Reason Foundation Comment on the Securities and Exchange Commission's proposed rule for "The Enhancement and Standardization of Climate-Related Disclosures for Investors." (File No. S7-10-22)

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Reason Foundation Comment on the Securities and Exchange Commission's proposed rule for "The Enhancement and Standardization of Climate-Related Disclosures for Investors."[1]

Executive Summary

The Proposed Rule requires registrants to make certain disclosures pertaining to climate-related risks ("if material") and greenhouse gas (GHG) emissions.

While the Proposed Rule requires disclosure of climate-related risks only if those risks are found to be material, all registrants must evaluate the risks, which is likely to be very costly—and disproportionately so for smaller registrants.

It is most unlikely that climate-related risks and GHG emissions constitute material information for the majority of registrants or otherwise affect registrants' financial performance. While that does not preclude the SEC from requiring such disclosures, it is contrary to the premise of the rule.

The uncertain nature of many climate-related risks means that the information disclosed is likely to be unreliable and inconsistent. It would thus mislead investors, resulting in adverse selection and misallocation of capital—the very problems the SEC claims the Proposed Rule reduces!

While the methodology proposed by the SEC for disclosing GHG emissions appears at first sight logical, it is likely to result in double counting, which would be misleading. In addition, the GHG reporting requirement would impose a harsh burden, especially on smaller registrants. For those registrants also disclosing "Scope 3" GHG emissions, an additional burden is imposed on other companies, including non-registrants, who will be obliged to disclose their emissions to the registrant company.

The large expenditures required to evaluate climate-change risks and GHG emissions entailed by the Proposed Rule would likely result in fewer private companies choosing to list on public U.S. markets and cause many registrants to leave the public markets in the U.S.

This shift away from public U.S. markets will reduce the liquidity of those markets and raise the cost of capital for U.S. companies as a whole. This will reduce investment, innovation, and economic growth.

The distortions created by the Proposed Rule would likely lead to less rather than more investment in innovative technologies that reduce GHG emissions and enable the U.S. to adapt to climate change.

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[1] 17 CFR 210, 229, 232, 239, and 249; Release Nos. 33-11042; 34-94478; File No. S7-10-22; RIN 3235-AM87

1. Introduction

In the summary of its proposed rule for "The Enhancement and Standardization of Climate-Related Disclosures for Investors" ("Proposed Rule"), the Securities and Exchange Commission (SEC) states:

> "The Securities and Exchange Commission ("Commission") is proposing for public comment amendments to its rules under the Securities Act of 1933 ("Securities Act") and Securities Exchange Act of 1934 ("Exchange Act") that would require registrants to provide certain climate-related information in their registration statements and annual reports. The proposed rules would require information about a registrant's climate-related risks that are reasonably likely to have a material impact on its business, results of operations, or financial condition. The required information about climate-related risks would also include disclosure of a registrant's greenhouse gas emissions, which have become a commonly used metric to assess a registrant's exposure to such risks. In addition, under the proposed rules, certain climate-related financial metrics would be required in a registrant's audited financial statements."[2]

This comment assesses the Proposed Rule, with a particular focus on the benefits claimed for the rule and the likely costs of the rule. It begins with a discussion of the materiality of potential climate-related disclosures required by the Proposed Rule. This is followed by a discussion of the current approach to material information as it relates to climate-related risks. Section four considers the way in which the Proposed Rule requires disclosure of climate-related risks. Section five discusses the Proposed Rule's disclosure requirements for greenhouse gas emissions. Section six looks at the likely responses by registrants and potential registrants to the Proposed Rule. Section seven evaluates the SEC's claimed economic benefits and costs of the Proposed Rule. Finally, section eight provides concise responses to the SEC's Request for Comments with regard to the Proposed Rule.

2. Are the Required Information Disclosures in the Proposed Rule Material or Likely to Affect a Registrant's Financial Performance?

A core premise of the Proposed Rule is that some investors are demanding that registrants make climate-related disclosures.[3] While that may be true, it is not necessarily relevant. What matters is whether such information is "material" or otherwise affects a registrant's financial performance, and, if so, whether there is currently a genuine "market failure" resulting, for example, from registrants' failure consistently and truthfully to disclose such information. These issues are explored in this section.

US securities law requires regulated companies to disclose to investors (including potential investors) certain information that would materially affect those persons' investment decisions. Thus, Section 17(a)(2) of the Securities Act of 1933 provides that "It shall be unlawful for any person in the offer or sale of any securities ... to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading." Likewise, Section 18(a) of the Securities Exchange Act of 1934 establishes liability for persons who make or cause to make any statement "in any

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[2] Securities and Exchange Commission, *The Enhancement and Standardization of Climate-Related Disclosures for Investors*, **Proposed Rule**, 17 CFR 210, 229, 232, 239, and 249, at 1.

[3] *Ibid* at 24-28.

application, report or document" that "at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact."

Over time, the SEC and courts have further developed the meaning of "material information." Of particular significance is the Supreme Court decision in *TSC Industries v. Northway*, which established that "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[4] Moreover, "only if the established omissions are 'so obviously important to an investor that reasonable minds cannot differ on the question of materiality' is the ultimate issue of materiality appropriately resolved 'as a matter of law' by summary judgment."[5]

While the SEC's role in mandating disclosures is not bound by the requirement that such disclosures necessarily be material,[6] the SEC has made clear that either materiality or the ability to affect a registrant's financial performance is the primary justification for the Proposed Rule:

> "We are proposing to require disclosures about climate-related risks and metrics reflecting those risks because this information can have an impact on public companies' financial performance or position and may be material to investors in making investment or voting decisions."[7]

A natural question, then, is whether reasonable minds can differ on the question of the materiality of information pertaining to climate change. If the answer is yes, at least in respect of some risks for some registrants, then the justification for mandating disclosure of such information is severely weakened. Meanwhile, if the mandated information is neither material nor otherwise likely to affect a registrant's financial performance or, worse, is likely to mislead investors regarding that performance, then the entire premise of the rule is void.

2.1 Are Climate-Related Risks Material or Likely to Affect a Registrant's Financial Performance?

The Proposed Rule summarizes climate-related risks as follows:

> "Climate-related conditions and events can present risks related to the physical impacts of the climate ("physical risks") and risks related to a potential transition to a lower carbon economy ("transition risks"). As proposed, "physical risks" is defined to include both acute and chronic risks to a registrant's business operations or the operations of those with whom it does business. "Acute risks" is defined as event-driven risks related to shorter-term extreme weather events, such as hurricanes, floods, and tornadoes. "Chronic risks" is defined as those risks that the business may face as a result of longer term weather patterns and related effects, such as sustained higher temperatures, sea level rise, drought, and increased wildfires, as well as related effects such as decreased arability of farmland, decreased habitability of land, and decreased availability of fresh water. Many of these physical risks have already impacted and may continue to impact registrants across a wide range of economic sectors.

[4] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976), at 449.
[5] Ibid. at 450.
[6] Allison Herren Lee, *Living in a Material World: Myths and Misconceptions about "Materiality"*, Securities and Exchange Commission, May 24, 2021. https://www.sec.gov/news/speech/lee-living-material-world-052421
[7] Proposed Rule at 7.

> The proposed rules would define transition risks to mean the actual or potential negative impacts on a registrant's consolidated financial statements, business operations, or value chains attributable to regulatory, technological, and market changes to address the mitigation of, or adaptation to, climate-related risks.188 Transition risks would include, but are not limited to, increased costs attributable to climate-related changes in law or policy, reduced market demand for carbon-intensive products leading to decreased sales, prices, or profits for such products, the devaluation or abandonment of assets, risk of legal liability and litigation defense costs, competitive pressures associated with the adoption of new technologies, reputational impacts (including those stemming from a registrant's customers or business counterparties) that might trigger changes to market behavior, changes in consumer preferences or behavior, or changes in a registrant's behavior. A registrant that has significant operations in a jurisdiction that has made a GHG emissions reduction commitment would likely be exposed to transition risks related to the implementation of the commitment."[8]

Each of these risks is open to interpretation:

a. "Physical risks"

Exposure to shorter-term "acute risks" may be reasonably well defined by reference to historical patterns. However, it is noteworthy that modern technologies have significantly reduced some of these acute risks. For example, the death rate from extreme weather events has fallen by over 90% in the past century due to a combination of increased wealth and better technologies.[9] And heat-related deaths in the US have fallen by about 75% since 1960, mainly due to the rapid increase in use of air conditioning.[10] But in spite of advances in technologies, Americans have increased their exposure—and in some cases that of registrants—to some acute climate-related risks, such as hurricanes: according to some estimates, the normalized costs of hurricane damage in the U.S. have not increased significantly over the past century, but absolute costs have increased substantially due almost entirely to an increase in the number of people living in hurricane zones and associated infrastructure.[11]

By contrast, longer-term "chronic risks" are far more difficult to determine. In part, this is because the future climate remains poorly understood. For example, the extent of likely human-induced increases in global mean temperature depends on changes in atmospheric concentration of GHGs and the temperature sensitivity of the atmosphere to these increases. Yet, future emissions of GHGs will depend on many factors that are not known with any precision (especially technologies that

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[8] Proposed Rule at 57-59.

[9] See: Indur Goklany, *The Decline in Deaths from Extreme Weather, 1900-2010*, Los Angeles: Reason Foundation, Policy Study 393 September 2011; for more recent numbers see: Bjorn Lomborg, "We're Safer From Climate Disasters Than Ever Before," *The Wall Street Journal*, Nov. 3, 2021.

[10] Alan Barreca, Karen Clay, Olivier Deschenes, Michael Greenstone, and Joseph S. Shapiro, "Adapting to Climate Change: The Remarkable Decline in the US Temperature-Mortality Relationship over the Twentieth Century." *Journal of Political Economy* **124**(1), 2016. https://www.journals.uchicago.edu/doi/10.1086/684582

[11] Roger Pielke, Jr. et al. "Normalized Hurricane Damage in the United States: 1900–2005," *Natural Hazards Review*, **9** (1), 2008; Jessica Weinkle et al. "Normalized hurricane damage in the continental United States 1900–2017." *Nature Sustainability* **1**, 808–813, 2018.

currently do not exist) and significant disagreement remains among leading scientists regarding the temperature sensitivity of the atmosphere to increased concentrations of GHGs.[12]

In addition, there are significant disagreements among leading scientists regarding the effects of temperature changes on precipitation (amounts, location),[13] sea level,[14] extreme weather,[15] and other possible consequences of global warming.

Finally, other factors play a significant role in many of the "chronic risks." For example, forest management plays a major role in wildfire risk;[16] rules regarding water rights play a major role in water availability;[17] and the availability of modern agricultural technologies plays a major role in the likelihood that heat and drought will result in famine.[18] In part, it is because there is considerable uncertainty regarding the extent to which humanity will adapt to those future changes and at what cost.

b. <u>"Transition risks":</u>

Transition risks are very much dependent on two factors: the rate of technological innovation and actions taken by politicians—and these two factors are interdependent.[19] Moreover, as has been demonstrated recently by the Russian invasion of Ukraine and consequent changes to the supply of fossil fuels, external factors can have a significant influence on the incentives to switch to lower-carbon fuels. Unfortunately, it is impossible to project future technological changes with any degree of accuracy or precision. This is fundamentally an epistemological problem: it is impossible to know what will be known in the future that is not known today. But there are practical aspects too: many of the most important innovations are "disruptive", which is to say that while incremental in

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[12] For example, contrast these two papers: (1) Nic Lewis and Thorsten Mauritsen, "Negligible unforced historical pattern effect on climate feedback strength found in HadISST-based AMIP simulations," *Journal of Climate*, **34**, 39-55, 2021; (2) Kevin Cowtan and Peter Jacobs, "Comment on 'The Impact of Recent Forcing and Ocean Heat Uptake Data on Estimates of Climate Sensitivity.'" Journal of Climate, **33**, 391-396, 2020.

[13] Tania Lopez-Cantu, Andreas F. Prein, and Constantine Samaras, "Uncertainties in Future U.S. Extreme Precipitation From Downscaled Climate Projections," *Geophysical Research Letters,* 2020. https://agupubs.onlinelibrary.wiley.com/doi/epdf/10.1029/2019GL086797

[14] Marjolijn Haasnoot et al. "Adaptation to uncertain sea-level rise; how uncertainty in Antarctic mass-loss impacts the coastal adaptation strategy of the Netherlands." *Environmental Research Letters* **15** 034007, 2020.

[15] Chris Landsea and Tom Knutson, *Can we expect Atlantic hurricanes to change over the coming century due to global warming?* Climate.gov, June 6, 2022. https://www.climate.gov/news-features/blogs/can-we-expect-atlantic-hurricanes-change-over-coming-century-due-global-warming

[16] *Wildfires and Forest Management: Charting a new path towards more fire-resilient forests and communities*. The Nature Conservancy, August 27, 2019. https://www.nature.org/en-us/about-us/where-we-work/united-states/idaho/stories-in-idaho/wildfires-and-forest-management/ ; Julian Morris, *Devastating Fires Show Forest Management Reforms Are Badly Needed*, Los Angeles: Reason Foundation September 1, 2015. https://reason.org/policy-brief/forest-fires-management-reform/

[17] E.g. Katherine Nelson and Emily Burchfield, "Effects of the Structure of Water Rights on Agricultural Production During Drought: A Spatiotemporal Analysis of California's Central Valley," *Water Research Resources*, **53** (10), 2017. https://agupubs.onlinelibrary.wiley.com/doi/full/10.1002/2017WR020666

[18] E.g. Calestous Juma, "Preventing hunger: Biotechnology is key," *Nature* **479**, 471-2, 2011. https://www.nature.com/articles/479471a.pdf?origin=ppub; Kaiser Jamil, *Biotechnology – A Solution to Hunger?* UN Chronicle, No Date. https://www.un.org/en/chronicle/article/biotechnology-solution-hunger

[19] Julian Morris, *Evidence-based policies to slow climate change*, Los Angeles: Reason Foundation, 2021. https://reason.org/policy-study/evidence-based-policies-to-slow-climate-change/

themselves, they arise from fields outside the dominant means of delivering a particular set of goods and/or services by small firms seeking to serve edge markets.[20] This is important because the Proposed Rule threatens specifically to hobble these smaller entrants through the disproportionate costs it imposes.

There will no doubt be many consulting firms lining up to undertake assessments of these risks on behalf of registrants, but the uncertainties described above mean that for most registrants, the estimates are likely to be given with confidence limits so wide as to be practically useless for investment purposes and subject to all manner of legal disclaimers such as "these estimates should not be relied upon for investment purposes."

As such, it seems fair to conclude that for most registrants, climate-related risks will remain a matter of speculation, poorly grounded in fact, and subject to wide ranges of uncertainty. It would be folly to conclude that these speculative risks should be considered material for the majority of registrants. Worse, for many registrants such disclosures will provide misleading information regarding financial performance.

Thus, the mere fact that the directors of some large investment management companies want climate-related risks and GHG emissions to be disclosed is no justification for the Proposed Rule. Investment management companies and others who seek certain disclosures by SEC-registered companies are at liberty to purchase shares in those companies and then seek shareholder resolutions that would, if passed, require such disclosures. But companies would be strongly advised to limit their disclosures to matters of fact not speculation.

3. Climate-Related Material Information Disclosures Today

The SEC had promulgated two regulations pertaining to materiality that directly relate to the Proposed Rule. Regulation S-K establishes how registrants should disclose material information in general.[21] Regulation S-X describes the material disclosure requirements for registrants' financial reports.[22] In addition, in 2010, the SEC published "Commission Guidance Regarding Disclosure Related to Climate Change," ("2010 Guidance") which identified four sections of Regulation S-K that may pertain to climate change.[23]

3.1 Costs of Compliance with Climate Change-Related Regulation

Item 101 of Regulation S-K requires disclosure of certain costs of complying with environmental laws.[24] Thus, where a registrant must expend capital in order to comply with regulations designed to address

[20] Clayton M. Christensen, Michael E. Raynor, and Rory McDonald, "What Is Disruptive Innovation?" *Harvard Business Review*, December 2015. https://hbr.org/2015/12/what-is-disruptive-innovation

[21] 17 CFR§ 229

[22] 17 CFR § 210

[23] 17 CFR PARTS 211, 231 and 241, 75 FR 6290 (Feb. 8, 2010); available at: http://www.sec.gov./rules/interp/2010/33-9106.pdf

[24] It states: "Appropriate disclosure also shall be made as to the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries. The registrant shall disclose any material

climate change, and where such expenditures are sufficient to meet the materiality threshold, the expenditures must be disclosed.

3.2 Costs of Legal Proceedings

Item 103 of Regulation S-K pertains to legal proceedings against the registrant.[25] To the extent that such legal proceedings have been brought by an emanation of the state in regard to climate-change-related regulation or, presumably, private entities in regard to disputes concerning a climate-change-related matter, and to the extent that such legal proceedings may result in liability that would have a material effect on the registrant, such proceedings must be disclosed.

3.3 "Risk Factors"

Item 105 of Regulation S-K requires registrants, "to provide under the caption 'Risk Factors' a discussion of the material factors that make an investment in the registrant or offering speculative or risky."[26] To the extent that climate change itself presents a material risk to a registrant, for example through the effects on weather-related property damage and associated insurance costs, Item 105 describes how registrants should disclose such risk. It is also notable that item 105 discourages the disclosure of "risks that could apply generically to any registrant". In some cases, the risk from climate change might be just such a generic risk.

3.4 Management's Discussion and Analysis

Item 303 of Regulation S-K requires disclosure of "Management's Discussion and Analysis" (MD&A). Among other things, MD&A may include the effects of climate-change-related legislation and regulation. This is arguably specifically relevant in the context of prospective legislation, where there is uncertainty regarding the likely effects (since for already-enacted regulations, capital costs will already be included under Item 101). In its 2010 Guidance the SEC notes that "Unless management determines that a material effect is not reasonably likely, MD&A disclosure is required. In addition to disclosing the potential effect of pending legislation or regulation, the registrant would also have to consider disclosure, if material, of the difficulties involved in assessing the timing and effect of the pending legislation or regulation."

3.5 Disclosures in Financial Reports

The 2010 Guidance does not offer any specific additional advice regarding financial reporting. Rather, Regulation S-X describes the broader criteria for financial reporting, such that any material information disclosed under Regulation S-K that has a material financial impact would be included in relevant financial reports.

3.6 The Effects of the Current Rules

Since failure to disclose material information can lead to liability (such as civil damages and fines), the current rules encourage companies to identify and disclose any *material* risks relating to climate change in an effective and parsimonious way. They also incentivize companies to limit or mitigate those risks

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estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material."

[25] 17 CFR§ 229.103 (Item 103) from *Modernization of Regulation S-K Items 101, 103, and 105*, 85 FR 63761, Oct. 8, 2020.

[26] 17 CFR § 229.105 (Item 105) Risk factors, 85 FR 63761, Oct. 8, 2020.

and thereby in some cases avoid the need to disclose climate change-related risks because they are no longer material.

4. The Proposed Rule Requires Companies to Evaluate Climate-Related Risks

In contrast to the existing Regulation S-K, the Proposed Rule would *force* registrants to evaluate their climate-related risks and then decide whether or not those risks are material. It does so by adding a new sub-part 1500 to Regulation S-K.[27] It also adds a new Article 14 ("Climate-related disclosures") to Regulation S-X.[28]

Of particular relevance is proposed subpart 1502 of Regulation S-K, which among other things would require registrants to describe, "any climate-related risks reasonably likely to have a material impact on the registrant, including on its business or consolidated financial statements, which may manifest over the short, medium, and long term would require registrants to undertake assessments of climate-related risks."[29]

The consequence of such a requirement is clear: all registrants will be forced to evaluate climate-related risks that might affect their business. This is true regardless of whether such risks are subsequently found to be material or not. For smaller companies in particular the burden may well be acute.

To establish whether specific climate-related risks are material, registrants might, for example, identify the total likely cost of each such risk, aggregate them and weigh them against the total activities of the company.[30] Such an analysis, in turn, entails at minimum (1) identifying potential climate-related risks; (2) determining the likely extent of such risks; (3) determining the likely effect of such risks on the registrant's business. All these steps are fraught with difficulties and, in many cases, prone to generate widely varying results. No doubt consultancies will be vying to offer standardized approaches. But given the inherent variability in the underlying risks, such standards will merely provide a patina of conformity and consistency. The potential for fraud in such disclosures seems significant.

Perhaps in an attempt to pre-empt this criticism, the proposed rule seems to have been written with a view also to cajoling companies to establish board-level positions for individuals with expertise in climate change, as well as significant management-level roles. Subpart 1501 would require registrants to "Describe the board of director's oversight of climate-related risks" and asks registrants to include various details such as:[31]

- "Whether any member of the board of directors has expertise in climate-related risks;"

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[27] Proposed Rule 17 CFR § 229.1500

[28] Proposed Rule 17 CFR § 210.14

[29] Proposed Rule 17 CFR § 229.1502.

[30] See e.g. the following analysis by a group from Deloitte: Emily Abraham, Doug Rand, Laura McCracken, Kristen Sullivan, and John Wilde, "Comprehensive Analysis of the SEC's Proposed Rule on Climate Disclosure Requirements," *Heads Up*, Vol. 29 (4), 2022. Available at https://dart.deloitte.com/USDART/home/publications/deloitte/heads-up/2022/sec-analysis-climate-disclosures#SL795982351-620384
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[31] Proposed Rule 17 CFR § 229.1501.

- "Whether and how the board of directors or board committee considers climate-related risks as part of its business strategy, risk management, and financial oversight;" and
- "Whether and how the board of directors sets climate-related targets or goals, and how it oversees progress against those targets or goals, including the establishment of any interim targets or goals."

Subpart 1501 also makes similar requests regarding the management of registrants.

While it may make perfect sense for some companies to appoint individuals with "expertise in climate-related risks" to their boards, in most cases, this is unlikely to be either desirable or even feasible, even for most larger registrants. Nor will most registrants voluntarily set climate-related targets and goals. The results of a recent Deloitte poll of "300 finance, accounting, sustainability, and legal executives at public companies with over $500 million in revenue" seem apposite:

> "more than half (57 percent) indicated that data availability (access) and data quality (accuracy or completeness) remain their greatest challenges with respect to environmental, social, and governance (ESG) data for disclosure. Less than a quarter (21 percent) of respondents currently have an ESG council or working group focused on ESG topics; however, more than half (57 percent) are actively working to establish one."[32]

And those are companies with over $500 million in annual revenue! It is difficult to avoid the conclusion that this Proposal was not written with smaller registrants in mind.

5. The Proposed Rule Requires Registrants to Disclose Emissions

In addition to the requirement that registrant boards of directors be encumbered with decisions regarding the disclosure of climate risks, with associated resource costs, the proposed rule expressly requires companies to disclose climate-related—i.e. "greenhouse gas" (GHG)—emissions. This is troublesome for several reasons, as discussed in this section.

5.1 The SEC's Authority to Mandate Disclosure

While some registrants might feel obliged to disclose certain of their GHG emissions because they deem them to be material risks (for example because of regulation or the possibility of regulation) or otherwise likely to affect the registrant's performance, it seems very unlikely that this would be the case for all registrants – and perhaps not even a majority. One reason is that GHG emissions are not directly related to a company's financial performance. Much depends on how they are regulated, which varies by type of GHG and by the location where they are emitted. For example, there are wide differences in state regulations of GHGs. As such, it is not clear that the SEC has the authority to require disclosures of GHG emissions per se. A more relevant metric might be, for example, "risks to investors resulting from a registrant's GHG emissions," but this seems already to be covered by the Regulation S-K Item 303 and Regulation S-X.

By contrast, the EPA does have the authority to require disclosure of GHG emissions and has already established a reporting program for such emissions that currently covers around 8,000 plants in the

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[32] Emily Abraham et al. "Executive Summary of the SEC's Proposed Rule on Climate Disclosure Requirements," *Heads Up* **29**(2), 2022. https://dart.deloitte.com/USDART/home/publications/deloitte/heads-up/2022/sec-proposed-rule-climate-disclosure

U.S.[33] This program is in one important sense more comprehensive than the SEC, since it covers not only public, SEC-registered companies, but also private companies. It also likely more closely approximates, for those plants owned by SEC-registrants, the set of companies for which disclosures might be material.

5.2 The GHG Reporting Proposed by the SEC

The Proposed Rule would require registrants not only to disclose their own (direct) emissions (termed "Scope One") but also emissions produced indirectly by contracting parties. Specifically, the Proposed Rule would require all registrants to disclose emissions related to electricity, steam, heat and cooling consumed by the registrant ("Scope 2").[34] In addition, the Proposed Rule requires disclosure of all other indirect emissions (for example from suppliers of goods and services, employee travel, waste disposal, and so on) ("Scope 3") "if material".[35]

At one level, such a "lifecycle" approach to emissions makes sense. After all, companies make a choice between in-house production and contracting out. If companies can avoid disclosure of emissions by contracting out activities, they may choose to do so. As such, requiring companies to disclose emissions of contractors where those emissions are material makes sense. However, the approach is not without its problems.

First, if a contractor is also a registrant, there is a risk of double-counting, since the contractor will include its own emissions in its Scope 1 disclosure, while the registrant will include the same emissions in its Scope 3 disclosure. In some cases, an investment fund might include both companies in its portfolio; if that portfolio discloses emissions, the effect of double counting is to increase the fund's emission profile, thereby misleading investors in the fund.

Second, many contractors are smaller companies that do not currently keep track of their own GHG emissions; to include those companies in Scope 3, it would be necessary for them to undertake such tracking, which could become a significant financial burden.

Third, while it is easy to assert that Scope 3 emissions should only be included "if material," the materiality of such emissions can only be judged by first calculating them. Thus, even if Scope 3 emissions are deemed not to be material, registrants and contracting parties will essentially have sunk the cost of evaluating their scale.

While it is difficult to estimate the scale of these problems, it seems likely that they would be significant and that the alternative approach currently employed by EPA is fundamentally superior since it encompasses the most highly relevant emissions. So, to the extent that the SEC feels obliged to mandate disclosure of GHG emissions, it would make more sense for it to mandate that registrants who are already obligated to disclose emissions under the EPA GHG Reporting Program should also detail those emissions, and associated risks, where relevant in SEC disclosures.

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[33] See: Environmental Protection Agency, *Greenhouse Gas Reporting Program*. Available at: https://www.epa.gov/ghgreporting; see also: 40 CFR Part 98, 2022; EPA, *EPA Fact Sheet: Greenhouse Gases Reporting Program Implementation,* 2013, *available at* https://www.epa.gov/sites/default/files/2014-09/documents/ghgrpoverview-factsheet.pdf.

[34] Proposed Rule at 460.

[35] Proposed Rule at 470.

6. The Likely Response by Companies to the Proposed Rule

In a speech published on the SEC's website in October 2021, Commissioner Allison Herren Lee noted that "Perhaps the single most significant development in securities markets in the new millennium has been the explosive growth of private markets. We've become all too familiar with the statistics: more capital has been raised in these markets than in public markets each year for over a decade with no signs of a change in the trend."[36] Commissioner Lee noted further that "The vast amount of capital in these markets [is] attributable in part to policy choices made by the Commission over the past few decades."[37] Moreover, Commissioner Lee worries that a further shift towards private markets, "could operate to obscure systemic risks such as those posed by climate change."[38] Yet, ironically the Proposed Rule would almost certainly result in just such a further shift to private markets.

Companies choose to list on a US exchange, and thus become subject to SEC registration, primarily because of the increased access to liquidity that such listing entails. But there are trade-offs. In particular, the costs of complying with the SEC's reporting requirements can be onerous. At the margin, any increase in these reporting costs is likely to result in a reduction in the number of companies that choose to list publicly in the US. Since the Proposed Rule would certainly increase reporting costs, perhaps significantly, as the SEC acknowledges.[39]

In addition, other consequences of the Proposed Rule would also likely discourage companies from being listed in the U.S. For example, as the SEC acknowledges, for some registrants the requirement to disclose climate-related risks and GHG emissions could indirectly disclose commercially confidential information relating to production processes.[40] This will mean:

- A reduction in US listings of US companies. Some closely held companies that had been contemplating a public listing will simply remain private. Meanwhile, some other US companies that are currently listed will be taken private.
- A reduction in US listing of non-US companies. Some foreign companies that had contemplated a US listing will likely choose not to list in order to avoid complying with the Proposed Rule.
- Some US companies may choose to redomicile and list on foreign exchanges where they would not be subject to the Proposed Rule.

All these effects would be harmful to the U.S. economy. Specifically, by reducing the number of companies that choose to list publicly in the U.S., they would reduce the attractiveness of U.S. exchanges and hence reduce the liquidity of public U.S. markets. Capital would be redeployed to private U.S. markets and overseas public markets. To the extent that, absent the Proposed Rule, capital would be deployed more efficiently in public U.S. markets, the Proposed Rule will raise the cost of capital. This, in turn, will reduce investment in general, which will reduce innovation and associated economic growth.

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[36] Allison Herren Lee, *Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy*, Securities and Exchange Commission, Oct. 12, 2021. https://www.sec.gov/news/speech/lee-sec-speaks-2021-10-12

[37] *Ibid.*

[38] *Ibid.*

[39] Proposed Rule at 294.

[40] *Ibid.*

7. The Effect on Adaptation to and Mitigation of Climate Change

Underlying some investors' interest in understanding climate-related risks and, especially, emissions of GHGs is a desire to address the threat of climate change. There are, broadly speaking, two approaches that might address this threat: adaptation and mitigation. Adaptation consists in finding strategies to enable humanity and its supporting ecosystems to reduce the consequences of climate change and continue to thrive. Mitigation consists in finding strategies to reduce the extent of climate change and thereby avoid the need to adapt. The optimal solution likely is a combination of these approaches.

Both adaptation to and mitigation of climate change require innovation,[41] yet by increasing the costs of doing business for registrants and by raising the cost of capital, the Proposed Rule is likely to reduce such innovation. In addition, the Proposed Rule would impose disproportionate costs on smaller registrants, which would impede disruptive innovation and its attendant benefits, which may include more cost-effective ways to reduce GHG emissions and adapt to climate change.

At the same time, the Proposed Rule might cause registrants and their contracting parties to increase investments in technologies that reduce current carbon emissions. By increasing demand for such technologies, this might in turn drive incremental innovation in lower-carbon technologies, as companies compete with one another and learn by doing. However, it will also likely divert resources away from other investments that might result in technologies that would more cost-effectively reduce carbon emissions but which are not favored because they are not able to reduce current emissions. This is particularly true for technologies that are not considered in and of themselves "low carbon" at all at present. Consider, for example, if the Proposed Rule had been in place at the time fiber-optic cable and lasers were invented: it seems most unlikely that these technologies would have been considered desirable for their "low carbon" properties, so might not have been developed at the pace they were. Yet without these technologies, we would not have fiber-optic broadband, which requires far fewer resources than the copper wire it replaced and in turn underpins the modern Internet that has the potential to dramatically reduce carbon emissions globally.[42]

The Proposed Rule might also cause more registrants to invest in technologies that enable them to adapt to climate-related risks than would otherwise be the case. However, this would likely come at a cost in terms of other kinds of investments, including investments in innovative technologies that would result in greater benefits in the future, such as those that would enable society as a whole to adapt better to climate change, or to reduce emissions and thereby mitigate climate change.

The overall Economic Effect of the Proposed Rule

In its economic analysis of the Proposed Rule, the SEC states:

> "We anticipate the proposed rules will give rise to several benefits by strengthening investor protection, improving market efficiency, and facilitating capital formation. The primary benefit is that investors would have access to more consistent, comparable, and reliable disclosures with

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[41] Julian Morris, *Evidence-based policies to slow climate change*, Los Angeles: Reason Foundation, 2021. https://reason.org/policy-study/evidence-based-policies-to-slow-climate-change/

[42] See e.g.: Börje Ekholm and Johan Rockström*, Digital technology can cut global emissions by 15%. Here's how*, World Economic Forum, 2019. https://www.weforum.org/agenda/2019/01/why-digitalization-is-the-key-to-exponential-climate-action/

> respect to registrants' climate-related risks, which is expected to enable investors to make more informed investment or voting decisions. By providing access to this information through SEC filings for all public issuers, this enhanced disclosure could mitigate the challenges that investors currently confront in assessing the nature and extent of the climate-related risks faced by registrants and their impact on registrants' business operations and financial condition. In this way, the proposed rules may reduce information asymmetry both among investors, which can reduce adverse selection problems and improve stock liquidity, and between investors and firms, which can reduce investors' uncertainty about estimated future cash flows, thus lowering the risk premium they demand and therefore registrant's cost of capital. The proposed rules could also mitigate certain agency problems between the firm's shareholders and management, thus strengthening investor protection. Further, by enabling climate-related information to be more fully incorporated into asset prices, the proposed rules would allow climate-related risks to be borne by those who are most willing and able to bear them, thereby strengthening financial system resilience. Taken together, the proposed rules are expected to contribute to the efficient allocation of capital, capital formation, competition, and the maintenance of fair and orderly markets.
>
> We are also mindful of the costs that would be imposed by the proposed rules. Registrants would face increased compliance burdens in meeting the new disclosure requirements. In some cases, these additional compliance burdens could be significant while in others relatively small if companies already provide information similar to that required by our rules. Other potential costs include increased litigation risk and the potential disclosure of proprietary information about firms' operations and/or production processes."

On the basis of the foregoing analysis, it seems reasonable to conclude that the SEC's assessment of the benefits of the Proposed Rule is excessively rosy and the costs insufficiently dark. Specifically:

a. There is a significant risk that the Proposed Rule will have the opposite effect regarding the availability of "consistent, comparable, and reliable disclosures with respect to registrants' climate-related risks." This is because, as discussed, many of the effects of climate change remain too poorly understood to make impartial, objective assessments in a range sufficiently narrow for such disclosures to be consistent, comparable, or reliable.
b. As such, there is a significant likelihood that the rule will cause an *increase* in adverse selection, as many stocks will be falsely identified as lower risk with respect to possible liabilities associated with climate change. Meanwhile, other stocks will be falsely labeled as higher risk and thus subject to an unnecessarily high risk premium. These latter stocks are likely to be among those that choose to go private or move domicile.
c. The resulting misallocation of capital will be far greater than the direct costs associated with compliance with the rule.

In sum, it is highly likely that the Proposed Rule, if applied in its current form, would do far more harm than good, not only to the reliability of information provided by registrants but also to the US economy more generally. Moreover, it is likely that the proposed rule would make the U.S. less resilient to climate change.

8. Response to SEC Request for Comment

The SEC asked several specific questions in its request for comment (RFC). These are listed below, with responses in bold based on the foregoing analysis.

1. Should we add a new subpart to Regulation S-K and a new article to Regulation S-X that would require a registrant to disclose certain climate-related information, as proposed?

   No. As noted above, this is unnecessary and would likely be counterproductive.

   Would including the climate-related disclosure in Regulation S-K and Regulation S-X facilitate the presentation of climate information as part of a registrant's regular business reporting?

   This seems likely to mislead investors. As noted above, the disclosures likely fail the materiality test and for most registrants would result in the provision of misleading information.

   Should we instead place the climate-related disclosure requirements in a new regulation or report?

   If this is to be contemplated at all, a separate report would likely be less harmful, especially if it came with a clear warning that the information was not to be relied upon by investors owing to the high degree of uncertainty.

   Are there certain proposed provisions, such as GHG emissions disclosure requirements, that would be more appropriate under Regulation S-X than Regulation S-K?

   It would be particularly inappropriate to include GHG emission disclosures under Regulation S-X, as these disclosures would have no *direct* bearing on the financial performance of registrants. What matters in re. Regulation S-X is the likely *financial* effects of registrants' GHG emissions. Indeed, the disclosure requirements contemplated in the Proposed Rule would be more appropriately situated, if at all, in Regulation S-K.

2. If adopted, how will investors utilize the disclosures contemplated in this release to assess climate-related risks? How will investors use the information to assess the physical effects and related financial impacts from climate-related events? How will investors use the information to assess risks associated with a transition to a lower carbon economy?

   As noted, investors are likely to misinterpret the required disclosures, resulting in increased adverse selection and misallocation of capital. This is true for all the contemplated uses described in the above paragraph.

3. Should we model the Commission's climate-related disclosure framework in part on the framework recommended by the TCFD, as proposed? Would alignment with the TCFD help elicit climate-related disclosures that are consistent, comparable, and reliable for investors? Would

alignment with the TCFD framework help mitigate the reporting burden for issuers and facilitate understanding of climate-related information by investors because the framework is widely used by companies in the United States and around the world? Are there aspects of the TCFD framework that we should not adopt? Should we instead adopt rules that are based on a different third-party framework? If so, which framework? Should we base the rules on something other than an existing third-party framework?

Modeling the disclosures on the TCFD would likely benefit those registrants that are already applying the TCFD, as their implementation costs will be relatively lower. It will also benefit consulting firms that have built practices around the implementation of the TCFD. And it may also benefit investment management companies, several of which have recently been accused of misleading investors regarding the "ESG" nature of funds so labelled, since they will be able to claim that the information upon which they rely was mandated by the SEC.

There is currently no third-party framework capable of providing reliable, consistent metrics for climate-related risks. Indeed, given the uncertainty discussed in this comment, no such framework is currently possible. As such, the SEC should not be seeking to impose rules based on the TCFD or any other third-party framework.

4. Do our current reporting requirements yield adequate and sufficient information regarding climate-related risks to allow investors to make informed decisions?

   This cannot be known. However, at least the current reporting requirements give registrants enough flexibility to choose the disclosures that are most likely to help investors make informed decisions.

   In lieu of, or in addition to the proposed amendments, should we provide updated guidance on how our existing rules may elicit better disclosure about climate-related risks?

   This would be a far more sensible alternative. Done well, it would be far less onerous and less likely to lead to misinformation, adverse selection, and a further shift away from publicly traded companies.

5. Should we require a registrant to present the climate-related disclosure in an appropriately captioned, separate part of the registration statement or annual report, as proposed? Should this disclosure instead be presented as part of the registrant's MD&A?

   No. Decisions regarding how best to disclose climate-related risks should be made at the discretion of individual registrants, who have better knowledge of the context in which they are being made than does the SEC.

6. Should we permit a registrant to incorporate by reference some of the climate-related disclosure from other parts of the registration statement or annual report, as proposed? Should we permit a registrant to incorporate by reference climate-related disclosure that appears in a sustainability report if the registrant includes the incorporated by referenced disclosure as an

exhibit to the registration statement or annual report? Are there some climate-related disclosure items, such as GHG emissions data, that we should not permit a registrant to incorporate by reference? Would requiring a registrant to include all of the proposed climate-related disclosures in a separate, appropriately captioned section, while precluding a registrant from incorporating by reference some or all of the climate-related disclosures, promote comparability and ease of use of the climate-related information for investors?

As per question 5, registrants are generally in a better position to decide where, when and how to disclose all this information than is the SEC.

7. Should we permit a registrant to provide certain of the proposed climate-related disclosures in Commission filings other than the annual report or registration statement? For example, should we permit a registrant to provide information about board and management oversight of climate-related risks in its proxy statement?

   Yes, for the same reasons as for questions 5 and 6.