal-challenges/.

[10] *See, e.g.,* Jill E. Fisch & George S. Georgiev, *Letter Regarding Enhancement and Standardization of Climate-Related Disclosures for Investors* (2022), https://www.sec.gov/comments/s71022-20130354-297375.pdf; John C.

the correctness of either set of claims here, other than to recognize that there remains *some risk* that a federal court might uphold one or more of the claims of invalidity. Below, I show that each of the claims of invalidity apply (if at all) only to a mandatory disclosure rule. Investor-optionality would thus nullify each of these attacks on the validity of the Proposed Rule. By substantially reducing the likelihood of invalidation, investor optionality would increase the *expected benefit* to investors from the Proposed Rule.

A. The Claim that Climate Disclosure is Compelled Speech

Many critics of the Proposed Rule have argued that the statements it would require regarding climate change would be compelled speech, in violation of the First Amendment rights of companies.[11] But the compelled speech claim applies, if at all, only to a mandatory rule. Investor-optionality would nullify this claim, because disclosure would no longer be *compelled* speech. Companies would not be compelled to speak, because they could opt-out of the requirement.[12] Of course, investor-optionality would protect investors by only permitting opt-outs where investors had approved them, thus allowing investors to place limits on the speech of their companies. But the ability of investors to limit the speech of the corporations they invest in is uncontroversial, and has recognized by the Supreme Court in *Citizens United v. Federal Election Commission*.[13]

B. Claims that Climate Disclosure is Not Material

One set of attacks on the Proposed Rule have, at their core, the claim that disclosure of climate-related information is not material. A version of this attack is that the Commission does not have the power to require disclosure of non-material matters, so cannot require disclosure of greenhouse gas emissions. Another version of this attack is that, because the information is not material to investors, the Proposed Rule cannot be "necessary or appropriate … to protect investors," and therefore falls outside the Commission's power.[14]

Critics cite the standard definition of materiality, put forward in *TSC Industries, Inc. v Northway, Inc.*, where the Supreme Court held that a matter is "material" if it "would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made

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Coates, *Letter to Vanessa Countryman, Secretary, Securities Exchange Commission* (2022), https://www.sec.gov/comments/s7-10-22/s71022-20130026-296547.pdf.

[11] *See, e.g.,* Griffith, *supra* note 8; Cunningham et al., *supra* note 6 at 14–15; National Association of Manufacturers, *supra* note 7 at 50; Peirce, *supra* note 8; West Virginia Office of the Attorney General, *supra* note 8 at 3.

[12] Sean Griffith has argued that Supreme Court precedents on compelled speech make it subject to heightened scrutiny where it is "controversial." Griffith, *supra* note 8 at 2. However, Professor Griffith concedes that "[d]isclosure mandates that are uncontroversially motivated to protect investors are eligible for deferential judicial review. *Id.* As well as the clear point that investor-optional speech would not be compelled speech, investor optionality would further answer this line of reasoning by only requiring disclosure where investors had not opted-out of it, leaving no doubt that investors regarded the disclosure as appropriate for their protection.

[13] *See* Citizens United v. Federal Electoral Commission, 558 U.S. 310, 362 (2010) ("There is, furthermore, little evidence of abuse that cannot be corrected by shareholders "through the procedures of corporate democracy." [Citation omitted]).

[14] *See, e.g.,* Peirce, *supra* note 8 ("The further afield we are from financial materiality, the more probable it is that we have exceeded our statutory authority.").

available."[15] Critics claim that the climate disclosure required by the Proposed Rule is not material, because reasonable investors would not consider it in making investment decisions.[16]

Leaving aside the validity of this claim, whether investors would or would not consider such emissions is an empirical question. Many investors have advocated for a climate disclosure rule, which suggests that a reasonable investor *would* consider it in their investment decisions.[17] The Commission has used their support to justify its claim that there is investor demand for climate disclosure. Nevertheless, critics of the Proposed Rule have argued that the investors supporting climate disclosure are not representative of investors generally, and presumably, that their views should not be probative in determining the views of a "reasonable investor."[18]

Investor-optionality provides a clear and compelling answer to this line of attack: it lets investors in a particular company *decide* whether a particular company is obligated to disclose its emissions. If investors in a particular company do not consider emissions information material they can authorize the company to opt-out of its obligations to disclose that information. Conversely, that a majority of investors at a particular company *do not* support opting-out of emissions disclosure can be taken as compelling evidence that the information is material to a reasonable investor, and therefore, that the Commission is entitled to require its disclosure.

Indeed, a decision by investors whether or not to opt-out of climate disclosure is likely to be *much better* evidence of the views of reasonable investors on the materiality of climate-related disclosure than the views of the Commission, or the views of critics of the Proposed Rule, or even than the views of a federal court reviewing the validity of the climate disclosure rule the Commission eventually adopts.

C. Claims that the Commission Lacks Statutory Authority for Climate Disclosure Rules

Several critics have argued that the Commission lacks statutory authority to require climate disclosure. One ground for this argument is the claim that neither the Securities Act of 1933 nor the Securities Exchange Act of 1934 provide such authority; another ground is the claim that

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[15] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). *See also* Basic Inc. v. Levinson, 485 U.S. 224, 231 (1987) (citing *TSC Industries, Inc. v. Northway, Inc.*).

[16] *See, e.g.,* Peirce, *supra* note 8.

[17] *See, e.g.,* TIAA, *Letter Regarding Request for Public Input on Climate Change Disclosure* (2021), https://www.sec.gov/comments/climate-disclosure/cll12-8907502-244231.pdf; LGIM America, *Re: File Number S7-10-22: The Enhancement and Standardization of Climate-Related Disclosures for Investors* (2022), https://www.sec.gov/comments/s7-10-22/s71022-20129965-296443.pdf; PGIM, *Response to the Request for Public Input by the Securities and Exchange Commission* (2021), https://www.sec.gov/comments/climate-disclosure/cll12-8911331-244286.pdf, Norges Bank Investment Management, *Letter Regarding SEC Call for Input on Climate Change Disclosures* (2021), https://www.sec.gov/comments/climate-disclosure/cll12-8906851-244201.pdf; New York State Comptroller, *Letter Regarding Comments on the Proposed Climate Change Disclosure Rule* (2022), https://www.sec.gov/comments/s7-10-22/s71022-20130550-299408.pdf.

[18] *See, e.g.,* Cunningham et al., *supra* note 6 at 3–5 (arguing that "the most vocal institutions" calling for climate disclosure are not representative).

climate disclosure is a "major question" which would require express Congressional authorization for rulemaking.[19]

The first of these claims is based on the argument that the matters that both acts initially required to be disclosed related to the finances of the company, and to the extent the Commission has since required disclosure of broader matters, those were authorized specifically by statute. These critics argue that emissions information does not relate to the finances of the company, and so—without explicit statutory authorization—falls outside the implicit ambit of the securities laws.[20]

A group of law professors have challenged the validity of these claims.[21] But even assuming that the claims are valid, they turn entirely on the question of what types of disclosure the securities laws permits the Commission to require. Inductive reasoning provides not just one, but many, different answers to this question. In addition to a narrow definition of financial matters, another inference is that the Securities Exchange Act of 1934 required disclosure of *those things that investors considered material in making investment decisions.* This category would much better capture both the matters required to be disclosed by the initial acts, and other disclosure items that the Commission has subsequently and required, without controversy. But there remains the question whether investors consider climate disclosure material for investment decisions. An investor-optional disclosure rule would clearly answer this question, in the same way described in Section II.B: to the extent that investors do not find climate disclosure material, or even sufficiently material that it is worth the cost of disclosure, they can opt-out of the requirement to disclose. Therefore, the fact that a registrant has not opted-out strongly suggests that its investors consider the information material in making financial decisions. Because the information is relevant and material to investors, it is functionally no different from other information that the Commission has required to be disclosed in past rulemaking.

A related argument made by critics of the Proposed Rule is that climate disclosure relates to a "major question," and is therefore governed by a nascent "major questions doctrine."[22] They claim that for regulators to make rules relating to a major question requires express statutory approval.[23]

An investor-optional rule would sidestep the major questions doctrine. A investor-optional rule would limit the ambit of the rule to companies whose investors were not willing to opt-out of the obligation. That is, the Proposed Rule would no longer require companies to make disclosures of

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[19] *See, e.g.,* Peirce, *supra* note 8; Andrew N. Vollmer, *Comment Letter Regarding Proposal on Climate-Related Disclosures for Investors* (2022), https://www.sec.gov/comments/s7-10-22/s71022-20123525-279742.pdf; Cunningham et al., *supra* note 6.

[20] *See, e.g.,* Vollmer, *supra* note 19.

[21] *See* Fisch and Georgiev, *supra* note 10; Coates, *supra* note 10; George S. Georgiev, *The SEC's New Proposal on Climate Disclosure: Critiquing the Critics*, OXFORD BUS. L. BLOG (2022), https://www.law.ox.ac.uk/business-law-blog/blog/2022/03/secs-new-proposal-climate-disclosure-critiquing-critics.

[22] *See, e.g.,* Cunningham et al., *supra* note 6 at 13; Andrew N. Vollmer, *Comment Letter Regarding Proposal on Climate-Related Disclosures for Investors* 14–15 (2022), https://www.sec.gov/comments/s7-10-22/s71022-20128334-291089.pdf. This argument follows that made by petitioner West Virginia in *West Virginia, et al. v. Environmental Protection Agency, et.al.*, currently pending before the Supreme Court.

[23] *See, e.g.,* Cunningham et al., *supra* note 6 at 13; Vollmer, *supra* note 22 at 14–15.

a controversial nature; instead, it would only require companies to give their investors what the company could clearly infer, without controversy, that those investors wished to receive.

D. Claims Regarding Cost-Benefit Analysis of Climate Disclosure Rules

A further line of attack against the Proposed Rule is that the Commission has not conducted appropriate or sufficient economic analysis of the Proposed Rule—that they have not sufficiently considered its costs, and/or its benefits—and that the economic analysis that the Commission has conducted does not justify the imposition of mandatory climate disclosure.[24] This may be a particularly challenging claim for the Commission to rebut, because there is no agreed-upon understanding of just *how much* cost-benefit analysis is sufficient, and therefore no limit to the potential analysis that could be undertaken.

Commentators have also suggested that the Commission's economic analysis understates the high costs of the Proposed Rule, or that the highly speculative (and unquantifiable) benefits cannot justify the high costs of the Proposed Rule.[25] Similar reasoning has been sufficient grounds to invalidated prior rulemaking by the Commission.[26] On its face, this is also a difficult claim for the Commission to rebut, because the costs of a proposed rule are concrete, and thus much easier to quantify. Most costs of the rule accrue to particular companies with accounting systems to determine their quantum. In contrast, the benefits from the Proposed Rule that the Commission identifies would accrue to a broad group of investors, which do not have systems to quantify those benefits.[27]

Making the Proposed Rule investor-optional would effectively nullify these criticisms, by effectively capping the costs of the Proposed Rule to investors at a very low level, and making clear that—by design—the benefits for investors from the Proposed Rule would exceed investors' costs.

The costs of the Proposed Rule to a particular registrant would be capped at the cost to the registrant of opting-out of the Proposed Rule. The overall costs of the Proposed Rule would thus be those costs, aggregated over all of those companies that are likely to opt-out. The per-company costs are likely to be similar and small for each company: They would consist of the marginal cost to the company of including an additional proposal in its annual report, and the marginal cost to the company's investors of voting on that proposal. These amounts could be reliably estimated by the Commission. They are likely to be orders of magnitude less than the amounts the Commission estimated as the costs of preparing the required climate disclosure.

By design, an investor-optional rule would also provide clear evidence that the benefits of the Proposed Rule would exceed the costs. For any company where investors believed the costs of climate disclosure to exceed the benefits they would receive from disclosure, those investor would

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[24] *See, e.g.,* Cunningham et al., *supra* note 6 at 15–16.
[25] *See, e.g., Id.* at 15–16.
[26] *See, e.g.,* Business Roundtable v. Securities and Exchange Commission, 647 F.3d 1144 (2011).
[27] For a detailed study of arguments regarding cost-benefit analysis by the Commission, see John C. Coates, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882–1011 (2015).

allow the company to opt-out of the disclosure obligation. Therefore, if a company has not opted out, the benefits of disclosure to investors in the company can be reliably inferred to be greater than the costs to those investors of such disclosure. Similarly, the overall benefits of the Proposed Rule for all of the companies that did not opt-out could reliably be inferred to be greater than the costs of the rule. Given the very small cost to any companies that do opt-out, which is capped at the cost of the opt-out process, it would be straightforward for the Commission to conclude that the benefits to investors of an investor-ordered rule exceeded the costs. The result would be to give much greater confidence to the Commission's economic analysis, and thus reduce the likelihood that a court would later find it inadequate.

III. Investor-Optional Disclosure Would Be Better for Investors than Mandatory Disclosure

The third reason why the Commission should implement investor-optional climate disclosure is that it would be *better for investors* than a mandatory climate disclosure rule. It may be the case that the Proposed Rule does not need saving, because those who have defended the validity of the Proposed Rule against its critics are correct, and a future challenge to the rule is destined to fail. But even if this were the case, the Commission should nonetheless make the Proposed Rule investor-optional, because it would be better for investors.

The rationale for why investor-optional obligations would be better for investor than a mandatory rule is based on very straightforward logic, which can be easily illustrated by considering two scenarios relating to the costs and benefits to investors from climate disclosure. As the two scenarios make clear, investor-optional disclosure would be no more costly for investors than mandatory disclosure, and in many scenarios it would be significantly less costly for investors.

Consider first the scenario where the benefits of the Proposed Rule for investors in all companies subject to the Proposed Rule are greater than the costs of the Proposed Rule for those investors. In this scenario, no sets of rational investors would choose to opt-out of the Proposed Rule, and the benefits and costs of an investor-optional rule would be identical to those of the Proposed Rule.

Now consider the alternative scenario where the costs to at least some companies of disclosure are greater than the benefits to investors in those companies from disclosure. This might be the case because there is likely to be variation among companies subject to the Proposed Rule in the costs and benefits that result to investors in those companies. The Release contemplates variation across companies, by treating small reporting companies (SRCs) differently from other companies subject to the Proposed Rule. But the costs and benefits of the Proposed Rule are also likely to vary among both SRCs and non-SRCs, depending on factors like the level of emissions of the company, the costs to the company of disclosure, and the composition of the company's investors. It may be the case that the variation is sufficient for some companies' investors to have benefits from the Proposed Rule that are less than the costs they would bear from the Proposed Rule.

If the Proposed Rule is made investor-optional, investors in those companies will support the company opting-out of the Proposed Rule, reducing the cost of the Proposed Rule to those investors. Aggregated across all companies, the costs of the investor-optional approach would therefore be less than that of a mandatory rule.

The analysis so far has focused on the costs and benefits to investors in a particular company from that particular company disclosing its climate emissions. However, it is possible that there may be externalities from such disclosure—that investors in *other companies* may benefit from the company disclosing its climate emissions. If these externalities were substantial enough to outweigh the cost savings to companies opting out of climate disclosure, a mandatory rule would be *better for investors* than an investor-optional rule, as it would not allow opt-outs that would eliminate those benefits.

It is important to note that, for this assumption to fail in such a way as to bring the superiority of investor-optional disclosure into doubt, the benefits would have to be to *other investors*, not to other members of the public. While the Commission could base its rulemaking on public benefit, doing so is more tenuous, and would open the Proposed Rule up to additional and even stronger attacks than those that have so far been directed at it. Instead, the ground on which the Commission has based the rule is investor protection, not rulemaking for the public benefit. I therefore limit my analysis to potential externality benefits to externality benefits to other investors.[28]

For investor-optional disclosure to be worse than a mandatory rule, two conditions must be satisfied. First, there must be a group of companies for whose investors climate disclosure would be sufficiently costly, and the benefits sufficiently small, that those investors would be willing to permit the company to opt-out of its disclosure obligation. And second, the benefits to investors outside the company from its climate disclosure must be sufficiently large to outweigh the net costs to the investors in the company that led them to opt-out of the obligation. For this to be the case, investors in the company must consider the value of its climate disclosure to be much less than other investors value that disclosure.

It is possible that these conditions may be satisfied, but it is so unlikely as to be implausible. The main reason is that the benefits from disclosure to the investors in the company are likely to be correlated with the benefits from disclosure to investors outside the company, because the preferences and processes of those groups are likely to be very similar.

The investor base of a company facing an opt-out decision is likely to consist of several types of investors.[29] Many of the investors in the company *will also* be investors in other companies, because they hold diversified portfolios. These investors are likely to decide how to vote on the particular company's opt-out decision based on the aggregate effects of the choice on all the companies in their portfolios, rather than merely the effects on the particular company.[30] However, the important point for our consideration is that any consideration of portfolio effects is likely to

[28] If the Commission were to consider the interests of the public at large, it would require a very challenging comparison of the benefits to non-investors from disclosure, to the costs to investors from the disclosure, which would further complicate (and threaten) the Commission's cost-benefit analysis.

[29] For reasons discussed in Section VI, I assume that the Commission will exclude investors affiliated with directors, executives, or controlling shareholders from the opt-out vote, so I also exclude them from the consideration of the investors that might vote to opt-out of the rule.

[30] For discussion of the effects of such consideration, and their desirability, see JEFFREY N. GORDON, *Systematic Stewardship* (2021), https://papers.ssrn.com/abstract=3782814; Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1–82 (2020); ROBERTO TALLARITA, *The Limits of Portfolio Primacy* (2021), https://papers.ssrn.com/abstract=3912977.

reduce the extent to which those investors would allow a single company to opt-out of climate disclosure where there are externality benefits to other companies.

Which investors outside the company might benefit from the company's climate disclosure? The two most plausible groups are *potential* investors considering buying a stake in the company, and investors (or potential investors) in other companies seeking an additional point of comparison for their own company.

There is little reason to expect that the preferences of potential investors are likely to differ from those of current investors. The main difference between potential investors, and current investors in the company that were *previously* potential investors is when they bought their shares. And because many of the costs associated with disclosure are ongoing, a potential investor that does decide to invest in the company will end up bearing a share of those costs in the same way as a current investor.

All that remains is investors that have no intention of investing in the company, but would like to use the company's emissions as a data point for comparison of another company they invest in. The externality benefit of climate disclosure to these investors is likely to be small. If, as is likely to be the case, there are several other companies that could be comparison points, the value of a single additional company of the particular company disclosing its climate emissions is likely to be much reduced.

It is therefore implausible to believe that if the costs of disclosure are sufficient to cause investors to opt-out of the disclosure requirement, that externality benefits to other investors would be sufficient to outweigh those costs. In order for the Commission use externality benefits to other investors to justify a mandatory rule it would need to justify its reasoning using cost-benefit analysis. This will be difficult, for similar reasons outlined in Section II.D: the costs to investors that opt-out are concrete, whereas the potential externality benefits to other investors described above are speculative.

IV. Failure to Consider and Implement Investor-Optionality May Subject the Rule to Invalidation

The fourth reason why the Commission should make the Proposed Rule investor-optional is because it may be required to do so. If the Commission does not, and chooses instead to adopt a mandatory climate disclosure rule, the fact that it could have adopted a superior, investor-optional disclosure rule would be strong grounds for invalidation of the mandatory rule under the Administrative Procedures Act.

The core of this argument is that the Commission has an obligation to consider reasonable alternatives to its Proposed Rules, and investor-optional disclosure is clearly a reasonable alternative. If the Commission failed to consider investor-optional disclosure, it would therefore be grounds for invalidating the rule the Commission adopts. And if the Commission *does* consider the investor-optional alternative, there are no reasonable grounds on which it could conclude that a mandatory rule would be better for investors. If it nonetheless implemented a mandatory rule in

the absence of reasonable grounds to believe that it was better, the decision to do so would likely be arbitrary and capricious, thus rendering the final rule subject to invalidation

There is clear precedent establishing the Commission's obligation to consider reasonable alternatives to a proposed regulation. In the U.S. Court of Appeals for the District of Columbia Circuit's decision considering the Commission changes to require investment companies to have a supermajority of independent directors, one of the Court's two grounds for invalidating the Commission's rulemaking was that the Commission's failure to consider a reasonable alternative to the rule violated the Administrative Procedure Act.[31] The Court clarified that the Commission is not required to consider every alternative.[32] The Commission would be excused from considering alternatives that are "for whatever reason, unworthy of consideration."[33] But the Court concluded that the alternative proposed was "neither frivolous nor out of bounds, and the Commission therefore had an obligation to consider it."[34]

As this Letter has explained, and as my Working Paper further elaborates, investor-optional disclosure is neither frivolous nor out of bounds. Far from being "unworthy of consideration," the arguments in Sections I, II, III make clear that investor-optionality is consistent with the Commission's rationale for promulgating a rule, and is *better* for investors than mandatory disclosure.[35] The Release considered 14 variations on the Proposed Rule, all of which are substantially *less likely* to be better for investors than an investor-optional alternative. This Letter has brought to the attention of the Commission the investor-optional alternative, and the strong arguments why it would be better for investors than a mandatory rule. In the past the Commission has considered an opt-out alternative to at least one proposed rule, its rule implementing proxy access.[36] For the Commission to heedlessly fail to consider the investor-optional alternative would be grounds for invalidating a mandatory rule.

If the Commission *does* consider the investor-optional alternative to mandatory disclosure, then in order to nonetheless implement mandatory disclosure rather than investor-optional disclosure, it would need a good reason to conclude that mandatory disclosure would be better for investors than investor-optional disclosure. The Commission's rulemaking would be arbitrary and capricious, and therefore subject to invalidation under the Administrative Procedure Act

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[31] Chamber of Commerce of the United States of America v. Securities and Exchange Commission, , 412 F.3d 133, 144 (2005) ("We conclude the Commission's failure to consider the disclosure alternative violated the APA.").

[32] *Id.* at 144. ("To be sure, the Commission is not required to consider ''every alternative . . . conceivable by the mind of man . . . regardless of how uncommon or unknown that alternative'' may be.", citing Motor Vehicle Manufacturers Association of the United States, Inc., et al. v. State Farm Mutual Automobile Insurance Co. et al., , 463 U.S. 29–59, 51, 103 (1982)).

[33] Chamber of Commerce, *supra* note 32 at 144

[34] *Id.* at 145, quoting Laclede Gas Company v. Federal Energy Regulatory Commission, 873 F.2d 1494, 1498 (1989).

[35] *See* Securities and Exchange Commission, *supra* note 1 at 21448–52.

[36] *See Facilitating Shareholder Director Nominations, Release No. 33-9136*, 75 FED. REG. 56667, 56679–56680 (2010). The consideration of opting-out included opting-out through a bylaw adopted by a shareholder vote, which would be functionally similar to the investor-optional approach proposed here.

> if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.[37]

Yet the discussion in Section III makes clear that investor-optional disclosure would likely be *better* for investors than mandatory disclosure. The only ground on which a mandatory rule could be better for investors than an investor-optional rule is if the Commission were to conclude, as discussed in Section III, that there would be a number of companies where investors would choose to opt-out if they were able to do so, but the benefits to other investors from disclosure by those companies would be sufficient to outweigh the costs to the investors in those companies of disclosure. Section V considers and rejects two other potential factors the Commission could consider in its decision whether to make its final rule mandatory or investor-optional. Any other grounds on which the Commission might prefer a mandatory rule would not relate investor protection, or the promotion of efficiency, competition, and capital formation. If the Commission were to choose a mandatory rule over an investor-optional rule on any other ground, it would therefore not be factors that Congress intended the Commission to consider, making the decision subject to invalidation as arbitrary and capricious.

V. Potential Objections to Investor-Optional Climate Disclosure

A. Are the Conditions Satisfied for Investor-Optionality to be Superior?

Section III has explained the straightforward reasoning for why investor-optional climate disclosure would be no worse than mandatory climate disclosure, and in most cases, better. However, that reasoning is based on two assumptions. If those are not satisfied, it is possible that investor-optional climate disclosure may be *worse* for investors than mandatory disclosure. This Section considers those assumptions, and concludes that they are reasonable, and explains why they are unlikely to be so inaccurate as to make investor-optional disclosure *worse* for investors than mandatory disclosure.

1. Investors making privately sub-optimal decisions?

The reasoning in Section III assumes that, when deciding whether to opt-out of climate disclosure, investors will vote for the choice that will maximize their own future welfare. If they do, they will opt-out when the costs to investors exceed the benefits of the rule, and they will choose not to opt-out if the benefits exceed the cost. But if they vote against their expected future interest, or if their expectation is consistently inaccurate, then they may choose to opt-out of rules that would benefit them, or not to opt-out of rules that would be costly for them.

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[37] *Motor Vehicle Manufacturers Association v. State Farm Auto Mutual Insurance Co*., 463 U.S. 29, 43 (1983), quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)).

In an extreme case, privately sub-optimal decision making by investors could result in an investor-optional disclosure rule being *worse for investors* than a mandatory rule. This would be the case only if investors wrongly chose to opt-out of an investor-optional rule, not if they wrongly *failed* to opt-out of the rule, because in the latter case, the disclosure obligation would continue to apply, just as it would under a mandatory rule.[38]

One argument raised by critics of the Proposed Rule is that investment managers supporting climate disclosure are not following the true preferences of their own investors.[39] There are plausible elements to this argument.[40] However, the argument of those opponents is that investment managers are more likely to *support* climate disclosure than their own investors would prefer.[41] Even if this is the case, it would *reduce* the extent to which they opted-out of climate disclosure, reducing the extent to which investor-optionality is *better* for investor than a mandatory rule, but not making it worse than a mandatory rule.

The only circumstances in which investors will wrongly choose to opt-out of an investor-optional rule are if they do not recognize the benefit of climate disclosure for themselves. This runs contrary to the claims of both sides in the current debate regarding the Proposed Rule. The Commission has relied on investor demand for climate disclosure to promulgate the Proposed Rule. If the majority of investors demand climate disclosure, they will not wrongly opt-out of it. Opponents acknowledge that many investors support the rule, but claim that there are many more that do not. For those investors to *wrongly* opt-out it would be necessary that climate disclosure was actually in the interests of those who oppose it, despite their belief to the contrary.

2. Opt-Outs Not Being Initiated?

A second critical assumption of the reasoning in Section III is that, where there is a reasonable chance that investors would vote to opt-out of climate disclosure, a vote will actually be initiated to opt-out of the disclosure obligation. If such votes are not initiated, companies will continue to be bound by those obligations even though they are costly to investors,

It is important to note that the failure of this assumption would not make an investor-optional *worse* than a mandatory rule. At the extreme, if opt-out votes were never initiated, the investor-optional and mandatory versions of the rule would be identical. But the extent to which opt-outs from the Proposed Rule are not initiated will reduce the margin by which the investor-optional rule is better than the mandatory rule (all other things being equal).

The reason why opt-outs are likely to be initiated where they are expected to be successful is because the directors and executives of the company have the ability to easily initiate opt-out votes,

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[38] Of course, their welfare may be worse than if there was no obligation on the company at all, but that would not be a reason to prefer the mandatory rule over the investor-optional rule.

[39] *See, e.g.,* Cunningham et al., *supra* note 6 at 5–7.

[40] For my own argument that investment managers do not follow the preferences of their own investors, see Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217–244 (2018).

[41] *See id.*

strong incentives to do so if they are beneficial, and no significant incentives *not* to do so.[42] As Nell Minnow artfully describes in her comment letter, "the only group who can object to the proposed rule are corporate executives and board members …".[43] For directors and executives, initiating an opt-out vote would be easy and inexpensive. It would simply require including an additional matter in the agenda and proxy materials for an annual shareholder meeting as part of the registrant's regular annual meeting preparation process. Directors and executives are the ones *most* likely to push for opting out from the company's disclosure obligations. They are the most familiar with the costs of the disclosure. Indeed, the groups generally opposing the Commission's Proposed Rule on the grounds that it would impose excessive costs on companies are those that are associated with the managers of corporations, rather than their investors.[44] If directors or executives believe that an opt-out is likely to be supported by investors, they therefore have both the incentive and the ability to put it forward.

The only reason that directors and executives might be deterred from initiating opt-out votes that they expect to be successful is by a fear of obloquy from doing so. But this possibility seems far-fetched. If shareholders holding a majority of shares were likely to support the opt-out proposal, sufficient for it to be successful, that substantial support would make it unlikely that managers would incur any obloquy were they to do initiate the vote. The same is likely to be the case even if a strong minority were willing to support the proposal, making it worthwhile to initiate the opt-out vote to determine whether there was actually a majority or not. The possibility of obloquy would only arise if the vast majority of shareholders were against opting out.[45] And if that were the case, there would be no problem, as an opt-out proposal would not be successful even if it were initiated.

B. Why Might the Commission Nonetheless Resist Investor Optionality?

Having considered (and rejected) additional conditions under which investor-optional climate disclosure could be considered worse for investors than mandatory climate disclosure, this Section turns to consider two reasons unrelated to the protection of investors (or the promotion of efficiency, competition, or capital formation) why the Commission might be resistant to implementing an investor-optional disclosure rule. However, as this Section shows, neither of these concerns are analytically correct. In addition, because they are not related to the permissible purpose of the Commission's rulemaking, if the Commission did base its decision to make its

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[42] Under-initiation of opt-out votes would be likely if investors were required to initiate those opt-out votes, given the costs to investors of initiating shareholder votes, their limited incentives to do so, and their resources constraints. *See* SCOTT HIRST, *Incentivizing Investor Initiation* (2022), https://papers.ssrn.com/abstract=3778436. This is the main reason to make the rule opt-out, rather than opt-in—to align the initiation of the vote with the incentives of directors and executives, rather than investors. *See* Scott Hirst, *The Case for Investor Ordering*, 8 HARV. BUS. L. REV. 227 (2018); Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489–520 (2002).

[43] Nell Minnow, *Letter Regarding Proposal on Climate-Related Disclosures for Investors* 5 (2022), https://www.sec.gov/comments/s7-10-22/s71022-20130308-297032.pdf.

[44] *See, e.g.,* National Association of Manufacturers, *supra* note 7 at 49–50.

[45] This would usefully prevent managers from *over*-initiating opt-outs.

disclosure rule mandatory on either of these rules, the decision is likely to be arbitrary and capricious.

1. Lack of Precedent

One institutional reason that the Commission might resist allowing investors to choose whether to opt-out of the rule is simply because it is not the way the Commission has made disclosure rules in the past. Since the Securities Act and Securities Exchange Act were implemented in the 1930s, none of the disclosure rules the Commission has promulgated under those acts have explicitly allowed companies or investors to opt-out of the disclosure requirements.

However, because the lack of precedent for the rule does not relate to investor protection (or the promotion of efficiency, competition, or capital formation) it is irrelevant to the Commission's consideration. In addition, even if that were not the case, there are three other reasons why it would not be reasonable to be bound by a lack of precedent.

First, the conditions that made mandatory disclosure superior to investor-optionality in the 1930s—and for a substantial period thereafter—no longer apply. Investor-optional rules would not have been effective in the 1930s, because public corporations in that era were characterized by their dispersed ownership.[46] Dispersed owners are rationally apathetic, their small stakes—and consequent small share of any returns to the company—giving them little or no incentive to invest time or energy even in determining how to vote.[47] However, since the 1990s, institutional investors now hold substantial majorities of the corporate equity of most corporations.[48] These organizations not only hold substantial stakes in companies, giving them incentives to invest effort in voting their shares, but in most cases, consider themselves to have a duty to vote their shares in an informed manner.[49] The reasons that investor-optionality did not make sense for more than half a century of the Commission's history therefore no longer apply.

Second, there is indeed precedent in other Commission rulemaking for key components of an investor-optional rule. The core of investor-optionality is providing for differential disclosure obligations for different types of registrants. Many of the Commissions disclosure rules provide for differential disclosure obligations for different types of registrants, including smaller reporting companies ("SRCs"), and emerging growth companies ("EGCs"). Differential disclosure for the group of companies whose investors had opted-out would be similar.

The way in which the Commission's disclosure rules apply to SRCs and EGCs is through opting-out. Both types of companies are can (but need not) opt-out of part of the disclosure rules; if they do not, the standard disclosure rules continue to apply. The only way this differs from investor-

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[46] *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[47] For an early and influential conclusion of rational apathy among voters generally, see Anthony Downs, *An Economic Theory of Political Action in a Democracy*, 65 J. POL. ECON. 135–150, 147 (1957).

[48] *See* Hirst, *supra* note 43.

[49] *See* Alan D. Lebowitz, *Letter from Alan D. Lebowitz, Deputy Assistant Secretary, Pension & Welfare Benefits Admin. of the U.S. Dep't of Labor, to Helmuth Fandl, Chair of the Retirement Bd., Avon Products, Inc.*, 1988 WL 897696 (1988) (providing that "the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock"). This was later codified in Department of Labor Interpretative Bulletin 94-2, 94 FED REG. 18198 (Jul. 29, 1994).

optionality is the latter incorporates guard rails to protect investors, by requiring their approval for the opt-out decision.

At least one set of rules that the Commission has approved does permit companies to opt-out of certain requirements based on characteristics of their investors. Changes to the listing rules of both the New York Stock Exchange and Nasdaq, both of which were considered and approved by the Commission, permit "controlled companies" to opt-out of the listing rules' requirements regarding the number of independent directors on the board of those companies, and the composition of compensation and nominating committees.[50] The definition of "controlled companies" is based on the number of shares of the company's stock held by an individual, group, or another company. This is closely analogous to investor-optionality, which would allow opt-outs based on there being a sufficiently large group of investors with a different characteristic, namely, that they had voted to opt-out of climate disclosure.

In addition, a recently-proposed Commission rule explicitly permits investment companies to opt-out of certain disclosure requirements relating to climate disclosure. The Commission's proposed rule requiring enhanced disclosures by certain investment advisers and investment companies about environmental, social, and governance investment practices would allow ESG-Focused funds to opt-out of disclosure obligations regarding emissions of its portfolio companies if it discloses that it does not consider emissions of portfolio companies in which it invests.[51]

Third, even if there weren't close analogs of investor-optionality among the Commission's other rules, the fact that the Commission has not previously taken a very similar approach is not a rational reason not to consider it, or not to implement it. All of the Commission's rulemakings involve some novel element, or there would be no need for the rulemaking. Indeed, by requiring disclosure of climate-related information, the Proposed Rule itself introduces many novel elements into the Commission's disclosure regime. Investor-optionality would simply be one more.

2. Investor-Optional Disclosure as a Slippery Slope?

A second reason unrelated to investor protection (or efficiency, competition, or capital formation) why the Commission might resist make climate disclosure investor-optional is a potential concern that investor-optionality might be a slippery slope, leading for calls to make future disclosure obligations investor-optional, or even to change existing disclosure rules to be investor-optional. If the Commission is willing to relax its mandatory-only approach to disclosure for emissions, the argument might go, it could create a precedent whereby the Commission could be asked to do so

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[50] *See* Securities and Exchange Commission, *Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes (SR-NYSE-2002-33 and SR-NASD-2002-141) and Amendments No. 1 Thereto; Order Approving Proposed Rule Changes (SR-NASD-2002-77, SR-NASD-2002-80, SR-NASD-2002-138 and SR-NASD-2002-139) and Amendments No. 1 to SR-NASD-2002-80 and SR-NASD-2002-139; and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2 and 3 to SR-NYSE-2002-33, Amendment Nos. 2, 3, 4 and 5 to SR-NASD-2002-141, Amendment Nos. 2 and 3 to SR-NASD-2002-80, Amendment Nos. 1, 2, and 3 to SR-NASD-2002-138, and Amendment No. 2 to SR-NASD-2002-139, Relating to Corporate Governance*, 68 FED. REG. 64154 (2003).

[51] *See* Securities and Exchange Commission, *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, Release No. 33-11068; 34-94985; IA-6034; IC-34594* 324 (2022).

for other disclosure rules. The Commission may be concerned that adopting (or even countenancing) investor-optionality might therefore fundamentally undermine its mandatory disclosure regime.

This is unlikely to be the case for the great majority of Commission disclosure obligations. For long-established Commission disclosure obligations, the fact that companies already have systems to comply with those rules, and that investors have systems that utilize that information, means that the benefits of retaining the rule for investors are likely to outweigh the costs of complying with it. There would not be serious pressure from investors to make such rules investor-optional. For instance, it is very difficult to imagine the Commission facing pressure to weaken the obligation to provide audited financial statements. In effect, what appears to be a slippery slope is actually a *sticky slope*.[52]

If the Commission were to face pressure to make other disclosure rules investor-optional in limited cases, it would only be because investor-optionality would have a strong chance of being *better for investors* than those rules, for the same reasons outlined in Section III. This would especially apply to new rules where there was significant uncertainty about the level of costs and benefits from the rule, and to existing rules where a substantial body of investors believed the disclosure was not useful, or was excessively costly to produce, or both. For instance, there may have been pressure to apply investor-optionality to the Commission's conflict minerals rule, or to the disclosure of management attestations of internal control under Section 404 of Sarbanes-Oxley. As this Letter has demonstrated, if there were robust guardrails to protect investors, investor-optional disclosure of these rules is likely to have been *better* for investors than the mandatory requirement for such disclosure.

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If the Commission followed either of these reasons to resist an investor-optional version of its climate disclosure rule, its decision is likely to be arbitrary and capricious. The test for when an agency decision will be arbitrary and capricious includes the situation where "the agency has relied on factors which Congress has not intended it to consider …". The factors that Congress has contemplated that it consider are investor protection, and the promotion of "efficiency, competition, and capital formation." Inertia in not giving letting investors decide, or a desire to avoid pressure to let investors decide about other rules, would run counter to investor protection, and to the promotion of efficiency, competition, and capital formation.

VI. The Optimal Design of Investor-Optional Disclosure

The reasons why the Commission should make climate disclosure investor-optional are clear and compelling. However, as with any rulemaking, the devil is in the detail. It would be remiss to advocate for an investor-optional rule without considering the details of how it should be implemented. This is especially the case for investor-optionality because, as discussed in Section III, the reasoning that it would be better for investors than a mandatory rule depends on the details

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[52] For a discussion of sticky slopes, see David Schraub, *Sticky Slopes*, 101 CALIF. L. REV. 1249–1314 (2013).

of the opt-out. This Part therefore considers two features that the Commission must include in an investor-optional disclosure rule to ensure it is better than a mandatory rule, and several additional features that the Commission should also include. Importantly, although the features proposed below are novel insofar as they relate to an opt-out from disclosure requirements, they merely combine elements found in other rules that the Commission has adopted or approved.

Making climate disclosure investor-optional would immediately shift much of the focus of the rulemaking from the disclosure obligations themselves, to the process and conditions required for opting-out. This Section explains how the Commission should structure requirements for the opt-out decision. These features are critical to the success of the Proposed Rule. They impose crucial guard-rails on the opt-out process. Indeed, without two of these features, described in VI.A and VI.B, there is a possibility that an investor-optional disclosure rule could be worse than a mandatory rule, or worse that the status quo.

A. A Majority Vote of Unaffiliated Investors

A critical requirement for the opt-out vote in order to ensure that investor-optionality is better for investors than a mandatory rule is that the approving majority be unaffiliated with the directors, executives, or controlling shareholders of the company. If this were not the case, in companies where directors or executives control a substantial proportion of the vote, or where there is a controlling shareholder, there could be a majority opt-out vote even if other investors in the company were strongly in favor of disclosure. This is especially problematic in a company where the company's charter gives a class of shareholders more votes per share than regular investors. Including the votes of affiliated investors in an opt-out choice would essentially allow all of those companies to opt-out of climate disclosure, even where investors representing a majority of the capital of the company prefer that the company disclose climate-related information.

Allowing a set of companies to opt-out against the preferences of the majority of their capital holders would impose costs on those investors. If sufficient companies opted out against the preferences of holders of a majority of capital, and/or the cost to those investors from the opt-out was high enough, the aggregate cost of those opt-outs could outweigh the cost-savings from companies that opted-out through a majority of unaffiliated investors. That would mean that the investor-optional disclosure rule would be *worse* than a mandatory rule.

To overcome this problem, the Commission should require a vote of shareholders holding securities that constitute a majority of the securities that are unaffiliated with the controllers or manager of the issuer. Functionally, this would have some similarities to the "majority-of-the-minority" vote that is part of the "MFW" process by which a conflicted transaction can be cleansed under state law.[53] However, rather than relying on state law rules, the Commission should craft its voting requirement out of its own equivalent definitions. For instance, Commission rules promulgated under the Securities Act contains a definition of affiliated investors that could be used

[53] *See* Kahn v. M&F Worldwide Corp., 88 A.3d 635 (2014) (requiring the vote of a fully informed majority of the minority in order for a conflicted transaction to receive business judgement review, rather than the stricter "entire fairness" standard).

for this purpose.[54] Those rules also includes a definition of "control" that could be applied in this context.[55]

B. Requiring Opt-Outs Since Going Public

A second way that a poorly designed opt-out mechanism would allow an investor-optional mechanism to be *worse* for investors than a mandatory rule is if a company is able to opt-out before the company goes public. If that is the case, the opt-out decision will be controlled by a different and much smaller group of investors than those that will form the shareholder base of the company after the company's initial public offering ("IPO"). As a result, even if the post-IPO investors would benefit from climate disclosure, they could be deprived of it by a pre-IPO opt-out. If sufficient companies, prior to going public, opted out of disclosure that their post-IPO investors would prefer, it is possible that the cost of those opt-outs might be greater than the aggregate benefit from the cost savings from other companies' post-IPO opt-outs, in which case the investor-optional alternative would be worse for investors than a mandatory rule.

For disclosure obligations contained in the Exchange Act—that is, disclosures in companies' annual reports on Form 10-K—this problem could be easily avoided by conditioning the opt-out on an appropriate vote after the company had gone public.

However, this solution would not function for disclosure obligations under the Securities Act, especially disclosures in registration statements, which are drafted before going public, as there isn't a body of public shareholders to vote to opt-out. This effectively requires the Commission to decide between a mandatory rule for disclosure in registration statements, or allowing companies to opt-out based on the vote of a different set of investors than will benefit from the disclosure. Even if the Commission chose the latter option, it is not clear that this would reduce the protection on investors substantially, since the company would still be obligated to either disclose the information at the end of its fiscal year in which it goes public, or opt-out through the vote of the public shareholders that *would* benefit from the disclosure. One benefit of allowing companies to opt-out of registration statement disclosure before going public is that it may reduce the cost of preparing a registration statement, thereby improving capital formation.[56]

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[54] *See* 17 C.F.R. § 230.405 (2021) (defining an affiliated person as a "person that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with," an issuer).

[55] *See* 17 C.F.R. § 230.405 (2021) (defining "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."). That definition of control is a rebuttable presumption. *See, e.g.,* Jay Knight & Taylor Wirth, *SEC Comment about "Affiliate" Stockholder in Public Float Calculation*, BASS BERRY & SIMS SECURITIES LAW EXCHANGE (2017), https://www.bassberrysecuritieslawexchange.com/sec-comment-affiliate-stockholder-public-float-calculation/ (describing SEC correspondence regarding the Registration Statement of Jaguar Health, Inc. filed on Form S-3 on August 29, 2017). This is similar to the situation under state law. *See, e.g.,* In Re Tesla Motors, Inc. Stockholder Litigation, (2018); Corwin v. KKR Financial Holdings LLC, 125 A. 3d 304 (2015).

[56] This would also be consistent with the rationale of requiring less disclosure for emerging growth companies.

C. Sunsetting Approval Requirements

A third (but much less likely) way in which an investor-optional rule could be worse than a mandatory rule is if investors that had supported an opt-out later change their preferences and *do* prefer to receive disclosure regarding climate emissions. If the cost to those investors from missing out on disclosure that would otherwise have been obligated is greater than the cost savings from investors choosing to opt-out, then the investor-optional rule would be *worse* than a mandatory rule.

To avoid this problem, the Commission should impose a "sunset" on the effectiveness of opt-out decisions. This could be done by allowing companies to opt-out where there had been an investor vote (of the kind described above) within the last five years (or a similar period). For the company to continue to opt-out after that period, managers would have to resubmit the opt-out to a vote of unaffiliated investors periodically, in this case every five years. This would allow investors to determine whether they wished to continue the opt-out or not.[57]

This sunset requirement is similar to the requirement that a company hold a say-on-pay vote at least once every three years, and a vote on the frequency of say-on-pay votes at least once every six years. Functionally, it has a similar effect to sunsetting the exemptions from certain disclosure obligations for emerging growth companies after five years, except in this case, the exemption could be renewed.

Structuring the rule in this way would also allow companies to opt-out of climate disclosure obligations before the rule had come into effect, so any public company whose investors supported opting-out could do so even before they became subject to the obligations, thereby avoiding any costs associated with the disclosure.

D. Opting Out by Disclosure of a Vote

One potential vector of attack against an investor-optional climate disclosure rule is the argument that, by making disclosure contingent on an investor vote, it strays into territory that has traditionally been the realm of state law. In *Santa Fe Industries, Inc. v. Green*, the Supreme Court refused to allow Rule 10b-5 to create a cause of action for breach of fiduciary duties, in part because "that cause of action [is] one traditionally relegated to state law," suggesting that the party seeking the right of action could instead avail itself of remedies created under state law.[58]

A close reading of that precedent suggests that mere consideration of a shareholder vote for purposes of determining if disclosure is required would not make the rule invalid. The Commission would not be creating a cause of action or a remedy, or doing something already done by state law.

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[57] An alternative solution would be to allow investors to opt-back-in, such as through a shareholder proposal. However, because of the collective action problems of investors, there would likely be under-initiation of opt-back-in votes, even where investors desired that they take place. The opt-back-in approach is therefore likely to be inferior to the sunset approach.

[58] Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 478 (1977) (quoting Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 40 (1976)).

State law does not require disclosure of climate emissions, or create a way of opting out of federal disclosure requirements. And much rulemaking by the Commission concerns voting matters, which have also traditionally been the role of state law.[59]

Nonetheless, the Commission may wish to avoid entanglement with state law as much as possible. One way to do so would be to avoid any language *requiring* or *obligating* a vote, or any features of a vote. Instead, the Commission could condition the opt-out on the registrant having *disclosed* a vote that meets certain conditions. Requiring *disclosure* of matters submitted to a vote of security holders, and details regarding those matters, is already an established and well-accepted part of the Commission's disclosure requirements.[60]

Conditioning an opt-out on disclosure is also the approach taken by the Commission in its proposed rule regarding investment advisors to provide additional information about their ESG practices. The Proposed Rule requires investment advisers of "ESG-Focused funds" to disclose aggregate GHG emissions.[61] The advisor is not required to make this disclosure for a fund "that affirmatively states in the "ESG Strategy Overview" table … that it does not consider the greenhouse gas ("GHG") emissions of the portfolio in which it invests".[62] The Commission could use a similar structure to allow issuers to opt-out of their emissions disclosure obligations, if they disclosed that a shareholder vote meeting the conditions described in this Section had taken place.

E. Changes to Disclosure Rules Regarding Shareholder Votes

If the Commission adopts a condition based on a disclosure of a vote of majority of unaffiliated shares as suggested in Section VI.D, it should also amend its rules requiring disclosure of matters submitted to a vote of security holders to also require disclosure of information relevant to opt-out votes. Issuers are currently required to disclose matters related to a vote of securityholders under Item 5.07 of Rule 8-K.[63] This includes the number of votes cast for and against a matter.[64] For the same reasons described in Section VI.A, it would also be useful for investors to know how many votes were cast for, against, and in the aggregate, by investors that are unaffiliated with directors, executives, or controlling shareholders.

Because such information is not currently required to be disclosed, investors will be unaware whether an opt-out vote has passed or not, and how close it was to passing. At a minimum, this disclosure should be applied to matters related to opting out from emissions disclosure. However, requiring this disclosure for other matters that are voted on would also benefit investors, by showing when unaffiliated investors disagreed with controlling shareholders.

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[59] *See, e.g.* 17 C.F.R. §§ 240.14a-1—240.14a-21 (2021) (regulating the solicitation of proxies).

[60] *See* 17 C.F.R. § 249.308, Item 5.07 (2021) (setting out disclosures required to be disclosed in Form 8-K with respect to submission of matters to a vote of securities holders).

[61] *See* Securities and Exchange Commission, *supra* note 52 at 323 (proposing the addition of Item 27.(b)(7)(E) to Form N-1A).

[62] *See id.* at 323 (proposing the addition of Item 27.(b)(7)(E) to Form N-1A).

[63] *See* 17 C.F.R. § 249.308, Item 5.07 (2021).

[64] *See id.*

F. Hedging Opt-Out Rules With an Opt-In Rule

As well as allowing investors to opt-out of climate disclosure, the Commission should consider *also* allowing investors to *opt-in* to climate disclosure.

This would have two benefits. First, if investors had previously voted to opt-out of climate disclosure, but since that time, reconsidered their decision, they could "opt-back-in." If so, the opt-out could be structured as requiring the disclosure unless the company has disclosed a vote by investors authorizing an opt-out, *and has not disclosed a vote opting back in.*

A second, and much more important benefit, is that an opt-in rule would provide a hedge against the possibility that the opt-out rule is invalidated by judicial review. Because an opt-in rule is more likely to survive judicial review, even a decision invalidating an opt-out rule is likely to leave it unaffected, thereby allowing it to remain as a backstop.

The core claim of this paper is that an opt-out rule would be better for investors than a mandatory rule. The reasoning for a backstop opt-in rule is that it would be better for investors than no rule at all. This is because it would provide an easy mechanism, and a focal point, for investors opting in to the rule if the opt-out rule were invalidated.[65] Even though the likelihood of an investor-optional climate disclosure being invalidated is substantially less than the likelihood that a mandatory rule would be invalidated, it is not zero—it is impossible to predict with certainty how a court will treat even an investor-optional rule. So despite the strong reasons why investor-optional rules *should* be valid, it is possible that a court may nonetheless invalidate such a rule. If the Commission had no backstop opt-in rule, the situation would return to the status quo. For companies where investors demand disclosure that managers do not provide, the investors must currently engage with directors, and/or put forward a precatory shareholder proposal urging the adoption of climate standards. Creating a simplified method for opting-in to the rule would make it much easier for investors to opt-in.

Conclusion

As this Letter explains, the change necessary to improve and protect the Proposed Rule is straightforward: climate disclosure should be optional. The Commission should allow an issuer to opt-out of all or part of the obligation to make the disclosures required by the Proposed Rule, if its investors authorize the issuer to do so, in the manner described in this Letter, which would provide appropriate guardrails to protect investors. Making climate disclosure obligations investor-optional is consistent not only with the claims of the Commission, but also those of its critics, and is the only way to resolve the tension between the two sets of claims. Allowing investors in a company to decide whether climate disclosure obligations apply to the company would nullify the major arguments against the validity of the Proposed Rule, which apply (if at all) only to mandatory rules. Allowing investors to opt-out of climate change disclosure would make the Proposed Rule better for investors than a mandatory rule. And because the Commission is required

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[65] For the foundational discussion of focal points, often referred to, eponymously, as Schelling points, see THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT (1960).

to consider reasonable alternatives such as investor-optionality, and the difficulty for the Commission to show that a mandatory rule would be *better* than an investor-optional rule, failing to make the final rule investor-optional would constitute strong grounds for its invalidation.

I hope that the suggestions and analysis in this Letter—and the forthcoming Working Paper—prove helpful to the Commission in its revision of the Proposed Rule. Should you have any questions about the analysis in either document, please do not hesitate to contact me.

Sincerely,

Scott Hirst