



GEORGETOWN LAW

June 17, 2022

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

Re: *Proposed Rule on Enhancement and Standardization of Climate-Related Disclosures for Investors*, 87 Fed. Reg. 21334 (April 11, 2022)
File No. S7-10-22

Dear Secretary Countryman:

Thank you very much for the opportunity to comment on these important proposed rules. The Commission should be commended undertaking rule-making in this important area. Ten years from now, stories about investing in companies that had committed themselves to manifestly unsustainable technologies will have the same resonance as those about going all-in on mortgage-backed securities fifteen years ago or buying czarist bonds a little over a century ago. If the SEC acts effectively, those will be genuinely funny stories about bullets dodged and calamities averted. If the SEC fails to finalize a set of strong disclosure rules, however, those will be stories about devastating, life-changing events crushing sincere investors' dreams.

The risks of unknowingly investing in companies depending on a high level of carbon emissions are entirely comparable to those of other business practices likely to create loss that the average investor cannot anticipate without specific disclosures. It is entirely consistent with the SEC's mission to prevent the sale of securities holding large hidden risks without disclosure of the nature of those risks. Since the Great Depression, we have periodically had to update our understanding of the nature of hidden risks. Some of these new kinds of risks were not effectively regulated until after they had caused widespread financial losses or even recessions. By acting now, the SEC is reducing the chances that companies with huge exposure to climate-related losses will be able to obtain large market capitalization on false pretenses and then destabilize the markets when those risks become apparent or are realized. Investors seeking to avoid climate-related risks, like those seeking to avoid other types of risks that are subject to current disclosure requirements, can play a constructive role in the financial markets and should not be left at the mercy of unscrupulous managers.

The current voluntary reporting systems are manifestly inadequate. Not only is the scope and clarity of disclosure that they require manifestly inadequate, but they suffer from a serious adverse selection problem: companies with strong profiles will happily provide all required disclosures while those whose actual practices might scare off investors will be inclined either to avoid disclosures completely or exploit fully all ambiguities in the current regimes. Perhaps a strategic investor might assume that a company's safety from climate-related risk is directly related to the extensiveness of its disclosures, but without considerable expertise most investors will not be able to tell the difference between guarded

climate reporting and a terse style of communication (or, indeed, the lack of areas of potential exposure to report). A standardized and mandatory reporting system such as the one the Commission is proposing is the only way to allow investors to make reasonably informed decisions.

A standardized and mandatory reporting system also is essential to uphold shareholder control of corporations through elected directors. No matter how well-meaning a director might be, she or he will not be able to assess the extent of the company's risk, or formulate specific, meaningful instructions for the board to issue to management, if she or he cannot gauge the extent of the company's current risks. In theory, shareholders could seek to ensure that one board seat goes to someone with the expertise to scrutinize management's climate-risk-mitigation efforts; in practice, allocating board seats in that manner will typically be impracticable.

As laudable as is the Commission's desire to act in this area, the proposed rules are not sufficiently clear or strong to accomplish its goals. In particular, the treatment of Scope 3 emissions creates a huge loophole that threatens to undermine the entire structure. The distinction between direct (Scope 1) and indirect (Scope 3) emissions may sound clear enough, but in practice the difference is vague and easily finessed. For example, parties ordinarily are free to structure transactions to specify that the transfer of title whenever they like; this power can be used to shift otherwise reportable emissions into a post-transfer (Scope 3) setting even when, absent this reporting system, they would have been made directly by the company in its regular obligations. Furthermore, treating leases as affecting accountability for emissions seems quite naïve given the proliferation of sale-and-lease-back arrangements and other means either of emulating a lease without creating one or creating a lease that has little or no economic substance. From the practical perspective of investors, if a company's line of business requires a high level of carbon emissions, that line may contract or collapse in the near- to medium-term future whether or not those emissions are formally made by the company or by another company or individual with whom its line of business requires it to deal. A company that leases oil drilling equipment is a bad investment for someone who expects the oil sector to decline whether or not that company actually emits much carbon itself. This should be disclosed.

The Commission seems to recognize this reality in (appropriately) treating Scope 1 and Scope 2 emissions similarly: two companies running the same production line, and giving rise to the same level of emissions, should be treated identically by the reporting system even if one of them generates the necessary electricity itself and the other buys electricity from a public utility. But the same principle should drive Scope 3 emissions to be reported in the same way that Scope 1 and Scope 2 emissions are: the Commission risks distorting efficient economic decision-making if its reporting requirements treat a company that has managed to find someone else to "hold" the emissions its business necessitates better than a company that owns up to the same emissions itself. Under the Commission's proposed rules, these companies might appear to have very different risk profiles, and the company that engineers an economically (and environmentally) unproductive out-attribution of its emissions might have substantially greater access to capital through the markets. More generally, to preserve public confidence and corporate compliance with its disclosure standards, the Commission should endeavor to avoid creating ones that are so readily and obviously susceptible to gaming. I elaborate further on these concerns in my June 15, 2022, column in *The Hill*, which I am appending to these comments.

As a middle ground between a mandatory disclosure of all Scope 3 emissions and none at all, the Commission might consider requiring companies to disclose "substantial", "material", "major" or some similarly described subset of those admissions. This choice would be undesirable as it would vitiate much of the certainty and clarity that this rule-making seeks to establish. It also would be subject to the adverse selection problems discussed above: basically honest companies, and those with little climate-related risk, will interpret their reporting duties broadly while dishonest companies and those whose risk profiles might scare away informed investors will interpret any language the Commission uses narrowly. This has been a persistent problem in other regimes, within Securities Law and beyond, that require

disclosures of “material risks”. At times, that sort of vague requirement is unavoidable, but this is not one of those cases.

If the Commission feels compelled for whatever reason to limit its mandated Scope 3 disclosures to some subset of risks, it should require analysis of disclosure duties to be made for each line of business or sector separately. If it allows companies to assess “materiality” or “substantiality” globally, a company is allowed to weigh a number of business lines that do not involve large climate-related risk together with lines of business that do to conclude it does not meet the reporting threshold in the aggregate, the rule will irrationally and unjustifiably favor conglomerates over smaller and specialized companies. The Commission’s reporting rules should not distort the markets and decisions over corporate form in this manner that brings no real-world economic value. If two companies engage in similar climate-risky activities, they should have the same reporting obligations, whether or not one of them is engaged in other, unrelated activities that may lack such risks. A coal mine with an insurance company attached is still a coal mine.

Because climate science, climate adaptation and mitigation, and substantive regulation (here and in other countries where countries listed in the U.S. do business) are rapidly changing, even the best rules the Commission might write are likely to prove inadequate, and possibly vulnerable to evasion, within a relatively few years. The Commission therefore should commit itself to reviewing these rules to explore the need for further refinements to ensure effective reporting. These reviews ought to occur every three years initially until the Commission is satisfied that that a secure, stable reporting regime is functioning as intended without substantial evasion.

Thank you very much for undertaking this important effort and for the opportunity to comment.

Sincerely yours,

David A. Super

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Securities and Exchange Commission Should Strengthen Required Climate Risk Disclosures

By David A. Super

The Hill, June 15, 2022

As the present effects, and likely future consequences, of climate change become ever more apparent, its menace will affect more and more aspects of our lives. Some are obvious: the dangers of building in low-lying areas or where risks of extreme weather or wildfires are rising. Others, however, remain largely hidden, nasty surprises awaiting those who believe they have taken proper precautions.

One such hidden risk is investing in companies whose businesses can be adversely affected by climate change. Just as ordinary investors who put their life savings into Enron stock or highly-rated mortgage-backed securities were pitched into financial ruin that they could not have anticipated, so too can those whose superficially diversified investments all turn out to be exposed to climate risk could see their financial security washed away like a low-lying island.

Fortunately, the Securities and Exchange Commission has recognized this risk and is taking action to combat it. Building on the work of two [non-governmental groups](#), the SEC has proposed a [rule](#) that would require companies to disclose the extent to which their profitability could be endangered by climate change. The SEC rule would be a major step forward in making these disclosures mandatory. That being said, the SEC has been disappointingly timid in the scope of the disclosures it requires. Public [comments](#), [due](#) by Friday, June 17, can encourage the Commission to move forward with this rule and to plug the loopholes that threaten to undermine its effectiveness.

Congress created the [SEC](#) in the wake of the [Black Thursday](#) stock market crash that launched the Great Depression. Although some investors that lost heavily in the crash knew they were playing risky games, [others](#) had no idea their families' well-being was at risk. Since its establishment, the SEC has sought to prevent a recurrence of that calamity. The SEC cannot and should not eliminate risk from investing, but it plays a crucial role in ensuring that investors have a fair chance of knowing what risks they are taking.

Some risky practices are [obvious](#): obscure bookkeeping practices, outsiders secretly buying up large fractions of a company's stock, various pump-and-dump maneuvers, etc. The SEC's [mandate](#) is not, however, limited to such risks. Whenever the Commission becomes aware of a set of practices likely to lead to misled investing on the front-end or destructive panic selling on the back-end, its mission calls on it to shine the light of mandatory disclosure on the problem. Indeed, these less well-recognized risks are more likely to ensnare innocent investors, and to escape the scrutiny of sincere board members, than more prosaic financial skulduggery.

As climate risks become better-known, most responsible managers have [endeavored](#) to reposition their companies to enter from growth markets, such as those in renewable energy and other climate [adaptation](#) or [mitigation](#) fields, while reducing their dependence on lines of business that may become unprofitable because of changes in physical conditions, government regulation, or consumer preferences. As seemingly always is the case, however, a few corporate [wolves](#) are donning sheep's clothing to infiltrate the flock, trying to extract short-term profits by staying in dying industries while leaving their companies with [dim](#) prospects for long-term viability.

With both the impacts of climate change and the strategies for combatting it touching so many facets of our lives, ordinary investors are ill-equipped to recognize most climate risks. Yes, a company devoted exclusively to coal-mining is certainly riskier than one focused on solar panels, but most real-world cases are not that clear. Indeed, without trustworthy, legally mandated reporting of climate risks, even corporate directors will be ill-equipped to assess how well the managers they supervise are minimizing the climate risks their companies are taking.

Unfortunately, the SEC's proposed rule contains a gaping loophole. Although it would require reporting of emissions directly caused by the company's activities – such as exhaust from its fleet of cars – and those required to generate electricity the company consumes, it would not require companies to report climate [risks](#) that are deemed indirect (“Scope 3”).

Thus, for example, a company would [not](#) have to report that its profitability depends heavily on leasing oil drilling equipment because the actual emissions are caused by the lessees. A company committed to this line of business will be in grave peril as the world turns away from fossil fuels, yet

under the SEC's proposed rule investors and conscientious board members would have no idea of the risk. Similarly, a company that sold equipment that reduced the fuel economy of vehicles would not have to report that risk because the actual emissions occur after the product is sold.

This direct-indirect distinction will leave many huge threats to corporate viability in the shadows. Worse, it will subvert the reporting requirements the rule does establish by encouraging companies to develop accounting gimmicks to recharacterize their involvement in climate-harming activities as indirect.

A common middle-ground in these situations is to require reporting only of those risks that the company deems material. This might yield some information from companies with little to hide, but it invites the truly reckless ones – the companies SEC should be most worried about – to absolve themselves of reporting duties. Managers seeking to deceive their investors and board members could readily cite all their (unrelated) activities that do not carry climate implications to claim that large risks that they are taking are proportionately too small to be material. The SEC should not open itself, and investors, to these tactics.

The days when climate change concerned only environmentalists are long gone. Those in many other fields, very much including finance, must think carefully about its implications for their work. The SEC's initial foray into mandating climate risk reporting is admirable. The Commission needs, however, to close the loopholes already apparent in its proposal and to commit itself to regular review of this rule to respond to changing conditions and new evasive tactics.

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<https://thehill.com/opinion/finance/3524896-sec-should-strengthen-required-climate-risk-disclosures/>