WEIGHING THE COSTS OF, AND AUTHORITY FOR, A MANDATORY CLIMATE DISCLOSURE REGIME

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Thank you, thank you, thanks to all of you who put so much work into this conference. When I got to my hotel room yesterday and received my happy bag, as we call them in the South, I received this personal note which I really appreciated and enjoyed from Bethany. One thing she wrote in the note struck me as particularly relevant for my talk today. She wrote, "I must admit, I had not previously realized the connection between the SEC and climate change. I look forward to the talk." Well, Bethany, neither had I. And that is what this talk is about.[1]

I want to begin just by talking a little bit about ESG generally. The recent phenomenon of environmental social and governance (or ESG) investing has been the focus of a lot of media attention and political debate. Most have assumed that ESG proponents are uniformly on the left, but there have been advocates and detractors on both ends of the political spectrum. It's not really a politically partisan issue. In particular, some devout political libertarians and free market proponents have supported the ESG movement as offering an opportunity to show how the private sector can actually outperform the government at solving some of society's seemingly most intractable problems. For example, racial injustice, gender discrimination, LGTBQ+ issues, and the challenge of human caused climate change, by offering market driven solutions that avoid political quagmires.

But if the principal advantage of ESG investing is its ability to affect needed social change from the bottom up, then what are the risks of enhanced top-down government regulation in this space? That's the topic of this presentation today. My focus here is going to be on the "E" of ESG. And more specifically, I will be looking at the Securities and Exchange Commission's proposed rule change, the "Enhancement and Standardization

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[1] Much of this presentation draws on and develops legal summaries and insights offered in a recent article I coauthored with Professor George Mocsary, University of Wyoming College of Law. *See* George A. Mocsary & John P. Anderson, *An Economic Climate Change?*, LAW & LIBERTY (Nov. 8, 2021), https://lawliberty.org/eco-disclosures/ [https://perma.cc/3XVG-7NFS].

of Climate-Related Disclosures for Investors."[2] What I'll be asking is whether the rule change is needed at all. Is it within the SEC's statutory authority? And will it advance the goals of the ESG movement, or will it do more harm than good?

I'll jump right in. First, I'll offer a little bit of background and history. In May of 2021, the Biden Administration issued its Executive Order on Climate-Related Financial Risks.[3] The order explains that the "intensifying impacts of climate change present physical risk to . . . publicly traded securities" due to "extreme weather."[4] In addition, the order explains that the "global shift away from carbon-intensive energy sources [through increased regulation also] presents transition risk to many companies."[5] The order then directs the Secretary of the Treasury, Janet Yellen, to issue a report discussing, among other things, the "necessity of any actions to enhance climate-related disclosures by regulated entities."[6]

Then, less than one year later, in March 2022, the SEC proposed the Enhancement and Standardization of Climate-Related Disclosure for Investors rule.[7] As the name suggests, the proposed rule looks to "enhance" existing climate-related disclosures. So, let's consider first some of the climate-related disclosure rules and guidance that currently is in place before we consider the proposed changes and whether they are needed.

In 2010 the SEC issued an interpretation to Regulation SK offering "Guidance Regarding Disclosure Related to Climate Change."[8] In it, the SEC addresses several provisions under which climate-related risk disclosure may be required. For example, Item 101, Description of Business, "expressly requires disclosure regarding certain costs of complying with environmental

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[2] The Enhancement and Standardization of Climate-Related Disclosures for Investors 87 Fed. Reg. 21334 (proposed Apr. 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, 249).
[3] Exec. Order No. 14,030, 86 Fed. Reg. 27967 (May 25, 2021).
[4] *Id.*
[5] *Id.*
[6] *Id.* at 27968.
[7] The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334.
[8] Commission Guidance Regarding Disclosure Related to Climate Change, 75 Fed. Reg. 6290 (Feb. 8, 2010) (to be codified at 17 CFR pts. 211, 231, 241).

laws."[9] So, in particular, it requires disclosure of 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."[10]

Next, item 103, Legal Proceedings, requires a registrant to briefly describe pending legal proceedings to which it or any of its subsidiaries is a party.[11] This litigation disclosure requirement is quite broad and is not even limited to proceedings that are likely to have material impact on the registrant's business or financial condition.[12] For example, it extends to environmental litigation to which a government entity is a party so long as there's a reasonable likelihood that a monetary sanction of a hundred thousand dollars or more may be imposed.[13]

Next, Item 105, formerly 503(c),[14] risk factors, "requires a registrant to provide where appropriate, under the heading 'Risk Factors,' a discussion of the most significant factors that make an investment in the registrant speculative or risky. [Item 105] specifies that risk factor disclosure should clearly state the risk and specify how it affects the particular registrant; registrants should not present risks that could apply to any issuer or any offering."[15]

Finally, we consider Item 303, Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). Among other things, the MD&A requires that management "identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably

[9] *Id.* at 6293.
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] *Id.* at 6294.
[15] *Id.*

likely to have a material effect on financial condition or operating performance" of the issuer.[16]

Let's now walk through how the 2010 guidance engages these basic provisions in the context of climate change. The guidance focuses specifically on two types of risk that are to be disclosed under these current provisions. Transitional and physical risk. With respect to transitional risks, the Congressional Research Service defines "transition risks" as follows: "These risks arise from policy, legal, technology, and market changes as the world transitions to a lower-carbon economy, with potential financial or reputational effects on businesses."[17] It then defines "physical risks" as including "direct and indirect risks arising from extreme weather events and from longer-term shifts in climate patterns, including, for example, changes in water availability and food security. Physical risks have important implications for many companies' physical facilities, operations, transportation costs, supply chains, and employees."[18]

So specifically with respect to transition risk, the 2010 guidance explains that the impact of litigation is one thing that is going to be covered under the current filing requirements. "[T]here have been significant developments in federal and state legislation and regulation regarding climate change. These developments may trigger disclosure obligations under Commission rules and regulations such as pursuant to Items 101, . . . [105], and 303" that we just mentioned.[19] The guidance cautions here that registrants should consider specific risks they face as a result of climate change regulation or legislation and avoid generic risk factor disclosure that could apply to any company. So again, what they're looking for here is for each company to uniquely assess how they will uniquely be affected by what they anticipate to be these litigation risks. If they're just responding more broadly to risks that all companies face across the board, then such risks need not be disclosed.

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[16] *Id.* (footnote omitted).

[17] EVA SU & NICOLE VANATKO, CONG. RSCH. SERV., IF11307, CLIMATE-RELATED RISK DISCLOSURE UNDER U.S. SECURITIES LAWS (2019).

[18] *Id.*

[19] Commission Guidance Regarding Disclosure Related to Climate Change, 75 Fed. Reg. at 6295.

Registrants must also consider and disclose any material impact of treaties or accords on their business, for example, the Paris Accord.

In addition, there are some indirect consequences to the business of regulation of business trends. For example, decreased demand for goods producing significant greenhouse gas emissions; increased demands for goods resulting in comparatively lower emissions; increased competition for development of eco-friendly products; increased demand for clean energy; and decreased demand for services related to carbon-based energy production.[20] Again, if any of these risks rise to the level of materiality (and in some cases, with respect to litigation, some specified risks that aren't necessarily material to the bottom line), then they must be disclosed under the current regime and its 2010 Guidance.

With respect to physical risk, companies with coastline operations may suffer property damage and disruption to operations; financial and operational impacts from disruptions to the operations of major customers or suppliers from severe weather such as hurricanes or floods; increased insurance claims and premiums; and decreased agricultural production due to drought or other weather-related changes. These risks, to the extent they rise to level of materiality, must currently be disclosed under the items and guidelines referenced above.[21] So, in light of this 2010 Guidance, Items 101, 103, 105, and 303 of Regulation SK already require the disclosure of material transitional and physical risks associated with human-caused climate change.[22] Consequently, what motivates the new rule imposing an "enhanced" mandatory disclosure regime?

Well, one of the principal justifications that has been offered for the new regime is that investors are demanding more consistent, comparable, and clear climate-related disclosures from issuers in light of recent ESG investing trends. Under the current guidance, firms are free to make their own determination as to whether these risks rise to a level of materiality such that they need to be disclosed under these provisions.[23] A mandatory regime

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[20] *Id.*
[21] *See supra* notes 8–16 and accompanying text.
[22] *See supra* notes 8–16 and accompanying text.
[23] *See supra* notes 8–16 and accompanying text.

would require that there be some treatment of these and related risks in every disclosure. In other words, the concern seems to be that registrants currently enjoy too much flexibility in determining whether and how to report their understanding of climate-related risks. How will the new mandatory regime solve this problem? Let's look at this new rule.

There are three basic categories of disclosure under the proposed rule. First, all issuers will be required to include certain climate-related risks in their periodic reports, including any transitional or physical risks which "have affected or are likely to affect the registrant's strategy, business model, and outlook." [24] Second, it would also require that issuers disclose their "governance of climate-related risks" and relevant risk management processes.[25] So, for example, under the proposed regime, issuers would have to report whether anyone on the board of directors is a climate-risk expert.[26] Issuers must also report the processes for identifying and assessing climate risk at their company.[27] These are the types of things that would have to be disclosed under the kind of governance categories of the new disclosure regime. Finally, under the proposed rule, issuers would be required to disclose their direct emissions (or Scope 1), indirect emissions through the purchasing of energy (or Scope 2), and upstream and downstream (or Scope 3) GHG or greenhouse gas emissions.[28]

So those are the three basic categories of new disclosures that would be mandated under this proposed regime. And with these preliminaries out of the way, my basic question is how (if at all) would these enhanced and standardized disclosure requirements advance the ball for investors? Let's start with risk disclosures. As we've learned, under the current regime and the 2010 guidance, issuers are already required to disclose transitional and physical risks that result from climate change to the extent that they're

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[24] The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334, 21345 (proposed Apr. 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, 249).
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.* at 21344.

material.[29] Consequently, concerning such risks, the only enhancement under the proposed mandatory regime would presumably be to require an explicit statement from firms that don't identify any such material risk to go on record with the claim that that no such risk exists. Now, it's unclear how this additional requirement is helpful to investors in my view because such an affirmation of the negative is already implicit in the failure to state the material risk exists.

Perhaps the expectation is that issuers are going to identify or speculate on even non-material transitional and physical impacts of climate change. It is, however, also unclear how these statements would aid investors. Concerning non-material transitional risk, this would appear to require little more than speculation on how future treaties, protocols, regulations, orders, or laws might affect operations. Such speculation is in my view unlikely to help investors, and in fact may expose issuers to increased litigation risk. You're asking issuers to prognosticate as to what Congress will pass or what nations will be able to agree to in terms of these treaties or protocols—or on whether these treaties or protocols will remain in effect or continue to apply. We just saw how the Paris Accord came into being and disappeared for four years under the Trump administration. Now it's back under Biden. Issuers are now going to be required to sit back and say, okay, who's going to win the 2024 election? If it is Trump, it is likely all this stuff goes out the window. And so how does an issuer try to plan for this in its disclosures and actually help investors without exposing themselves to litigation if they guess wrong? How can the issuer really say anything meaningful to investors on these political points? It's a problem. Moreover, you would think such political risks would be market-wide—precisely the type of risks that are specifically identified as not warranting disclosure under the current regime. This brings us back to the point I made earlier, that disclosure may put issuers in this awkward position of serving as political prognosticators, which is not the expertise of a typical board of directors.

Now similar problems also exist for non-material physical risk disclosures under the new rule. Such disclosures would focus on risk to firms' physical

[29] *See supra* notes 8–16 and accompanying text.

assets, business, and supply chain from extreme weather events (such as drought, flooding, fire, hurricanes, and tornadoes) caused by climate change.[30] The principal challenge for disclosure in this area is going to be the difficulty in predicting these events generally, and then tying them to human-influenced climate change specifically.[31] Such a disclosure requirement forces issuers to take a stand on what they consider to be the current state of attribution science, which is a brand-new field of science that tries to tie weather events to climate change and anticipate such events.[32] It's not very good right now. It's not very reliable.[33] And, for issuers to try to determine probability and magnitude based on attribution science, and to try to choose among the various models out there is going to be a major challenge for issuers. And regardless of the approach, the substance of these disclosures is going to amount to what I would consider to be mere speculation, not terribly helpful to investors.

What about the governance disclosures? Well, the new disclosure regime is going to require that firms offer some disclosure concerning their risk oversight and governance model.[34] How does it work? Again, these disclosures require issuers to state whether board members are climate risk experts and explain their processes for identifying climate-related risks.[35] Now, I can see how these disclosures might help investors generally learn about the issuer's ability to plan and manage climate risk. But this begs an important question, why do investors need such information only about climate risk, versus all other global risks that we're currently facing? Significant risks such as overpopulation, pandemics, substance abuse, generative AI, conflict, etc., are all huge global issues. Do we need separate disclosure rules for each of these as well? Do we need board members who

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[30] The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. at 21345.

[31] *See, e.g.*, William Allison, *Climate Litigation Supporters Admit That Attribution Science is Failing in Court*, ENERGY IN DEPTH (June 28, 2021), https://eidclimate.org/climate-litigation-supporters-admit-that-attribution-science-is-failing-in-court/ [https://perma.cc/FT92-9N2M].

[32] *Id.*

[33] *See generally*, STEVEN E. KOONIN, UNSETTLED (2021).

[34] The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. at 21345.

[35] *Id.*

are experts assigned to each of these issues as well? Why elevate or privilege climate change, which by its nature is going to be slow and gradual, over many of these other emergencies (many of which are more imminent)? Some of these other emergencies, e.g., those involving international conflict or generative AI, may be irreversible in two years or less. So why aren't we requiring disclosures for these risks?

A related concern is that the SEC seems to suggest or maybe recommend that the shareholders vote climate experts onto the board. This is interesting because it signals that the SEC is perhaps moving from its historical model for disclosures, which was merely descriptive, into a normative phase where it's prescribing certain types of conduct by issuers, and that can be potentially problematic.

Another thought here is that most experts claim that the risk of extreme climate change can be averted entirely by policy and behavior changes. If such changes are made, then does this disclosure regime persist after the issue is addressed? Should there be a sunset provision once the world achieves net zero? Are issuers expected to still disclose all this information once the emergency has passed? This is an interesting question not addressed by the rules themselves.

Turning now to the emission disclosures under the proposed rule. Unlike scope 1 and scope 2 emissions, the SEC's Scope 3 emission disclosures are limited to only material upstream and downstream emissions. So presumably such disclosures would already be covered under the existing regime. But the new rule adds something. It effectively presumes that such emissions will always be material "to help investors assess the registrants' exposure to climate-related risks, particularly transition risks."[36] So the SEC appears to presume the magnitude portion of the probability-magnitude test for materiality will effectively render all scope-three emissions material. I admit this is an overstatement, but there's a suggestion there. Oddly, the SEC seems to recognize the difficulty in accurately assessing the probability and magnitude of such disclosures by offering a safe harbor for Scope 3 disclosures. They are automatically deemed not fraudulent unless

[36] *Id.* at 2378.

unreasonable or in bad faith.[37] To me, this appears to be a concession that issuers cannot be expected to determine this category of disclosure with any accuracy.

The SEC also offers suggestions to issuers who have difficulty determining Scope 3 emissions that they look for low GHG contracting parties to avoid the risk of materiality. Is the SEC the proper agency to make such suggestions? And again, is the SEC remaining neutral? Or is it becoming prescriptive in its approach to disclosure?

So again, will this new rule really be helpful for investors, or will it just generate more noise? Drawing on language from *TSC Industries*, will the new disclosures risk "burying the shareholders in an avalanche of trivial information?"[38]

At the end of the day, are the new SEC disclosure rules needed? In sum, my view is that, by definition, the proposed mandatory regime does not provide investors with additional material information beyond what is already required under the existing regime. Significant compliance costs are inevitably going to be incurred by issuers in meeting the demands of the new rule. There is going to be uncertainty in determining the content with any accuracy, which may undermine the contention that it's going to improve consistency and clarity. For example, with respect to physical risk, the SEC is not going to require that issuers use one specific model for assessing that, so how does one expect to get consistency across the board given the current state of attribution science? Uncertainty also increases the risk that additional disclosures will just generate noise, or worse, dilute reliance on other disclosures. Concerning the emissions disclosures, doesn't it make more sense at the end of the day for the EPA to be governing or handling scope one, scope two, and scope three disclosures?

Now I know I'm running low on time, but let me just say a few words concerning the statutory authority for the proposed rule. Historically, the SEC's statutory authority has been limited to protecting investors, facilitating capital formation, and fostering a fair, orderly, and efficient market.

[37] *Id.* at 21391.
[38] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 406, 448 (1976).

Nevertheless, the SEC relies on a provision of the statute that grants it "broad authority to prescribe disclosure requirements that are 'necessary or appropriate in the public interest or for the protection of investors'" to justify the proposed climate change disclosure rule to the extent it's not obviously consistent with its historical mission.[39] But many commentators, including then SEC Commissioner Hester Peirce, who was a commissioner at the time that the rule was proposed, point out that it has always been understood that this clause refers to discretion within the scope of the three main mission goals of the SEC, not that it grants the SEC the ability to require disclosure on anything it decides is within the public interest. So that's one point. According to Commissioner Peirce, "[w]e do not have a clear directive from Congress, and we ought not wade blithely into decisions of such vast economic and political significance as those touched on by [the SEC] proposal." [40] Now Commissioner Peirce's comment highlights some vulnerability for this proposed rule under the Supreme Court's "major question" doctrine. Under that doctrine, the Court has been refusing to grant agencies deference where the subject matter of their rulemaking is too economically or politically important to not be addressed directly by Congress.[41] Since addressing climate change is one of the most politically divisive public policy issues of our time, it is hard to imagine the Court is not going to regard this as a major question. The statute is therefore, in my view, quite vulnerable to scrutiny by the Court. Now, the major question doctrine is not going to preclude the SEC from entering into the space altogether. It is just likely to preclude it from entering into the space without congressional approval.

There are, however, also causes for concern here that might prevent even Congress from compelling these disclosures explicitly. Namely, demanding such disclosures may touch on the First Amendment freedom of speech

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[39] Allison Herren Lee, *Shelter from the Storm: Helping Investors Navigate Climate Change Risk*, SEC (March 21, 2022) (quoting 15 U.S.C. § 77g(a)(1)), https://www.sec.gov/news/statement/lee-climate-disclosure-20220321 [https://perma.cc/YV8P-LCH9].

[40] Hester M. Peirce, *We Are Not the Securities and Environment Commission—At Least Not Yet*, SEC (Mar. 21, 2022), https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321 [https://perma.cc/YV8P-LCH9].

[41] *See, e.g.*, West Virginia. v. EPA, 597 U.S. 697, 716 (2022).

protections that corporations enjoy. The Court has of course recognized that there is a power to compel corporate speech where the subject matter is purely factual and uncontroversial in nature.[42] But again, given the controversy and politically charged debates surrounding the impacts of climate change and the appropriate responses to it, it's possible the court will find that such disclosures would be unconstitutional, in which case even Congress cannot compel it.

So, finally, where are we at? And I'll conclude with this because I've already pointed toward a lot of these issues. But what are the costs of this proposed rule? I've argued that, by and large, given the current disclosure requirements with respect to climate change and the 2010 guidance, there's not much that's added by the proposed rule that is useful or helpful to investors. I've also pointed out what I consider to be some risks that the rule would not be supported by its statutory authority or perhaps would even be unconstitutional. But what are the costs of this regime? If there are few benefits, are there any significant costs? Well, here are just a few to mention.

First, there is clearly the cost of compliance. I think the SEC estimates that around $600,000 per issuer per year would be required to comply with this new rule. But read the articles on your own. Most people think this dramatically underestimates the costs of compliance.[43]

Second, there's also the risk that the compelled speech on climate change necessary for compliance will drive companies private. The climate change debate can be quite divisive. We've seen what can happen when companies engage in politics. (Think Disney, Target, Bud Light, etc.) They can lose their customer base. Forcing corporations to take a particular stand on climate change might drive some companies to go private to avoid losing market

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[42] Sean J. Griffith, *What's "Controversial" About ESG? A Theory of Compelled Commercial Speech Under the First Amendment*, 101 NEB. L. REV. 876, 880 (2023) (first quoting Zauderer v. Off. Of Disciplinary Couns. of Sup. Ct. of Ohio, 471 U.S. 626, 651 (1985), then quoting Nat'l Inst. Of Fam. & Life Advoc. v. Becerra, 585 U.S. 755 (2018)).
[43] *See, e.g.*, Matthew Winden, The Unconsidered Costs of the SEC's Climate Disclosure Rule (June 17, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20132304-302836.pdf.

share. Well, if they do go private, then that gives the average investor fewer opportunities for investment.[44]

Third, the proposed rule could also risk forcing the board to focus more on climate impact at the expense of profits. This is a common criticism of contemporary stakeholder theory. If you give corporate boards an option of which of these stakeholders to focus on, there's the risk that they will not focus on the investor's interest in growth or profit, but rather on these other concerns—which may be a problem for retirement funds.[45]

Fourth, there is the risk that unreliable, speculative information provided in climate disclosures may dilute investor confidence in other disclosures. If much of what's in these disclosures is inherently speculative, the average Main Street investor may begin to assume that other portions of the disclosures are speculative and untrustworthy. Moreover, unreliable or speculative content in disclosures may expose issuers to increased litigation risk, another reason to perhaps go private.

Fifth, to the extent that it is fund managers or institutional investors who are the ones clamoring for these climate-related disclosures, and not Main Street investors (and a number of surveys have shown that that is in fact the case), we should ask ourselves what are the interests of these two types of investors.[46] Generally, the interest of Main Street investors is higher returns. Generally, the interest of institutional investors is higher fees. Is the SEC now advancing this rule favoring institutional investors over Main Street investors—favoring Wall Street over Main Street? And is that consistent with the SEC's historical mission? I question that.

Finally, to the extent investors regard this new rule as an attempt to achieve political ends by other means, the SEC's credibility as a neutral guardian of markets will be diminished. I'll end with this quote from Commissioner Peirce:

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[44] *See, e.g.*, Mocsary & Anderson, *supra* note 1.
[45] Lawrence A. Cunningham et al., *The SEC's Misguided Climate Disclosure Rule Proposal*, 41 BANKING & FIN. SERVS. POL'Y REP. 1, 4–6 (2022).
[46] *Id.*

> [W]hile the existence of anthropogenic climate change itself is not particularly contentious, how best to measure and solve the problem remains in dispute. The Commission, which is not expert in these matters, will be drawn into these disputes as it reviews, for example, the climate models and assumptions underlying companies' metrics and disclosures about progress toward meeting climate targets. The proposal could inspire future, more socially and politically contentious disclosures, which would undermine the SEC's reputation as an independent regulator.[47]

And with that, I will close. I am grateful for any comments. Thank you very much.

[47] Peirce, *supra* note 40.