EMORY LAW

George S. Georgiev
Associate Professor of Law

Emory University School of Law
1301 Clifton Road NE
Atlanta, GA 30322

March 28, 2022

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

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

Dear Secretary Countryman:

I connection with the SEC's ongoing rulemaking on climate-related disclosure, I enclose my essay entitled "The SEC's Climate Disclosure Proposal: Critiquing the Critics," which was published on the Business Law Prof Blog on March 27, 2022 (https://lawprofessors.typepad.com/business_law/2022/03/the-secs-climate-disclosure-proposal-critiquing-the-critics.html), and which is also available as a working research paper on the Social Science Research Network (SSRN): https://ssrn.com/id=4068539.

Sincerely yours,

/s/ George S. Georgiev

George S. Georgiev
Associate Professor
Emory University School of Law

cc: Hon. Gary Gensler, Chair, U.S. Securities and Exchange Commission
Hon. Hester Peirce, Commissioner, U.S. Securities and Exchange Commission
Hon. Allison Herren Lee, Commissioner, U.S. Securities and Exchange Commission
Hon. Caroline Crenshaw, Commissioner, U.S. Securities and Exchange Commission

The SEC's Climate Disclosure Proposal: Critiquing the Critics

By: George S. Georgiev
Source: Business Law Prof Blog (March 27, 2022)
Available at: https://ssrn.com/id=4068539

The SEC released its long-awaited Climate Disclosure Proposal a few days ago, on March 21, 2022. The Proposal is expansive, the stakes are high, and, predictably, the critical arguments that started appearing soon after the SEC kicked off this project a year ago are being raised ever more forcefully in preparation for a potential court challenge. A close review of the Proposal, however, suggests that it is firmly grounded within the traditional SEC disclosure framework that has been in place for close to nine decades. The Proposal is certainly ambitious (and overdue), but it is by no means extraordinary. This, in turn, suggests that challenges to the Proposal's legitimacy ought to fail, even if certain aspects of the Proposal could stand to be improved as part of the ongoing rulemaking process.

This view is not universally held. In voting against the Proposal, SEC Commissioner Hester Peirce admonished that it "turns the disclosure regime on its head" and erects "a hulking green structure" that will "trumpet" a "revised mission" for the SEC: "'protection of stakeholders, facilitating the growth of the climate-industrial complex, and fostering unfair, disorderly, and inefficient markets.'" This certainly sounds problematic—and, indeed, quite dramatic. But once we set aside the entertaining rhetorical flourishes, we see that many of the arguments against the Proposal misstate the applicable legal constraints and mischaracterize important aspects of the Proposal. Moreover, even though Commissioner Peirce goes out of her way to praise "the existing regulatory framework that for many decades has undergirded consistent, comparable, and reliable company disclosures," her lengthy dissenting statement reveals that she actually opposes many important and established elements of the very framework she says she wants to conserve.

I will make the case that the SEC's Climate Disclosure Proposal is in keeping with longstanding regulatory practice by examining several features of the traditional disclosure regime and the new Proposal. I will focus my analysis on arguments I've developed in prior research, certain other less-known arguments, and the particular aspects of the new Proposal. This piece is not intended to be comprehensive, and I want to note that the broader issue of ESG disclosure has generated extensive debate and much insightful analysis.

Shareholders, Stakeholders, and Expert Groups

The SEC's Climate Disclosure Proposal immediately prompts the well-worn question: Is this disclosure intended for shareholders or for stakeholders? But posing this as a binary choice automatically shifts the terms of the debate in favor of opponents of climate-related disclosure, regardless of the actual content of the Proposal. Since climate change has society-wide implications, information about it will inevitably resonate beyond the boundaries of the disclosing

firm and the capital markets, even when the focus is on financially-material disclosure relying on investor- and issuer-generated disclosure frameworks (as is the case here). The social resonance of climate-related disclosure can drown out its clear-cut financial relevance, render any proposed disclosure rule suspect, and lead to a situation that, when we stop and think about it, is quite illogical: A subject matter's relevance to one audience (stakeholders) is used as an argument to cancel out the well-established relevance of that same subject matter to another audience (investors). This is a general vulnerability that applies not just to climate-related disclosure, but to other ESG disclosure as well. It is important to understand it and de-bias policymaking accordingly.

Commissioner Peirce's dissenting statement deftly zeroes in on this vulnerability by asserting that the Proposal "tells corporate managers how regulators, doing the bidding of an array of non-investor stakeholders, expect them to run their companies" and "forces investors to view companies through the eyes of a vocal set of stakeholders, for whom a company's climate reputation is of equal or greater importance than a company's financial performance." Reading this, one would think that the Proposal was written by the Sierra Club and the National Resources Defense Council—or by a D.C. bureaucrat, who, in Peirce's telling, is both clueless and corruptible. Yet, nothing could be further from the truth.

The SEC's Proposal draws on technical frameworks for financially-material disclosure developed by expert groups such as the Task Force on Climate-Related Financial Disclosures (TCFD) and the Greenhouse Gas Protocol. Take the TCFD, for example: Its members include representatives of mainstream investors (including BlackRock and UBS Asset Management), banks (JP Morgan, Citibanamex), insurance companies (Aviva, Swiss Re, Axa), giant industrial firms (BHP, Eni, Tata Steel, Unilever), rating agencies (Moody's, S&P), accounting firms (Deloitte, E&Y), and others. Its secretariat is headed by a leader in the financial industry and capital markets, Mary Schapiro, who holds the unique distinction of having served as Chair of the SEC, Chair of the CFTC, and CEO of FINRA. And, for better or worse, no environmental NGOs or stakeholder organizations are represented on the TCFD. As its name suggests, the TCFD's focus is on *financial disclosures* of the kind that investors require and use. The TCFD has generated an impressive roster of supporters and official adopters in just over six years, and, importantly, each of the "big three" (BlackRock, State Street, and Vanguard) has endorsed the TCFD framework.

Commissioner Peirce rightly points out that the SEC does not have the depth of expertise on climate-related matters that other, specialized regulators have. Such expertise, however, is not necessary here since the SEC is not setting GHG emission limits, calculating carbon trading prices, drawing up climate transition plans, or setting climate resilience standards for businesses. The SEC's Proposal is limited to disclosure—and only disclosure—on a technical topic, and the SEC has decades-long experience handling disclosures on technical topics. For example, the SEC is not an energy regulator, but it drew up a specialized disclosure framework for oil and gas extraction activities in the 1970s (with help from expert groups, much like it has done here), and it has administered this framework successfully since then. As the composition of the economy has

changed, the SEC has had to develop some expertise in cybersecurity disclosure, tech disclosure, and in other specialized areas. The Climate Disclosure Proposal does not veer away from this time-tested approach; the only difference is that it concerns a hot-button topic.

Statutory Authority and Regulatory Practice: Recalling Schedule A of the Securities Act

A central challenge to the Proposal is that it goes beyond the authority given to the SEC by Congress because the rules are too prescriptive, not rooted in "materiality" (more on which later), and because Congress has not directed the SEC to pursue rulemaking on this particular topic. A fair amount of debate has focused on what it means for the SEC to act as "necessary or appropriate in the public interest or for the protection of investors"—language that has been part of the securities laws since they were passed in the 1930s but that has not been tested in court.

So how should the SEC interpret the statutory language when engaging in rulemaking? In the case of disclosure rulemaking, the answer seems fairly clear. Though this is often forgotten, Congress supplied the SEC with a detailed initial template: Schedule A of the Securities Act. Schedule A prescribes 32 categories of information, both general and highly specific, that are required to be included in SEC-filed registration statements. At the same time, Congress also delegated power to the Commission to waive some of the requirements of Schedule A, and, importantly, to mandate disclosure of "such other information, and . . . such other documents, as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors." (Section 7(a)(1)). The SEC has continuously mandated such disclosures on a wide variety of topics over the course of its 88-year history, without challenge to its authority. Regulation S-K as it exists today can be traced back directly to Schedule A (which has never been amended or repealed by Congress).

It's worth taking a close look at what Congress did (and did not do) through Schedule A in 1933:

- First, Congress did not impose a materiality requirement—either for Schedule A as a whole, or for the type of "other information" the SEC is expressly authorized to require. Congress was clearly aware of the concept of materiality, since a few of the particular items it included in Schedule A are qualified by materiality (e.g., "material contract"). But most others are not, and neither is Schedule A as a whole. The provisions of the securities laws pertaining to SEC disclosure rulemaking simply do not contain a materiality constraint. (As I discuss below, this does not mean that materiality is entirely irrelevant.)

- Second, Congress deemed it appropriate to require disclosure of information that many today may find financially insignificant. For example, Schedule A requires the disclosure of any contract with a public utility company that provides for the "giving or receiving of technical or financial advice or service (if such contract may involve a charge to any party thereto at a rate in excess of $2,500 per year)." This threshold amount translates to only

$52,500 today, but the SEC has used its discretion to drop the entire disclosure provision. Schedule A also requires disclosure of "the remuneration, paid or estimated to be paid, by the issuer . . . to . . . its officers *and other persons*, naming them whenever such remuneration exceeded $25,000 during any such year." This threshold amount translates to $525,000 today. Even though Schedule A is still on the books, the SEC has, once again, exercised its discretion and does not require public companies to name all employees earning more than half a million dollars. The SEC has, however, developed an extensive executive compensation disclosure framework to which Congress hasn't objected over the three decades it's been in place.

- Third, Congress calibrated Schedule A to the particular risks of the time, with abuse by public utility holding companies being one. Based on the delegation of authority and the Schedule A template, the SEC today should, similarly, develop disclosure requirements that take into account contemporary realities. Incidentally, public utilities during the 1930s employed pyramid structures and various business practices that harmed *both* investors and the broader economy. The fact that a particular problem was not *exclusively* an investor protection problem did not preclude Congress from imposing disclosure regulation. Similarly, the fact that today's climate issues affect non-investor constituencies as well as investors shouldn't be used as an argument against the Proposal.

Relying on the power granted to it by Congress in 1933, the SEC has, decade after decade, built out a detailed disclosure regime aimed at protecting investors, which covers a number of matters that are not mandated by Schedule A or subsequent acts of Congress. These matters include executive compensation, related-party transactions, asset-backed securities, and various technical industry-specific items. Since 1940, the form and content of financial statements and notes thereto (which contain a substantial amount of prescribed disclosure) have fallen into the same category. While the subject matter of the SEC's new Proposal—climate change—implicates existential threats to businesses, the economy, and human habitats, from the vantage point of securities regulation, the Proposal is simply part of a tradition spanning nine decades.

Given Supreme Court dicta stating that "[w]hen an agency claims to discover in a long-extant statute an unheralded power to regulate a significant portion of the American economy, we typically greet its announcement with a measure of skepticism," it is understandable why Commissioner Peirce seeks to portray the Proposal as a break with tradition. The factual record discussed above, however, does not support this view. The Securities Act of 1933 is, indeed, a "long-extant statute," but, far from being "unheralded," the regulatory power at issue has been exercised consistently since the 1930s without any objection from Congress. Moreover, while the Proposal touches various economic actors, it can hardly be said to "regulate" the economy in the command-and-control sense in which the Supreme Court has spoken about regulation.

Materiality: *TSC Industries* and *Basic* Do Not Impose a Constraint

As we saw, the federal securities statutes do not impose a materiality constraint on SEC disclosure rulemaking. Contrary to oft-repeated assertions, neither do the two leading Supreme Court cases on materiality, *TSC Industries* and *Basic*. The *TSC Industries* court noted that information is material if there is a "substantial likelihood that a reasonable [investor] would consider it important" in making an investment or voting decision. A crucial first step in understanding this and other cases is that they deal with whether or not an issuer, at some specified point in the past, had *a legal duty to disclose* particular information, under a particular set of circumstances and in light of the applicable regulatory framework. In other words, the Supreme Court's materiality test applies to an *ex post* liability determination, not to an *ex ante* policy choice by a regulator. When it engages in disclosure rulemaking, the SEC inevitably has to make *ex ante* policy choices. Unsurprisingly, then, neither *TSC Industries*, nor *Basic*, nor any other Supreme Court case touches on or limits the types of information the SEC is empowered to require when it promulgates disclosure rules. (Of course, when courts are tasked with adjudicating *ex post* liability for non-disclosure under Rule 10b-5, they will inquire into materiality by applying the Supreme Court's test. It is perfectly normal for a complex concept such as materiality to operate differently depending on the context.)

These principles extend beyond Supreme Court jurisprudence. When the D.C. Circuit has struck down SEC rules, it has been for failure to carry out adequate cost-benefit analysis, and never due to a finding that the challenged rule lacked materiality. Importantly, the D.C. Circuit has not ruled that cost-benefit analysis requires an assessment of materiality. The closest the D.C. Circuit has come to considering materiality in the context of SEC disclosure rulemaking has been to find that the SEC is entitled to deference in its determination on the materiality (or lack thereof) of particular topics. During the 1970s, the National Resources Defense Council challenged the SEC's refusal to pursue disclosure rulemaking in response to its petition, which the SEC had justified on the grounds that the non-disclosed information was not material; the D.C. Circuit sided with the SEC.

The existing confusion on this point is understandable, at least to a certain degree. The SEC has referenced the Supreme Court's succinct articulation of materiality with some frequency for the sake of consistency. Many, though certainly not all, existing disclosure requirements are qualified by materiality (e.g., "material risks"). In these cases, however, the SEC hasn't left firms to struggle with the Supreme Court's elegant-yet-economical articulation of materiality; instead, the SEC has supplemented it by developing extensive guidance on how firms are to go about making the often-difficult materiality judgments.

The other reasons for the confusion are more unfortunate: Over the past decade, SEC commissioners, speaking in their individual capacities, have implied or asserted that *TSC Industries* imposes a limit on the SEC's power to promulgate disclosure rules, and that the already-existing framework "requires disclosure of *all material information*" (which, conveniently,

would make it unnecessary to promulgate any additional disclosure rules). The law is clear, however, that there is no general requirement to disclose "all material information"; issuers have to disclose information only when a particular SEC rule requires it, including "as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."

Materiality as an Appropriate Background Principle

To say that *TSC Industries* and *Basic* do not impose *a formal constraint* on SEC rulemaking is not to say that they are *irrelevant* to SEC rulemaking. The SEC should be (and has been) guided by the general materiality of a given subject matter when deciding whether to adopt new disclosure rules. And once the SEC identifies a general subject area that is material to investors, it usually comes up with detailed guidance and/or an information-generating framework that ensures the consistency, comparability, and reliability of public companies' disclosures in that area.

Even though the specific language of *TSC Industries* and *Basic* cannot serve as a self-executing disclosure criterion—securities regulation is too complicated for that—it can help illuminate aspects of the SEC's policy analysis. On this score, too, the Climate Disclosure Proposal appears both justified and consistent with established practices. Consider the following:

The "Reasonable Investor": Materiality is always viewed through the eyes of the "reasonable investor," but the particular attributes of this construct are so ambiguous as to generate an entire sub-genre of securities law scholarship. Commissioner Peirce and other opponents of ESG disclosure have long used this ambiguity to dismiss evidence of significant investor demand for climate-related disclosure by implying that this demand does not come from reasonable, financially-motivated investors. But as the SEC points out in the Proposing Release, the investors demanding climate-related disclosure include BlackRock, State Street, Vanguard, Calpers, and others who, in the aggregate, invest the bulk of Americans' savings. These investors have expressly endorsed the TCFD framework upon which the SEC Proposal is based and have indicated how they use climate-related information in their investment decisions. The SEC is right to take these mainstream investors at their word and not second-guess their motivations. To do otherwise would be to imply that U.S. capital markets are dominated by investors who are not "reasonable"—a conclusion that would raise troubling questions about the price efficiency and overall health of these same markets. And, as between BlackRock (an actual investor) and the Chamber of Commerce (a lobbying group that is an always-reliable detractor to disclosure regulation), who is better positioned to speak about the disclosure needs of the "reasonable investor"?

The "Probability-Magnitude Test": In *Basic*, the Supreme Court stated that materiality determinations should be made by considering *both* the probability and the magnitude of an event or effect. A highly-consequential event may be material even if the probability of it occurring is relatively low. Applying this rationale to climate-related risk militates in favor of mandating

disclosure. The magnitude of the adverse effects from climate change is extremely high both for individual firms and across the economy. And, in most cases, the probability of adverse events occurring isn't low, but, rather, difficult to estimate. Such uncertainty and estimation difficulties are also being used to brand the Proposal as outside the mainstream. We should remember, however, that the disclosure regime already incorporates provisions where firms have to weigh risks and estimate probabilities (e.g., ASC 450 loss contingencies).

Red Herring: "Universally Material"

Commissioner Peirce concluded her dissenting statement by promising to keep an open mind about the final rule and then asking commenters to identify for her "types of *universally material* climate information that are not being disclosed under [the] existing rules." Though its provenance is uncertain, the notion of "universal materiality" implies that for a category to be *universally* material, it should be material for all public companies at all points in time. This is an incredibly high bar that few, if any, of the SEC's existing disclosure rules would meet. Consequently, it cannot be the proper standard for evaluating new disclosure rules. Given that materiality is by its nature both contextual and relative, how many categories of information could possibly be relevant for *all companies*, *all the time*? How would we identify those categories and how could we be confident of their universal materiality? These questions go to the design and administrability of the entire securities disclosure regime. And even though Commissioner Peirce does not offer answers, she points out in a footnote that long-settled rules on executive compensation, related-party transactions, and environmental litigation do not meet the materiality standard (as she understands it) and do not belong in the disclosure regime.

In a quest to operationalize "universal materiality," we might stipulate that basic information about a company, such as the number of employees, is "universally material"; after all, one cannot understand a company—any company—without it. But according to Commissioner Peirce, even this basic data point doesn't meet the standard of "universal materiality" that would qualify the information for unconditional disclosure. In 2020, she expressed support for eliminating the requirement to disclose the number of employees because it "might be material for some companies under some circumstances, but not for others." An impossibly high bar, indeed. It is safe to assume, then, that those commenting on the Proposal would not be able to identify climate-related information that meets Commissioner Peirce's idiosyncratic standard of "universal materiality." A disclosure regime built on this standard would likely be one where all of Regulation S-K and Regulation S-X fit on a single page.

The First Amendment/Compelled Speech Angle

Commissioner Peirce's statement also echoes arguments suggesting that SEC disclosure regulation on climate-related matters may fall foul of the First Amendment's limitations on compelled commercial speech. This is a fairly new line of attack first advanced by the West Virginia Attorney General in March 2021 (subsequently joined by a group of Republican state

attorneys general), which has since been taken up by others as well. The relevant questions appear to be whether a disclosure mandate focuses on "purely factual and uncontroversial information" and whether it is "unjustified or unduly burdensome." Even though opponents of the SEC's climate disclosure initiative made it controversial well before the contours of the Proposal became known, this does not mean that the actual information required by the actual Proposal is controversial, burdensome, or unjustified. In her statement, Commissioner Peirce cited unpublished academic research suggesting that the subject matter of climate-related risk may not be "uncontroversial" because it is not "consistent with the language and objectives of the statute authorizing the mandate." But this assertion is called into question by our analysis of the disclosure template established by Congress in 1933 and almost nine decades of subsequent regulatory practice. Still, the First Amendment arguments deserve dedicated attention because they could be a risk factor not only for climate-related disclosure rules, but for other disclosure rules as well.

The Big Picture

Climate change is an existential phenomenon, which entails sizeable but underappreciated economic risks. Even though disclosure will not solve the problem of climate change (and no one is claiming that it could), corporate disclosure would certainly bring to light the effects of climate change on firm valuations in the real economy and, in turn, enable market participants to adjust those valuations accordingly. Since price is the most important term of any transaction, ensuring accurate asset and firm valuations is an essential element of investor protection. And, as we have seen, investors also take a firm's climate strategy and its handling of climate-related matters into consideration when exercising their well-established voting rights under corporate law. While we can quibble with certain choices on the margins, the SEC's new Climate Disclosure Proposal is fairly standard on the whole, and well within the traditional parameters of the decades-old securities disclosure regime. I am confident that the Proposal will be refined further during the next stage of the rulemaking process and that it should withstand any legal challenges. As for the considerable amounts of energy being expended in opposing the Climate Disclosure Proposal, the analysis presented here suggests that this energy would be better directed at solving real economic problems—or simply conserved.