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Securities and Exchange Commission
100 F Street, NE
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<u>File No. S7-10-22</u>
<u>Proposal on Climate-Related Disclosures for Investors</u>

The enthusiasm of many Commissioners and Staff of the Securities and Exchange Commission (the "SEC") to participate in the global debate about climate change is understandable. After all, protecting the earth's sustainability is perhaps the most compelling issue of our time. It's an issue all must take seriously and everyone must do their part. But each of us, and particularly governmental authorities, must always act in accordance with law and fairness.

The undersigned, a group of professors of law and finance, are concerned that the SEC's recent proposal to impose extensive mandatory climate-related disclosure rules on public companies (the "Proposal") exceeds the SEC's authority. In addition, rather than provide "investor protection," the Proposal seems to be heavily influenced by a small but powerful cohort of environmental activists and institutional investors, mostly index funds and asset managers, promoting climate consciousness as part of their business models.

The framework of this letter traces the potential sources of the SEC's authority, which are a function of federal statutes and other federal laws. The statutes that created the SEC in the 1930s authorize the SEC to promulgate disclosure regulations that are "necessary or appropriate in the public interest or for the protection of investors."[1] Amendments to those statutes in the late 1990s instructed the SEC to report on whether a proposed regulation will promote efficiency, competition, and capital formation.[2]

[1] Securities Act Sections 7, 10, 19(a); Exchange Act, Sections 3(b), 12, 13, 14, 15(d), and 23(a).

[2] Securities Act §2(b); Exchange Act § 23(a)(2); see *American Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010).

The following analysis raises concerns that the Proposal is neither necessary nor appropriate for either investor protection or the public interest and will not promote other statutory goals. The SEC would do better to withdraw the Proposal and revisit the subject with a fresh approach focused on America's ordinary investors rather than an elite global subset. The three parts of this letter address each statutory issue in turn, as follows:

I. "Investor Demand" versus "Investor Protection"

The SEC and its proponents rely heavily on "investor demand" as a way to invoke SEC authority based on investor protection. When a substantial portion of investors across all segments of the investment industry and across the investing public concur in the appropriateness and/or necessity of SEC intervention, "investor demand" is a credible rationale for SEC regulation. Prominent examples are accounting reforms that the SEC undertook pursuant to the Sarbanes-Oxley Act of 2002 as well as the specific targeted disclosure requirements it adopted concerning "Year 2000 issues" arising from systemic risk of widespread software malfunctions when the calendar reached January 1, 2000.

However, on divisive political topics of uncertain and inchoate corporate significance, like climate change, such a consensus is elusive. In this context, people's opinions differ sharply and investors have varied views on issues associated with the earth's climate, including whether and how to incorporate the concept into their investment processes. Many investors have long done so implicitly, some have recently begun doing so with great fanfare, and others have no plans to do so. Therefore, asserting "investor demand" from the most vocal segment of the investment industry provides a dubious basis for the SEC to claim exercise of its statutory authority in the name of "investor protection."

A. Investor Varieties: Diverse Institutions and Individuals

The investors demanding climate-related information are overwhelmingly institutional asset managers who are managing other people's money, not their own. This raises the obvious question whether their advocacy is prompted by concern for their beneficiaries' returns or their own profitability. Two of the SEC's current major rulemaking proposals relating to private fund advisors each contain dozens of references to potential conflicts of interest between private advisors and their sophisticated clients.[3] Yet this Proposal makes not a single reference to potential conflicts of interest between retail asset managers and their less-sophisticated clients, instead taking it as given that what is good for the asset manager is good for the beneficiary.

To determine whether adopting the Proposal will protect investors, the SEC must explicitly consider the conflicts that arise between large asset managers and their beneficiaries and whether climate disclosure mandates will exacerbate them.[4] There is no indication that the SEC has attempted to assess, much less quantify, the potential losses to individual investors from self-interested voting or engagement by the asset managers to whom 160 million Americans entrust their savings. That fact alone is a fatal flaw of the Proposal.

1. <u>The Most Vocal Institutions</u>.

The Proposal refers to "investor demand" 54 times, with copious citations tied to one segment of the investment industry.[5] The Proposal devotes five pages to introduce what it calls "growing investor demand," mainly by listing six consortia of large global institutions along with reported assets under management.[6] The list starts with three groups of such institutions that have signed the United Nations' policy advocacy documents urging countries to reduce climate risks.

The United Nations is neither a business nor an investor and lacks any relevant expertise in either domain. It is a political institution coordinating international policies on contentious topics, including as an incubator of the concept of "ESG" and climate management that provide the backdrop for the Proposal.[7] The other three groups are avowed climate activists, reflected in their names: Net Zero Asset Managers Initiative, Climate Action 100+ and Glasgow Financial Alliance for Net Zero.

The Proposal does not identify these investors nor indicate the portion of the reported assets invested in SEC registrants as compared to other investments around the world.[8] Aside from obvious member overlap in the first two referenced initiatives, the Proposal does not disclose overlaps in these numbers, except a vague general acknowledgement that "There is some overlap in the signatories to the listed initiatives."[9]

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[3] SEC, Release No. IA-5950; File No. S7-01-22, https://www.sec.gov/rules/proposed/2022/ia-5950.pdf and SEC, Release Nos. IA-5955; File No. S7-03-22, https://www.sec.gov/rules/proposed/2022/ia-5955.pdf.

[4] See Paul G. Mahoney & Julia D. Mahoney, The New Separation of Ownership and Control: Institutional Investors and ESG, 2021 Columbia Business Law Review 840.

[5] See Appendix hereto for an analysis of the citation patterns in the Proposal.

[6] Proposal, pages 25-29 (repeated at pages 332-333).

[7] ESG refers to "environmental, social and governance" principles that the United Nations believes should guide all management and investment decisions worldwide. See U.N. Principles for Responsible Investment, https://www.unpri.org.

[8] The Appendix hereto notes that, of the seven investors the Proposal relies upon most, four are non-U.S. entities, organized in Canada, England, France, and Scotland.

[9] Proposal, footnote 56.

Nor does the Proposal disclose the proportion of the listed assets under management invested in SEC registrants that are actively managed versus passively managed. It does not delineate other important matters of investment style, particularly whether these investors follow traditional fundamental valuation analysis, conventional diversification based on modern portfolio theory, or fashionable indexing based on rankings of companies according to their climate-related practices. It does not delineate which of these investors invest for their own account or on behalf of clients or the breakdown of such clients between institutions or individuals.

Such investor demographics and styles are essential predicates to determining whether there is a need for rulemaking along the lines stated in the Proposal.[10] Such an understanding of which institutions are expressing such demand is particularly important for SEC disclosure regulations because these investor types demand different kinds of information and utilize it differently.[11] For instance, traditional index funds do not select stocks by parsing SEC disclosure but rather formulaically buy and sell based on fluctuations in an index, without regard to such disclosure.[12] Traditional stock pickers scrutinize such information carefully to ascertain business value, economic advantages, and investment trajectory.[13]

BlackRock, State Street, and other large index fund providers face a challenging competitive environment. Fees for index funds have been driven nearly to zero. Profitability therefore depends on spreading the managers' fixed costs over a larger pool of managed assets. In attempting to attract investment inflows, large index funds compete against one another and with active managers. The latter have a built-in advantage in attracting socially conscious investors because they can offer non-indexed products specifically catering to ESG-focused investors.

For the manager of an index fund that must invest in all or substantially all companies in the index, public statements that climate is a top priority across the entire portfolio can be an important competitive marketing tool. A recent academic article makes the point cogently:

> [I]ndex funds are locked in a fierce contest to win the soon-to-accumulate assets of the millennial generation, who place a significant premium on social issues in their economic lives. With fee competition exhausted and returns irrelevant for index investors, signaling a commitment to social issues is one of the few dimensions on which index funds can differentiate themselves and avoid commoditization.[14]

While index funds may be interested in using climate-friendly voting and engagement as a marketing device, they cannot afford to incur substantial new costs to do so. A mandatory climate

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[10] See SEC Office of Inspector General, Follow-Up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Act Rulemakings, Report No. 499 (Jan. 27, 2012) at 31-36.

[11] E.g., Amir Amel-Zadeh & George Serafeim, Why and How Investors Use ESG Information: Evidence from a Global Survey, 74 Financial Analysts Journal 87 (2018).

[12] See John C. Bogle, The Little Book of Common-Sense Investing: The Only Way to Guarantee Your Fair Share of Stock Market Returns (2017); Burton G. Malkiel, A Random Walk Down Wall Street (12th ed. 2019).

[13] See Benjamin Graham & Jason Zweig, The Intelligent Investor: The Definitive Book on Value Investing (rev. ed. 2009); Warren E. Buffett & Lawrence A. Cunningham, The Essays of Warren Buffett: Lessons for Corporate America (5th ed. 2019).

[14] Michal Barzuza, Quinn Curtis & David H. Webber, Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance, 93 USC Law Review 1243, 1244 (2020).

disclosure regime requiring publicly traded companies to bear the cost of producing and standardizing the climate-related information would save such funds costs while advancing their agendas. The Proposal fails to assess how its rules will affect different segments of the investment industry differently; it also fails to consider alternative approaches that would avoid favoring some sectors at the expense of others.[15]

Another subgroup of investors the Proposal unfairly favors are those who, unlike traditional investors, are not focused on economic gain from their investments. For instance, the boards of public employee pension funds, such as CalPERS, include government appointees and elected officials, all of whom respond to politics, including the politics of climate change.[16] Less overtly, the Proposal benefits fund managers promoting virtues other than investor protection, such as the pension funds of the AFL-CIO, which advocate shareholder proposals pushing a labor agenda.[17]

Another powerful force in certain segments of the investment industry are proxy advisors, such as Institutional Shareholder Services (ISS). These organizations invest heavily in nonfinancial products such as climate ratings. For instance, ISS's ESG ratings unit assigns sustainability ratings to companies. Then ISS's Corporate Solutions unit turns around and sells a separate set of services to those companies to improve their ratings.[18] Pushing companies to disclose more and more of the information contemplated by the Proposal, and to reset behavioral baselines around such services, may well be good for ISS's business. But the SEC's assessment of "investor demand" should adjust for these powerful forces.

2. <u>The Unsung: Individual Investors</u>.

The investor group most in need of the SEC's "protection" are not the multi-trillion-dollar funds the Proposal repeatedly emphasizes, but the 160 million individual American investors who cannot fend for themselves. Yet, inexplicably, while the Proposal repeatedly cites the interests of such powerful institutions, it mentions individual investors only once in 508 pages. This occurs

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[15] See *Business Roundtable v. SEC*, 647 F.3d 1144, 1150 (D.C. Cir. 2011).

[16] See David Webber, The Rise of the Working-Class Shareholder: Labor's Last Best Weapon (2018).

[17] See Ashwini K. Agrawal, Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting, 25 Review of Financial Studies 187 (2012).

[18] ISS offers an "ESG Corporate Rating." It solicits business from companies in email campaigns. These announce that ISS plans to assign a rating to the solicited company, inviting management to participate. The email describes the process, stressing that it gives "prime status" to companies ISS dubs "sustainability leaders." A footnote explains that ISS ESG is the corporate arm selling to ISS's investor clients and that its sister subsidiary, ISS Corporate Solutions (ICS), sells to corporate issuer clients to enable them to improve their ISS ESG ratings. The footnote continues:

> To manage any potential conflict relating to ICS, ISS has implemented a firewall designed to prevent information flows regarding the identity of ICS clients (or potential clients). Pursuant to ISS' "firewall" policies, ISS personnel are prohibited from being made aware of the identity of corporate issuers that are clients (or prospective clients) of ICS. The intent of this firewall is to avoid the appearance or possibility that ISS research regarding an issuer could be affected by the knowledge that the issuer is a client of ICS. *To the extent that your company has purchased any products or services from ICS, we ask that you do not disclose to ISS or its employees, either directly or implicitly, that you are a client or potential client of ICS.* (Italics in the original.)

when it says that if institutional analysts digest the detailed climate disclosure using certain advanced software:

> this would likely benefit retail investors, who have generally been observed to rely on analysts' interpretation of financial disclosures rather than directly analyzing those disclosures themselves.[19]

The SEC should not give America's individual investors such short shrift. To the contrary, the SEC should directly attempt to gauge the level of investor demand among individuals for the controversial and expensive disclosures the Proposal envisions. Relevant research raises serious doubts about whether individual investors share the SEC's enthusiasm for such disclosure and the SEC should take these views into consideration.

For instance, when scholars explicitly distinguish institutional from investor "demand," they find that "ESG disclosures are irrelevant to retail investors' portfolio allocation decisions."[20] A recent survey of individual investors co-sponsored by FINRA indicates that most do not share the institutional enthusiasm for "ESG investing," many are unfamiliar with it, and one-fourth think the acronym stands for "earnings stock growth."[21]

The SEC would also do well to ask the institutions "demanding" such information whether they have polled their individual clients, the ultimate investors, to determine whether they agree on the desirability or need for such information. That would provide a more meaningful measure of "investor demand" than the Proposal presents. It would also help assure that such institutions are meeting their fiduciary duties when managing assets for others.[22] The empirical evidence also raises doubts about whether institutional investors, particularly public pension funds, are doing so.[23]

The Proposal makes much of the assertion that large institutional money managers say that climate policy is the number one thing they like to discuss with companies during their engagements with them.[24] In doing so, the Proposal overlooks two critical features of such shareholder engagement.

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[19] Proposal, page 384.

[20] See Austin Moss, et al., The Irrelevance of ESG Disclosure to Retail Investors: Evidence from Robinhood (2020), https://papers.ssrn.com/abstract_id=3604847.

[21] See Lauren Foster, Investors Know Little About ESG, a New Study Finds, Barron's (April 12, 2022), https://www.barrons.com/articles/esg-meaning-sustainable-investing-study-51649719876 (citing survey of 1,128 individual investors indicating that only 9% say they have ESG-related investments).

[22] See Max M. Schanzenbach & Robert H. Sitkoff, Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee, 72 Stanford Law Review 381 (2020).

[23] See Jean-Pierre Aubry, et al., ESG Investing and Public Pensions: An Update, Boston College Center for Retirement Research (2020) ("The evidence suggests, however, that social investing: 1) yields lower returns; and 2) is not effective at achieving social goals. Hence, *any form of social investing is not appropriate for public pension funds*.") (emphasis added).

[24] Proposal, pages 330-331 (citing survey of 42 large institutions managing $29 trillion in assets indicating that climate risk is "the number one investor engagement priority" or the "leading issue driving their engagement with companies").

First, the practice of shareholder engagement is relatively new and is evolving.[25] At present, most institutional investors continue to prioritize engagement with those companies and on those topics of special interest for particular reasons, not recurring matters of business life. If they are prioritizing climate, that may not reflect pervasive investor demand as much as it does specific issues at certain companies or specific priorities for certain investors and their business models.

Second, the SEC overlooks that while institutional investors may have the power and influence to get engagement meetings with companies, individual investors do not. Individual investors must be content with annual shareholder meetings and periodic investor Q&As. To elevate the priorities and practices of such privileged institutions over those of individual shareholders is perverse for an agency whose historical raison-d'etre and current website emphasize protecting individual investors.[26]

B. Climate Shareholder Proposals: Few Are Made, Most Lose, Many Are Political

The SEC and other proponents arguing investor demand as the force behind the Proposal cite shareholder proposal proliferation as evidence.[27] In theory, this could be a fruitful source of evidence about investor protection issues. The shareholder proposal process has been a recognized method for shareholders to register their voice. One or more shareholders or nominal shareholders submit proposals for votes at annual meetings, using SEC proxy rule 14a-8. The board weighs in. Shareholders vote. The board decides what to do, in accordance with longstanding state corporation law.

The SEC and proponents say ecological stewardship by corporate directors is important to investors by citing the rising number of shareholder proposals on the topic and "increasing" shareholder votes favoring them. They do not point out, however, that few such proposals are made, being limited to a minority of public companies; most lose; and many are made not by traditional investors but by political activists taking advantage of the shareholder proposal process.

Consider data from 2020 and 2021.[28] Across some 12,000 SEC companies, 720 and 802 shareholder proposals were received, respectively, in those two years. The greatest percentage concerned governance topics (40% and 36% of each year's total); a small portion addressed climate change (8% and 14%). The lion's share of climate change proposals was filed by climate activist "As You Sow Foundation." While quite a few governance proposals won supermajority support (in excess of 80%), few climate proposals eked out a simple majority (4 in 2020, 11 in 2021).

When a climate proposal carries by a majority of votes, the victories are so unusual that the press presents them vividly.[29] Such spotlights may lead people to believe that the trends

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[25] See Shareholder Engagement: An Evolving Landscape, Drexel University https://www.lebow.drexel.edu/news/shareholder-engagement-evolving-landscape.

[26] See Lawrence A. Cunningham, SEC's Climate Change Proposal Gives Main Street Investors No Voice: Here's How to Make Yourself Heard, MarketWatch (April 9, 2022).

[27] Proposal, page 334 and footnote 803.

[28] See Gibson Dunn, Shareholder Proposal Developments During the 2020 Proxy Season (August 2020); See Gibson Dunn, Shareholder Proposal Developments During the 2021 Proxy Season (August 2021).

[29] E.g., Fight for the Soul—and the Future—of ExxonMobil, Washington Post (May 22, 2021); see also Majority Support for E&S Proposals Almost Doubles in US, Corporate Secretary (October 28, 2021)

favoring such proposals are stronger than they are. In fact, the important victories on climate matters have congregated in the companies producing the greatest emissions and facing corresponding risks, particularly energy companies. And even the headline grabbing proxy contest vote at ExxonMobil carried by only 62% and emissions disclosure votes were approved by relatively low margins at ConocoPhillips (by 59.3%) and Chevron (60.7%).

From another point of view, moreover, the number of climate-related shareholder proposals is a poor measure of investor protection. Late last year, the SEC Staff announced a new approach to its review of no-action requests to exclude shareholder proposals concerning ordinary business operations.[30] The Staff indicated that it will not permit exclusions of proposals so long as they "relate to a significant social policy issue." The Staff thus acknowledges that many climate-related proposals are not related to a company's business operations.

The SEC and the Proposal are therefore at war with themselves: the SEC would simultaneously prohibit public companies from excluding shareholder proposals relating to "ordinary business" yet portray the proliferation of such proposals as evidence of the "business case" for climate-friendly practices. If the SEC intends to draw a link between the number of climate-related shareholder proposals and the protection of investors, it must first study whether such proposals reflect business interests shared broadly by all investors or the political preferences of a subset.

As a preview of what such a study might show, during the 2022 proxy season so far, 65 shareholder resolutions propose that a company adopt greenhouse gas emissions goals.[31] Most were submitted by organizations whose websites unambiguously indicate that their objective is to pursue political values, not investment returns. Many of these filers, in turn, are among the authorities the SEC cites most often in the Proposal, particularly CERES and As You Sow.[32]

In short, the evidence from shareholder proposal practices does not support the case that "investor demand" justifies invoking the SEC's "investor protection" authority to pass the Proposal. At best, it reveals the political activism of a powerful subset. Assessed objectively, the evidence rather suggests that investors and managers are working together to determine which companies ought to disclose what information, not that all companies must now produce standardized data.

C. The Ample Supply of Climate Disclosure

As of 2021, nearly half of SEC registrants adhere to one of the leading international reporting authority's frameworks for disclosing risks and impacts of climate change.[33] Such

(despite the headline, reporting that 23 of 36 environmental proposals failed to attract a majority of the votes and average support was 39%).

[30] Securities and Exchange Commission, Division of Corporation Finance, Staff Legal Bulletin No. 14L (Nov. 3, 2021), https://www.sec.gov/corpfin/staff-legal-bulletin-14l-shareholder-proposals (concerning a company's authority to exclude shareholder proposals from proxy statements under SEC proxy rule 14a-8(i)(7)).

[31] Proxy Preview 2022, https://www.proxypreview.org.

[32] See Appendix hereto.

[33] See Sankalp Gaur, et al., TCFD-Aligned Reporting by Major U.S. and European Corporations, Moody's Analytics (February 2022).

adherence to private frameworks provides useful information to shareholders who digest this information in their investment process. The homogenized data the SEC proposes may please a powerful vocal cohort of asset managers and meet their demands for a single standard for comparative purposes. But the data would be paid for by individuals and other shareholders, whether or not they desire such information.

Revealingly, industry sectors leading in climate disclosure are among the most carbon-intensive sectors: energy and building materials.[34] Sectors with lower disclosure are industries like technology and telecommunications, which face limited climate-related risks. Such trends show that the system is working towards the intended effect of the SEC's 2010 interpretive guidance, which instructed firms to disclose material risks specific to their business from climate change.[35] Imposing a standardized framework may produce more raw data, but it will do little to get shareholders additional information they utilize for investment decisions.[36]

By the same token, there is evidence that the market already has the information needed to enable individual investors to continue to invest in traditional actively-managed or index funds or migrate to the fashionable funds promoted as prioritizing climate-consciousness or other political causes. For instance, the Proposal cites data indicating that in the past few years, individual investors have allocated a far larger portion of net investment dollars to funds boasting social or political priorities compared to those offering traditional investments.[37]

While the Proposal presents the allocation of investment dollars to social and political funds as evidence supporting the case for mandating information, a more plausible interpretation is that investors have the information they need to make such choices. Certainly, if the funds have sufficient information to market their financial products as environmentally conscious, for instance, they must have enough useful information to support the assertion.[38] If they did not, the SEC should investigate such funds for compliance with applicable investor protection laws. At the

[34] Id.

[35] SEC, Disclosure Related to Business or Legal Developments Regarding Climate Change (2010).

[36] Increasing the supply of information to satisfy the demand of one distinctive cohort may be myopic even from the viewpoint of proponents. For instance, the proposed regime may instead induce a false sense of complacency, alleviating social anxieties more than mitigating climate change. See Michael Power, The Audit Society: Rituals of Verification 138-147 (1997). Such regulation may even create its own pathologies such as collection, reporting, control and auditing practices "oriented towards the production of comforting labels." Id.; see also Lawrence A. Cunningham, The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills, 29 Iowa Journal of Corporation Law 267 (2004).

[37] Proposal, footnote 804 (since 2019, $473 billion versus $103 billion).

[38] A different interpretation of the data than the SEC offers is also possible: that such high flows to the fashionable funds reflects the faddish appeal of this style of investing compared to stodgy old fundamental value investing. See Scientific Beta, "Honey, I Shrunk the ESG Alpha": Risk-Adjusting ESG Portfolio Returns (April 2021) ("Recent strong performance of ESG strategies can be linked to an increase in investor attention."), https://cdn.ihsmarkit.com/www/pdf/0521/Honey-I-Shrunk-the-ESG-Alpha.pdf.

Yet another explanation, at least in the case of BlackRock clients, is that BlackRock has simply been redirecting client funds into ESG funds whether or not the clients are aware of this or request it. See Cam Simpson & Saijel Kishan, How BlackRock Made ESG the Hottest Ticket on Wall Street, Bloomberg (December 31, 2021), https://www.bloomberg.com/news/articles/2021-12-31/how-blackrock-s-invisible-hand-helped-make-esg-a-hot-ticket.

very least, the SEC must consider reasonable alternatives to the Proposal that address the existing supply of climate-related information.[39]

Moreover, the Proposal does not explain why climate risk information warrants compelled disclosure, rather than rely on voluntary disclosure, compared to information about all the other risks a company faces. After all, companies must manage many risks that government could in principle require specific disclosure on. With that disclosure, investors would have more information, which, in theory, should lead to better decision making. If there were no costs, government could require disclosure of all of them.

But there are costs, and so a line must be drawn. The SEC's original disclosure regime focused on an audited set of financial statements that investors would find useful. Related accounting rules, ultimately generally accepted accounting principles (GAAP), provided the anchor. Expected future events, to be disclosed, had to pose a material risk on ensuing financial statements. Most SEC disclosure rules remain anchored to such principles.[40]

The Proposal, however, is not anchored to any principles. It is unmoored and does not offer any limiting principle to what the SEC can compel companies and their managers to declare. Its potential costs are therefore unlimited. The SEC must articulate a reasoned—non-arbitrary and non-capricious[41]—basis to distinguish climate change not only from financial reporting but also from the myriad other risks businesses face, such as war, pandemic, monetary policy or social and political concerns such as transacting with companies in China or Russia.

Since disclosure is costly to companies, requiring disclosure must also confer benefits greater than their costs on those companies and their investors. Presumably this benefit is directly tied to investors being able to use the information that is disclosed. But consider two facts: (1) numerous climate models exist and none of them agree with each other and (2) take any climate model and feed in the conditions of the past, and they are unable to predict the present.[42] In a setting so beset with inherent imprecision, it is most challenging to see how investors will benefit from such disclosure.

A related issue is the definition of "climate risk." Climate evolves over decades and centuries. A report by the Basel Committee on Banking Supervision highlights the practical difficulties and inherent unreliability of calculating climate risk information:

> the range of impact uncertainties, time horizon inconsistencies, and limitations in the availability of historical data on the relationship of climate to traditional financial risks, in addition to a limited ability of the past to act as a guide for future developments, render climate risk measurement complex and its outputs less reliable as risk estimators.[43]

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[39] *Chamber of Commerce v. SEC*, 412 F.3d 133, 144-5 (D.C. Cir. 2005).

[40] E.g., Items 101, 103, 105, 303, and 503(c) of Regulation S-K.

[41] Administrative Procedure Act, 5 U.S.C. 706(2); *Business Roundtable v. SEC*, 647 F.3d 1144, 1150 (D.C. Cir. 2011).

[42] See Steven E. Koonin, Unsettled: What Climate Science Tells Us, What It Doesn't, and Why It Matters (2021).

[43] Basel Committee on Banking Supervision, Climate-Related Financial Risks—Measurement Methodologies (April 2021) p. 17 https://www.bis.org/bcbs/publ/d518.pdf.

How will SEC reporting companies declare risk exposure to such long-term change? Even if it were feasible to do so, despite the limits of climate models, how will companies characterize the risk itself? To calculate exposure, they would need, at the very least, a distribution of the risk. Where will that come from?

On the other hand, the risk could be that companies are exposed in the shorter term to changing attitudes to products thought to harm the environment. Clearly that will affect businesses and will expose them to risks. But how is that different from any risk firms face with changing preferences? It would be unprecedented for the SEC to mandate disclosure modeling the risks of shifting consumer preferences.

At a minimum, the SEC should specify what benefits investors will derive from the disclosure contemplated by the Proposal. Otherwise, without such a foundation, the government may simply cite "investor demand" to exert control over private companies in ways that constrain other investors' choices, returns and protection.

D. Correlation of Climate Practices with Economic Performance Is Not Causation

Proponents say that investors increasingly use climate information in their investment processes, that companies that fail to provide this information deprive investors of this capability, and that the SEC is therefore authorized to compel the creation and disclosure of such information as a matter of investor protection. They say investors take such an approach to evaluate the long-term viability of a company's business model, its adaptability to potential future regulation, and its susceptibility to reputational harm. Many say that investors perceive a connection between a company's climate practices and its economic performance. Some acknowledge that the goal is to compel companies to incorporate climate matters into operational decision making.

To take these points in reverse order, it would be beyond the SEC's authority to compel the creation and disclosure of any information for the purpose of inducing companies to modify their operational decision making in any way. That is the province of state corporation law, and not within the SEC's jurisdiction, as Part II of this letter will explain. Indeed, the SEC has never questioned the basic decision of the Congress that, insofar as investing is concerned, the primary interest of investors is economic.[44] Departures from this principle would require explicit Congressional directive.[45]

Second, despite its repeated invocation, the perception of a causal link between ideal climate conservation and superior economic returns is fallacious.[46] There is *no such causal evidence*. Abundant empirical research has been conducted to test for aspects of the relationship between climate practices and economic performance.

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[44] See Securities Act of 1933 Release No. 5569 (February 11, 1975) & Securities Exchange Act of 1934 Release No. 5627 (Oct. 14, 1975):

> The SEC's experience over the years in proposing and framing disclosure requirements has not led it to question the basic decision of the Congress that, insofar as investing is concerned, the primary interest of investors is economic. After all, the principal, if not the only, reason why people invest their money in securities is to obtain a return.

[45] *National Association of Manufacturers v. SEC*, 800 F.3d 518 (D.C. Cir. 2015).

[46] See Sanjai Bhagat, An Inconvenient Truth About ESG Investing, Harvard Business Review (March 31, 2022), https://hbr.org/2022/03/an-inconvenient-truth-about-esg-investing.

For example, researchers have found a variety of relationships, some positive,[47] some non-negative,[48] some negative.[49] Several attribute most of any relationship to the disproportionate presence of low-carbon high-performing technology stocks in many outperforming portfolios.[50] Yet others raise serious questions about the existence of any relationship whatsoever.

In summary, despite tremendous research efforts, *no substantial evidence* exists to suggest any causation between climate practice and superior economic performance.[51]

It is insufficient to counter, as some do, that compelling the production and presentation of such information is lawful because it will enable researchers to test whether sustainability practices really do cause superior economic performance. For instance, the U.S. Court of Appeals for the District of Columbia Circuit recently struck down an SEC rule designed to experiment with stock market bid-ask spreads.[52]

Moreover, any claim of causation would also necessarily imply suboptimality. That is, if such causation is asserted, then the Proposal is also asserting that managers are either unaware of this causation or are not maximizing shareholder value. Either way, the SEC is implying that it knows better how to run a firm than the firm's managers do.

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[47] E.g., Ramakrishnan Ramanathan, Understanding Complexity: The Curvilinear Relationship Between Environmental Performance and Firm Performance, Journal of Business Ethics (Feb. 26, 2016); Soh Young In, et al., Is 'Being Green' Rewarded in the Market?: An Empirical Investigation of Decarbonization and Stock Returns, Stanford Global Project Center (Aug. 21, 2017); Timo Busch, The Robustness of the Corporate Social and Financial Performance Relation: A Second-Order Meta-Analysis, Corporate Social Responsibility and Environmental Management (March 30, 2018); Camille Smith, et al., ESG Factors and Risk-Adjusted Performance: A New Quantitative Model, Journal of Sustainable Finance & Investment (June 13, 2016); Ikram Radhouane, et al., The Impact of Corporate Environmental Reporting on Customer-Related Performance and Market Value, Management Decision (July 9, 2018).

[48] E.g., Jun Xie, et al., Do Environmental, Social, and Governance Activities Improve Corporate Financial Performance? Business Strategy and the Environment (Aug. 14, 2018) (finding that most ESG activities have a "nonnegative relationship" with corporate financial performance); Lars Kaiser, ESG Integration: Value, Growth and Momentum, Journal of Asset Management (Jan. 25, 2020) (finding that integrating ESG into traditional investment strategies does not burden risk-adjusted performance).

[49] E.g., Scientific Beta, "Honey, I Shrunk the ESG Alpha": Risk-Adjusting ESG Portfolio Returns (April 2021); Samuel Hartzmark & Abigail Sussman, Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows, Journal of Finance; Aneesh Raghunandan & Shivaram Rajgopal, Do ESG Funds Make Stakeholder-Friendly Investments? (November 19, 2021), https://ssrn.com/abstract=3826357; Rajna Gibson Brandon, et al., Do Responsible Investors Invest Responsibly? https://ecgi.global/working-paper/do-responsible-investors-invest-responsibly.

[50] E.g., Akane Otani, Big Technology Stocks Dominate ESG Funds, Wall Street Journal (Feb. 11, 2020); Camila Hodgson, Funds Branded "ESG" Are Laden with Technology Stocks, Financial Times (Aug. 14, 2020).

[51] See Bradford Cornell & Aswath Damodaran, Valuing ESG: Doing Good or Sounding Good? (2020), https://papers.ssrn.com/abstract_id=3557432.

[52] *New York Stock Exchange v. SEC,* No. 19-1042 (D.C. Cir. 2020).

II. Authority of Others and the "Public Interest"

In theory, the SEC could claim authority to promulgate the Proposal under the "public interest" prong of its statutory power. Weak as the grounding in investor protection is, however, a public interest rationale is even more problematic.

A. The Environmental Protection Agency's Statutory Jurisdiction

Climate change is perhaps the most important public policy question of our time, as the SEC's leadership's repeated assertions attest.[53] Commissioners and other officials have stressed in speeches and other forums that climate poses enormous economic and political consequences. Congress is aware of these and has long been active on the topic.[54]

The Clean Air Act of 1974 expressly delegates climate disclosure regulation, particularly greenhouse gas emissions, to the Environmental Protection Agency (EPA). The EPA exercises that authority through its Greenhouse Gas Reporting Program, which currently measures and reports on almost all such emissions in the United States from all sources. A general principle of federal law holds that more recent and specific laws addressing a subject matter supersede earlier and more general laws on that subject.

Accordingly, the EPA's empowerment over this topic probably preempts any statutory authority the SEC might claim. For another apt analogy, the SEC should consider the landmark Supreme Court ruling that the ERISA statute, under the jurisdiction of the Department of Labor, abrogates the jurisdiction of the federal securities laws and the SEC's regulation.[55]

Concerning major questions such as climate change, moreover, federal law also recognizes that Congress can be expected to speak explicitly, thereby narrowing the scope for inferences of authority such as the SEC necessarily relies upon. Indeed, this was the rationale for the Supreme Court's recent repudiation of an agency rule imposing national COVID vaccination requirements.[56] Congress had not clearly authorized the agency to do so as is expected concerning matters of "vast economic and political significance." The SEC should take heed of such Supreme Court guidance.

B. State Corporate Law Prerogatives on Purposes, Powers and Business Judgments

Many advocacy groups the SEC cites for action make it clear that their passion on climate change leads them to want significant changes in behavior.[57] Many champions of ESG generally are equally clear in their passion that corporations should not prioritize shareholder interests but treat all stakeholders equally.[58]The Proposal provides a mechanism for implementing those

[53] See Joseph P. Grundfest, The SEC is Heading Toward a Climate Train Wreck, Bloomberg (April 5, 2022).

[54] As an indicator of that awareness, as well as a measure of the highly political nature of the Proposal, it prompted letters from 19 Senators and 40 House Members challenging the SEC's power and urging it to withdraw the Proposal.

[55] *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979).

[56] See *National Federation of Independent Business v. Department of Labor,* 595 U.S. ____ (2022).

[57] See Appendix hereto.

[58] See Ann M. Lipton, Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure, 37 Yale Journal on Regulation 499, 532 (2020): ("[t]he goal, in short, is to make sustainability information

advocacy groups' desired outcomes that they have not been able to accomplish through legislative changes.

The Proposal, a radical departure from current law, would require companies to disclose extensive climate-related risks that have little to do with firms' current financial outlook but serve an ulterior political purpose.[59] For instance, the Proposal prescribes a wide range of detailed disclosure requirements. These start with emissions and extend to a company's governance, strategy, business model and outlook, risk management targets and goals and climate-related financial statement metrics. All such matters, while far afield from the information shareholders need for investment decision making, are extremely useful for advocacy groups' aims at influencing the behavior of corporations in which they have little, if any, economic stake.

But the SEC's mission does not include adopting positions intended to promote particular conceptions of acceptable corporate behavior. By law and tradition, that is the province of state corporation law, not federal securities law.[60] While a minority of critics have long sought to federalize corporate law by preempting state law, they have failed.[61] Those laws repose the power and duty to formulate corporate strategy in the board, not shareholders, and make boards accountable to shareholders above all other stakeholders. Courts defer to the business judgements that a board makes, including on matters of climate and their relationship to business.

The Proposal appears to be informed by a different vision, one in which a subset of shareholders dictate corporate policy, corporate mission is geared to all stakeholders not primarily shareholders, and boards no longer enjoy deference to their business judgment. But the SEC has generally respected these longstanding boundaries and has been repudiated when it failed to do so.[62]

Some portray the Proposal as purely a matter of disclosure, which is the standard guardrail delineating the boundary between federal securities law and state corporation law. But many consider such a portrait as disingenuous. At a minimum, the Proposal's scope, novelty, and highly politicized subject matter warrants far greater attention to this question than the SEC has given it.

C. Risk of Unconstitutional Compelled Political Speech

Governments in the United States may compel the disclosure of a wide variety of information but the government may make no law "abridging the freedom of speech," as the First Amendment puts it. Long-settled precedent forbids regulatory agencies such as the SEC to compel

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relevant to financial performance, even if it is not currently, by empowering noninvestor groups to pressure corporations into improving their behavior" and that, "[f]ar from pursuing investor wealth, much of the sustainability movement is designed to make corporate profits difficult to achieve unless management attends to the needs of noninvestor stakeholders").

[59] See Ruth Jebe, The Convergence of Financial and ESG Materiality: Taking Sustainability Mainstream, 56 American Business Law Journal 645, 669 (2019).

[60] E.g., *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977).

[61] See Roberto Romano, The Genius of American Corporate Law (1993).

[62] *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (dual class capital structures).

citizens, including officers and directors and corporate entities, from expressing particular views, whether on politically charged topics such as climate change or otherwise.[63]

Climate change is a politically-charged issue. The Proposal would compel corporations and officials to regularly speak on these issues, explaining the views and opinions of their boards and officers. As the Supreme Court made clear in prohibiting compelled speech as long ago as 1943:

> If there is any fixed star in our constitutional constellation, it is that no official, high or petty, can prescribe what shall be orthodox in politics, nationalism, religion, or other matters of opinion or force citizens to confess by word or act their faith therein.[64]

The compelled speech prohibition has been repeatedly reaffirmed by numerous federal courts in the context of SEC rulemaking. A prominent recent example rebuked Congress, and the SEC, for its attempted compulsion of political speech on the topic of "conflict minerals."[65]

Responding to the passions of a subset of investors demanding this information is not a sufficient government interest that might warrant such compulsion. Prudence alone counsels caution against the intrusive and prescriptive rules in the Proposal.

III. Other Statutory Considerations

Beyond investor protection and the public interest, amendments to the securities law statutes in the late 1990s instructed the SEC to report on whether a proposed regulation will promote efficiency, competition, and capital formation.[66] As suggested by the previous arguments, the Proposal would retard these objectives, as the following brief additional points affirm.

A. Certain High Costs versus Highly Speculative Benefits

The Proposal follows the form of cost-benefit analysis expected of U.S. federal agencies. The substance, however, leaves a great deal to be desired. It can be difficult to predict how a court would assess the validity of the SEC's cost-benefit analysis in the Proposal. But there is ample precedent of courts abrogating SEC rules for failure to conduct an adequate cost-benefit analysis and there are good reasons to doubt the sufficiency of that appearing in the Proposal.[67]

For one, climate change is a global issue not just in the political sense, but, more importantly, in the physical geographical sense. The Proposal, if implemented, would require extensive and costly disclosure, and likely greater focus on reduction of greenhouse gas emissions by SEC registrants, mostly U.S. listed companies.

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[63] Sean J. Griffith, What's "Controversial" About ESG? A Theory of Compelled Commercial Speech under the First Amendment (forthcoming 2022).

[64] *West Virginia State Board of Education v. Barnette*, 319 U.S. 624 (1943).

[65] *National Association of Manufacturers v. SEC,* 800 F.3d 518 (D.C. Cir. 2015).

[66] Securities Act §2(b); Exchange Act § 23(a)(2).

[67] *Business Roundtable v. SEC* (D.C. Cir. 2011) (vacating proxy access rule as arbitrary and capricious for lack of adequate cost-benefit analysis).

But, during the last two decades, greenhouse gas emissions have *decreased* in the U.S., whereas these emissions have *more than tripled* in China.[68] China is by far the largest global emitter of greenhouse gas, representing more than 30% of world emissions, compared with less than 15% for the U.S. The Proposal does not appear calculated to have any meaningful impact on China's emissions. Without a meaningful impact on China's greenhouse gas emissions, the Proposal, even if implemented, will not have a meaningful impact on climate change.

The SEC's cost-benefit analysis does not explain why it would impose such huge costs on American companies for so little payoff. The Proposal does make clear that the costs will be enormous, approaching an average of $1 million per company per year apiece. But the SEC recognizes that it cannot be sure of what benefits, if any, the Proposal will produce. The Proposal refers repeatedly to benefits that "could," "may" or "might" arise.

Institutional investors may be able to afford such an uncertain cost-benefit analysis. But individual investors have the right to know whether the effort is worthwhile. Indeed, as the Proposal expressly acknowledges, the focus of large index funds is on the average market return, not on the profitability of particular companies. While individual investors would care a great deal about how much a company paid in relation to the gain, institutional index investors might care little. In its next attempt to address this topic, the SEC should differentiate between the interests of powerful institutional investors and everyday American investors and delineate the different costs and benefits for each.

The SEC should also compare the purported gains to individual investors to the likely gains for other interested groups, especially the legal profession. The SEC recognizes that a major cost of the Proposal concerns litigation risk. But it suggests that costly lawsuits would be the result only for companies who fail to comply. In fact, however, detailed prescriptive disclosure rules like those proposed are magnets for lawsuits, including those that are frivolous or borderline. Such suits can cost tens of millions of dollars each and produce scant or no benefits for either particular companies or society. The SEC should both acknowledge and explain these trades-off candidly and clearly.

Litigation risk is amplified by the inherent uncertainty embedded in what the SEC is asking companies to disclose. For example, if a company fails to anticipate or disclose a risk of a climate related extreme natural disaster—such as a fire or flood—will the company face lawsuits for the board's failing to anticipate such a risk? The Proposal's extensive and prescriptive disclosures pose grave risks for issuers and investors alike.

B. Impairs Investment Industry Competition

The Proposal will unevenly benefit a vocal cohort of institutional investors whose business model is uniquely suited to gain from the disclosure regime proposed. These are mainly managers of funds that promote an orientation toward non-economic values, particularly climate consciousness. Other investors will share in bearing the cost of the Proposal, despite otherwise gaining no benefit themselves and, in the case of institutions serving investment clients, despite ceding competitive advantages to those rivals. The Proposal therefore functions as a means of inhibiting competition.

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[68] https://www.eia.gov/international/data/world.

From the U.S. perspective, moreover, the Proposal relies heavily on global institutions and institutional investors incorporated outside the U.S.[69] It is not obvious that such institutions share any concern for American competitiveness and the Proposal does not address this topic.

C. Compliance Burdens Discourage Public Company Registrations

Given its high costs and intrusive nature, the Proposal will continue to drive some companies into private equity rather than public markets. That impairs capital formation through public markets, contrary to the SEC's longstanding mission and value.

Conclusion

We respectfully urge the SEC to withdraw the Proposal. We are concerned that the passions of this topic have led the SEC to overzealous rulemaking that exceeds its authority. Governments, above all, must adhere to the rule of law, especially when officials believe honestly and fervently in a specific agenda. The federal securities laws focus on investor protection generally, while the Proposal prioritizes the demands of a subset of the global investment industry. We encourage the SEC to focus on all American investors, not just the most vocal and activist voices.

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[69] See Appendix hereto.

[70] The expertise reflected in this letter combines finance and law. While the signatories concur with the letter's principal arguments and themes, each person is not necessarily attesting to every assertion in the letter and we limit our opinions to those within our respective areas of expertise. Institutional affiliations are supplied for identification and are not intended to suggest that we speak for our respective institutions.

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Appendix: Analysis of the Proposal's Citation Patterns

The Proposal's citations skew heavily toward organizations that are prominent environmentalists, not prominent investors. The following are the seven organizations the Proposal cites most frequently (each cited in 14 to 28 different footnotes):

MOST CITED OVERALL	Footnotes
Environmental Protection Agency (EPA)	28
Carbon Disclosure Project (CDP)	27
Natural Resources Defense Council	22
American Institute of Certified Public Accountants (AICPA)	22
Coalition for Environmentally Responsible EconomieS (CERES)	21
Sustainability Accounting Standards Board (SASB)	19
United Nations Principles for Responsible Investment Corp. (PRI)	14

The investors the Proposal cites most frequently skew toward those focused on social and political investing and many are non-U.S. entities. The following are the seven investors the Proposal cites most frequently (each cited in 9 to 14 different footnotes; a majority are non-U.S.):

MOST CITED INVESTORS	Footnotes
New York State Comptroller	14
BNP Paribas (French)	12
BlackRock	11
Impax Asset Management (English)	9
Baillie Gifford (Scottish)	9
Trillium: Socially Responsible Investing	9
Northwest & Ethical Investments (NEI) (Canadian)	9

Of the 36 other organizations the Proposal cites heavily (at least 5 footnotes), 12 are climate advocacy groups.

OTHER MOST CITED	Footnotes
Climate Governance Initiative	12
Interfaith Center on Corporate Responsibility	9
Carbon Tracker Initiative	8
Regenerative Crisis Response Committee	7
Friends of the Earth	7
Amazon Watch	6
Partnership for Carbon Accounting Financials (PCAF)	5
As You Sow	5
Center for Climate and Energy Solutions	5
Institute for Governance and Sustainable Development	5
World Benchmarking Alliance	5
World Resources Institute	5