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June 17, 2022

Vanessa A. Countryman, Secretary
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 Ms. Countryman:

Thank you for the opportunity to comment on the above-reference proposal. My comments relate to the heightened securities law liability risk that the proposed disclosure mandates would impose on registrants. This is a topic that I believe is not given sufficient consideration in the proposing release. The release identifies litigation risk as an indirect cost of the proposed rules and devotes two paragraphs to it. Specifically, the release states:

> In addition to the direct costs of preparing climate-related disclosures, the proposed rules could also lead to indirect costs. For example, the proposed rules may result in additional litigation risk since the proposed climate-related disclosures may be new and unfamiliar to many registrants. The proposed rules would significantly expand the type and amount of information registrants are required to provide about climate-related risks. Registrants unfamiliar preparing these disclosures may face significant uncertainty and novel compliance challenges. To the extent this leads to inadvertent non-compliance, registrants may face additional exposure to litigation or enforcement action.
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> However, certain factors may mitigate this concern. First, existing and proposed safe harbors would provide protection from liability for certain statements by registrants, including projections regarding future impacts of climate-related risks on a registrant's consolidated financial statements and climate-related targets and goals. Second, the proposed rules would include phase-in periods after the effective date to provide registrants with sufficient time to become familiar with and meet the proposed disclosure requirements.[1]

I believe that this discussion is flawed and incomplete in important respects, as I detail in my comments below.

[1] Release p.388.

1. The discussion assumes that registrants will only face additional exposure to litigation "[t]o the extent" that they "inadvertent[ly] non-compl[y]" with the new disclosure obligations.[2] That is a clearly flawed assumption. Registrants making fully compliant disclosure choices under the proposed rules would also face heightened liability risk. I urge the Commission to reconsider the costs of litigation risk based on the accurate assumption that securities fraud class actions sometimes challenge correct disclosure choices, such as a registrant's choice to omit information that was not material or the disclosure of which was unnecessary to make other statements made not misleading, and that such cases impose burdens on registrants.

2. The "newness" of the proposed disclosures and registrants' resultant "unfamiliarity" with them is not the primary reason why the proposed rules would result in additional litigation risk, and consequently phase-in periods will not significantly mitigate the concern. The amount of information that registrants would be compelled to provide in their Commission filings regarding, *inter alia*, climate-related risks, the potential impacts of those risks, and how management is considering and addressing those risks, would vastly expand registrants' vulnerability to so-called "event-driven" securities fraud litigation. In my article *A Response to Calls for SEC-Mandated ESG Disclosure*, 98 WASH. U. L. REV. 1821 (2021), which I previously submitted in response to Commissioner Lee's March 15, 2021 request for input on climate change disclosures, I explain the phenomenon of event-driven securities litigation, the concerns this type of litigation raises, the reasons for those concerns, and why expanding so-called "ESG" disclosure mandates would make event-driven securities litigation more likely. I hereby resubmit my article as an attachment to this letter and urge the Commission to consider the points raised at pages 1847-1854. If the proposal becomes law in its current form, any registrant that experiences a climate-related event that has a negative effect on its stock price will be vulnerable to a federal securities fraud class action. This would be a boon to securities litigators but would impose real costs on investors.

3. The discussion also points to the existing safe harbor for forward-looking statements contained in the PSLRA as mitigating concerns about heightened litigation risk. However, the protection afforded by this safe harbor is limited in important ways.

    a. First, the safe harbor is only potentially applicable if a court views a complaint as challenging a "forward-looking statement," and courts may find it inapplicable in cases alleging fraud due to, *inter alia*, the non-disclosure of a climate-related risk or based on a registrant's characterization of its current efforts to mitigate climate-related risks.

    b. Second, as the release acknowledges, the safe harbor is inapplicable in IPO registration statements. As I discuss in my paper *SPAC Mergers, IPOs, and the PSLRA's Safe Harbor: Unpacking Claims of Regulatory Arbitrage*, 64 WILLIAM & MARY L. REV. – (forthcoming 2023), which I hereby submit as an attachment to this

[2] *Id*.

letter, the typical response of IPO issuers to Section 11 liability exposure coupled with the inapplicability of the PSLRA safe harbor is to avoid any public disclosure of projections. Silence will not be an option for avoiding Section 11 liability risk for the mandatory forward-looking disclosures proposed in the release. If the specter of this liability does not discourage firms from going public in the first place, it will likely cause firms to incur higher liability insurance premiums and underwriting fees. The specter of liability risk may also cause IPO issuers (as well as other registrants) to avoid disclosure triggers by altering the way they would otherwise deal with climate-change related issues, in a manner that is counterproductive to environmental goals (such as by declining to set specific climate-related targets). Issuers might also distort their disclosure choices in ways that are harmful to investors to mitigate liability risk (such as by inundating investors with every conceivable climate-related risk rather than meaningfully informing them of firm-relevant exposures). I urge the Commission, if it moves forward with the proposal, to consider excepting IPO registration statements from the proposed disclosure mandates and, as I discuss in my article and in a comment letter I submitted in connection the Commission's proposed SPAC rules, I believe that the Commission should undertake a broader review of the PSLRA safe harbor and its existing exclusions—including but not limited to the IPO exclusion.

c. Third, the PSLRA safe harbor is also inapplicable with respect to statements included in a financial statement prepared in accordance with generally accepted accounting principles. Thus, the proposed financial statement metrics disclosures would not be protected by the safe harbor, heightening liability risk for both registrants and their auditors. This is likely to lead to increased audit fees across the board—and particularly those charged in connection with public offerings subject to Section 11 liability.

4. The discussion also references the proposed safe harbor for Scope 3 emissions disclosure as mitigating litigation risk. That safe harbor provides that a covered statement "is not deemed to be a fraudulent statement . . . unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith." It thus mimics the language of safe harbor rules that the Commission adopted in 1979 for forward-looking statements, Rule 175 under the Securities Act of 1933 and Rule 3b-6 under the Securities Exchange Act of 1934. Rules 175 and 3b-6 have proven ineffective,[3] and so will the safe harbor proposed in the release. This is in part because it does not add in any meaningful way to what plaintiffs are already required to prove under existing law. In order to impose liability under Rule 10b-5, for example, plaintiffs must prove that a challenged statement was made with, at minimum, a reckless disregard for its truth. If plaintiffs can

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[3] *See* Safe Harbor for Forward-Looking Statements, Securities Act Release No. 7101, p.15 (October 13, 1994), *available at* https://www.sec.gov/rules/concept/fwdinfo.txt (observing that "[c]ontrary to the Commission's original intent," these safe harbor rules are "currently invoked on a very limited basis in a litigation context"). Commission efforts to strengthen these safe harbors were eclipsed by Congress' adoption of the PSLRA.

prove that then surely they can prove that the statement was made without a "reasonable basis." Moreover, plaintiffs cannot prove that an estimate or assumption—both of which are a species of an opinion statement—is even a false statement of fact without proving that the registrant did not actually believe it.[4] If plaintiffs can prove that then surely they can prove that the estimate or assumption was made in "bad faith." Not only does the proposed safe harbor not meaningfully increase plaintiffs' substantive burden, but importantly it also fails to increase their procedural burden. Reasonableness and good faith are fact-laden issues that courts will often be unwilling to decide on a motion to dismiss; given the costs of defending securities class actions, the enormous potential damages awards, and the potential for legal error, registrants whose Scope 3 emissions disclosures were made reasonably and in good faith might nevertheless rationally choose to settle cases challenging those disclosures over defending them past a motion a dismiss. Because the safe harbor as proposed provides only illusory protection against liability risk, I urge the Commission, if it moves forward with the proposal, to consider more robust alternatives, including providing that Scope 3 emissions disclosures shall not be actionable in private litigation brought under the federal securities laws.

5. Many of the proposed mandatory disclosures are subject to a "materiality" qualifier. It is my opinion that clarification is needed as to what the SEC considers "material." The release reiterates the standard formulation of the term: material information is information that a "reasonable investor" would be substantially likely to consider important in making an investment or voting decision, which is an objective standard.[5] But how should registrants, seeking to comply with the sweeping new disclosure obligations that have been proposed, conceive of the "reasonable investor" when making their disclosure choices? Clarity on this is vital, given the substantial liability risk registrants face.

   Although it has always been a fuzzy concept,[6] the "reasonable investor" is usually conceptualized as an investor who cares about maximizing the value of his or her investment in a particular firm. At times, the release speaks of a link between climate-related risks and firm financial performance, consistent with this traditional conception of the reasonable investor and the materiality of information. But the release also speaks in terms of ESG "investor demand" for climate-related information, and it further emphasizes that climate-related information may be important to investors because of its potential effects on investors' broader portfolios. This gives rise to considerable ambiguity and raises important policy questions.

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[4] *See Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 575 U.S. 175, 186, 135 S. Ct. 1318, 1327 (2015).

[5] *See* Release, p. 64 & n. 209.

[6] In *The "Reasonable Investor" of Federal Securities Law: Insights from Tort Law's "Reasonable Person" & Suggested Reforms*, 43 J. CORP. L. 77 (2017), which I hereby submit as an attachment hereto, I critique the ambiguity surrounding the reasonable investor concept and argue that the SEC should more specifically identify who the reasonable investor is in various contexts.

a. Certain investors, including those in "ESG" funds, may find climate-related information important to their investment and voting decisions even if it is not material to firm performance. Moreover, the reaction of these investors (and like-minded consumers) to climate-related information about a firm may have financial repercussions for the firm. The discussion of these investors in the release raises an important question: Is information material even if *absent disclosure* it would be unlikely to have an important impact on the firm's financial performance? Consider Company A and Company B and information on Scope 3 emissions. Assume Company A operates in jurisdictions where there is a significant risk that regulatory actions will be taken against firms whose Scope 3 emissions exceed Company A's levels and those actions, if taken, would have a significant impact on Company A's financial performance. By contrast, assume that in the jurisdictions in which Company B operates there is not a credible risk of similar regulatory intervention, but if its Scope 3 emissions were disclosed it would cause environmentally conscious investors to sell their stock in Company B, potentially affecting (at least temporarily) the company's stock price. Assume further that such disclosure might also lead to a consumer backlash that could impact Company B's financial condition, if—but only if—Company B is consumer-facing. On these facts, Company A's Scope 3 emissions would be traditionally material, applying the framework for contingent information adopted in *Basic v. Levison,* 485 U.S. 224 (1988). Company B's Scope 3 emissions, by contrast, would potentially be material *only if disclosed*. Should registrants like Company B consider their Scope 3 emissions material and thus feel compelled to disclose them under the proposed Scope 3 disclosure standard? If the answer is yes, environmentally conscious investors in Company B will have their interests protected, but at a cost to purely financially-motivated investors in Company B. Costs would be incurred by the latter group both because Company B would have to spend resources to track its Scope 3 emissions (unlike Company A, absent the disclosure obligation it might not do so) and because of the potential negative financial impact of the disclosure on the firm's value—something that could be avoided only if Company B spent resources to reduce its Scope 3 emissions. Prodding companies to reduce their Scope 3 emissions is a laudable goal but using SEC disclosure rules to advance that goal raises profound questions that warrant frank discussion.[7]

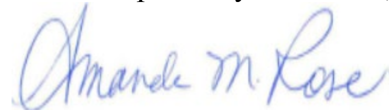
b. The release gestures toward a theory that has been advanced in academic circles and articulated by asset managers. The idea is that investment funds care about climate-related information because they can use that information to reduce the systematic risk of their portfolio and hence enhance risk-adjusted returns. For example, index fund managers may use their fund's governance rights to advocate for changes that, although not value maximining at the individual firm level, are value-maximizing at the portfolio level. Should companies view various climate-related disclosures as

[7] *See, e.g.*, Rose, *A Response to Calls for SEC-Mandated ESG Disclosure*, *supra* at 1842-1847.

> "material" because index funds view the information as important for this purpose? If the answer is yes, consideration should be given to how effective index fund managers might actually be at using the information to reduce their systematic risk exposure. After all, the costs of disclosure mandates are real and should be measured against realistic expected benefits. There is also a normative question lurking: assuming it has the authority to do so, as a prudential matter should the SEC use its authority to mandate disclosure in order to assist index funds in their quest to reduce systematic risk? This again creates a trade-off between investors. Index investors may benefit by increasing their risk-adjusted portfolio returns (assuming index fund managers can and will effectively use the information to accomplish such gains), but the hypothetical portfolio gains would come from convincing portfolio companies to take steps that are not value-enhancing at the firm level, thus harming firm-specific investors. It may make good policy sense to subordinate the interests of individual firms in order to achieve a reduction in the risks posed by climate change, but it does not follow that the SEC has the authority or institutional competence to be the agent of this change. These are issues, at least, that warrant more serious reflection.[8]

These issues are relevant not only to discerning the proper meaning of the term "materiality," but also to evaluating the wisdom of the disclosure mandates in the proposal that have no materiality qualifier, to the extent they are justified by ESG investor demand or asset managers' interest in the information for the purpose of reducing portfolio-level risk.

Respectfully submitted,



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Attachments:

1. Amanda M. Rose, *A Response to Calls for SEC-Mandated ESG Disclosure*, 98 WASH. U. L. REV. 1821 (2021): https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3805814.
2. Amanda M. Rose, *SPAC Mergers, IPOs, and the PSLRA's Safe Harbor: Unpacking Claims of Regulatory Arbitrage*, 64 William & Mary L. Rev. – (forthcoming 2023): https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3945975.
3. Amanda M. Rose, *The "Reasonable Investor" of Federal Securities Law: Insights from Tort Law's "Reasonable Person" & Suggested Reforms*, 43 J. CORP. L. 77 (2017): https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2840993.

[8] *See id*.