NON-MATERIAL MANDATORY CLIMATE CHANGE DISCLOSURES

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In March of 2021, Allison Herrin Lee, then Acting Chair of the Securities and Exchange Commission (SEC), requested public input[1] on expanding climate change disclosures. In May, Commissioner Lee argued that the SEC had broad authority to require such disclosures, even if the disclosures are "not material" to a reasonable investor.[2] She based this argument on wording found in the federal securities law that repeatedly states that the SEC has authority to require disclosures as long as they are "in the public interest" *and/or* "for the protection of investors."[3] As she correctly points out, this wording is not qualified by any standard of materiality. Therefore, it is highly likely that the SEC will adopt this approach in arguing the legality of whatever new climate change disclosures are to be found in a proposed rule that is expected to be published by year end.[4]

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[1] Allison Herren Lee, *Public Input Welcomed on Climate Change Disclosures*, U.S. SEC. & EXCH. COM. (March 15, 2021), https://www.sec.gov/news/public-statement/lee-climate-change-disclosures [https://perma.cc/X2RE-9QD9].

[2] Allison Herren Lee, *Living in a Material World: Myths and Misconceptions about "Materiality*," U.S. SEC. & EXCH. COM. (May 24, 2021), https://www.sec.gov/news/speech/lee-living-material-world-052421 [https://perma.cc/F8FS-PF6U]. The U.S. Supreme Ct. defined material facts in the proxy context as facts for which there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *See* TSC v. Northway, 426 U.S. 438, 449 (1976).

[3] *See generally* The Securities Act of 1933 and Securities Exchange Act of 1934.

[4] Gary Gensler, *Prepared Remarks Before the Principles for Responsible Investment "Climate and Global Financial Markets" Webinar*," U.S. SEC. & EXCH. COM. (July

If the SEC is not limited by materiality,[5] then what are the statutory parameters or boundaries that it still must abide by in promulgating mandatory climate change disclosures? That is, how far beyond the SEC's 2010 interpretative release on climate change disclosures,[6] which focused on the disclosure of material climate change risk factors "that make an investment in the registrant speculative or risky" or "are reasonably likely to have a material effect on a public company's financial condition or operating performance,"[7] can the SEC go in creating a mandatory climate change disclosure regime?[8] In this Article I argue that its statutory authority does not allow the SEC to stray far from its 2010 approach. That is, its ability to require mandatory climate change disclosures are limited.

I. "IN THE PUBLIC INTEREST"

The language of the statute is critical in determining what limitations the SEC faces in promulgating non-material mandatory climate change disclosures. More specifically, what kind of parameters are to be placed

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28, 2021), https://www.sec.gov/news/speech/gensler-pri-2021-07-28 [https://perma.cc/8KE8-PV3S].

[5] The issue of whether the SEC has statutory authority to adopt this approach is not settled law and may eventually become the focus of litigation. However, an analysis of this issue is beyond the scope of this Article. Moreover, the overriding issue of whether the SEC has statutory authority to adopt mandatory disclosure rules without additional enabling legislation is also beyond the scope of this Article. For a discussion of this issue, *see* Andrew N. Vollmer, *Does the SEC Have Legal Authority to Adopt Climate-Change Disclosure Rules?,* MERCATUS CENTER, GEORGE MASON UNIV. 1 (2021),.

[6] U.S. SEC. & EXCH. COM., *Commission Guidance Regarding Disclosure Related to Climate Change,* Release Nos. 33-9106; 34-61469 (Feb. 2, 2010).

[7] *Id.*

[8] It is quite possible that the SEC will adopt a hybrid approach, retaining the guidance found in the 2010 interpretive release but also adding non-material mandatory climate change disclosures. The objective of signaling to the market that the 2010 interpretive release may still serve as foundation for climate change disclosures, but with a higher level of enforcement, may have been the point of the recent sample letter on climate change disclosures posted by the SEC's Division of Corporation Finance. *See* Div. of Corp. Fin., *Sample Letter to Companies Regarding Climate Change Disclosures,* U.S. SEC. & EXCH. COM. (Sept. 22, 2021), https://www.sec.gov/corpfin/sample-letter-climate-change-disclosures [https://perma.cc/5QDZ-VENT]. This sample comment letter on their climate change disclosures essentially reminds companies that they needed to abide by the 2010 release and that their disclosure documents are being reviewed for compliance. If the SEC planned on scraping the 2010 release in the near future, it is hard to see why it would put such a public focus on companies complying with the materiality standard at this time.

on the term "in the public interest"? In this section I argue that the statutory language "for the protection of investors" places a limit on the SEC's legal authority when mandating non-material climate change disclosures.

A. *The Legal Parameters of "In the Public Interest"*

Even though the term "in the public interest" is mentioned numerous times both in the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"; together the "Acts"), the Acts do not attempt to define it. Therefore, it is up to the SEC to take the first crack at defining this term and under *Chevron*[9] the SEC's definition must be given deference.[10] However, that deference is still reviewable by a court and the SEC's definition can be rejected if the court has a "substantial reason for doing so."[11] That is, deference may be rejected under the Administrative Procedures Act ("APA") if its actions were found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[12] Therefore, in defining the term "in the public interest," the SEC must be cognizant of not running afoul of the APA.

But how does the SEC know when it is violating the APA when invoking the term "in the public interest"? As argued below, such disclosures are arbitrary and capricious when they go beyond the statutory requirement of being "for the protection of investors."

B. *Staying within the Requirements of the Administrative Procedures Act*

Whenever the term "in the public interest" appears in the Acts, the term "for the protection of investors" is almost always sure to follow. The only ambiguity is that it is not entirely clear whether the two terms are to be understood as being conjunctive ("and") or disjunctive ("or").[13] However, in 1996, Congress added Section 2(b) to the Securities Act and

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[9] Chevron U.S.A., Inc. v. NRDC, 467 U.S. 837, 844-845 (1984).
[10] SEC v. Citigroup Global Markets Inc., 673 F.3d 158, 168 (2d Cir. 2012).
[11] *Id.*
[12] *Id.* quoting 5 U.S.C. § 706(2)(A).
[13] *See*, Wm. Dennis Huber, *The Myth of Protecting the Public Interest: The Case of the Missing Mandate in Federal Securities Law*, 16 J. BUS. & SECURITIES L. 401, 418 (2016).

Section 23(a)(2) to the Exchange Act that helps clarify this ambiguity. These parallel sections provide that:

> Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine *whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors*, whether the action will promote efficiency, competition, and capital formation.[14]

The statutory language in italics confirms Congress's intent that the terms be understood in the conjunctive. Moreover, it is illogical to think otherwise. According to a speech by former Chairman Arthur Levitt, "the primacy of investor interests was present at the creation" of the SEC.[15] Moreover, according to Levitt, investor protection was the "overriding concern" of our securities laws.[16] Finally, while he was not talking about mandatory climate change disclosures, this quote from Levitt's speech is still extremely instructive: "[T]he foremost mission of the SEC for 62 years has been *investor protection*, and no matter how well-intentioned any additional role may be, it will inevitably distract attention from our primary focus. That's a price we can ill afford."[17] As a result, the SEC would be committing an arbitrary and capricious act, an act in violation of the APA, to promulgate mandatory disclosures based on the rationale of being "in the public interest" but yet excluding "for the protection of investors." In sum, the two must go together whenever the SEC promulgates mandatory disclosures.

C. *"For the Protection of Investors"*

What does "for the protection of investors" mean in the context of mandatory climate change disclosures? The term "for the protection of investors" is also not defined in the Acts. However, the meaning should be clear. The Acts were children of the 1929 stock market collapse and meant to correct the wrongs that paved the way for the Great Depression:

> The stock market crash of 1929 exposed a catalogue of corporate practices employed to deceive and discriminate against the small

[14] Securities Act § 2(b); Exchange Act § 23(a)(2).
[15] Arthur Levitt, Remarks by Chairman Arthur Levitt, U.S. Sec. and Exch. Comm'n, Commonwealth Club, San Francisco, Cal. (May 17, 1996), [https://perma.cc/9T5H-JPSS]
[16] *Id.*
[17] *Id.*

> investor. These practices were largely instrumental in bringing on mass *financial ruin*. For years corporations had floated large quantities of unsound stocks without telling investors about the true state of their assets and earning power, or the identity of their promotors, managers, and chief stockholders. Corporate insiders, capitalizing on secret information about impending corporate action, had themselves extracted huge profits from ordinary investors by selling their own stock to the public in advance of expected price declines. Organizers of holding and investment companies, by obtaining unfair contracts or excessive payments from their operating subsidiaries, had siphoned off vast sums of subsidiary profits. In reorganizations, security conversions, and dividend declarations, the interests of small investors were often sacrificed to those of large stockholders.[18]

In response, the Acts were focused on protecting "investors from fraud, an unlevel informational playing field, the extraction of private benefits from the firm-by-firm insiders, and investors' propensity to make unwise investment decisions…."[19] Such protections made sure that investors are adequately informed of firm specific investment risks.

Such disclosures do include those that result from climate change. For example, the SEC's 2010 interpretative release on climate change disclosures recommends a number of disclosures that focus on firm specific investment risks.[20] The following topics and how they affect the reporting company may require disclosure: the impact of climate-change legislation and regulation; international accords on climate change, such as the Paris Accord; indirect consequences of climate-change regulation, such as a reduction of demand for goods that create high levels of greenhouse gas emissions; and the physical impacts of climate change, such as severe weather, on the company's operations.[21]

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[18] Unnamed author, *The Meaning of "Control" in the Protection of Investors*, 60 YALE L. J. 311, 311 (1951).
[19] Michael D. Guttentag, *On Requiring Public Companies to Disclose Political Spending*, 2014 COL. BUS. L. REV. 593, 619 at n.92 (2014) citing Michael D. Guttentag, *Protection from What? Investor Protection and the Jobs Act*, 13 UC DAVIS BUS. L.J. 207, 222-233 (2013).
[20] U.S. SEC. & EXCH. COM., *Commission Guidance Regarding Disclosure Related to Climate* Change, Release Nos. 33-9106; 34-61469 (Feb. 2, 2010).
[21] *Id.*

However, while the Acts provide the SEC with authority to require disclosures regarding firm specific investment risks, they do not specify or imply that disclosures "for the protection of investors" include those that are for the purpose of "expressive investor protection."[22] This is a term coined by Professor Michael Guttentag and refers to disclosures that investors would use to protect themselves from investing in securities issued by firms with attributes that investors simply find objectionable.[23] For example, disclosures on the level of Scope 1, 2, or 3 emissions that an issuing company may produce. Such disclosures would allow investors to reject investment in the securities of a company that produces carbon emissions that go beyond a certain level. While these disclosures would help investment advisors structure ESG funds that investors may want to invest in, such "expressive investor protection" is not currently provided for in the Acts and therefore requiring such climate change disclosures would be an arbitrary and capricious act under the APA. Simply put, promulgating such disclosures is not currently within the SEC's authority. For the SEC to have such authority, Congress must provide it in new legislation.

D. *UPDATING THE SEC'S 2010 INTERPRETATIVE RELEASE ON CLIMATE CHANGE DISCLOSURES*

The discussion above suggests that the SEC can go ahead and update the 2010 release with new disclosures even if they are not material. Since 2010 we have become much more aware of how impactful climate change events can be to a company's financial well-being. Investors need to be made aware of low probability, high impact climate change events that management may know of, but investors do not. Once these risk factors are disclosed, investors can then gauge just how well the company can *adapt*. As discussed by Armen Alchian many years ago, the ability to adapt to a changing business environment is critical to the profitability and success of any company.[24] Therefore, with that in mind, I propose that the SEC require a company to specifically disclose known low-probability high-impact climate-change events as risk factors under Item 503(c) of Regulation S-K—for example, the possibility that a company may be significantly impacted by multiple freak winter storms

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[22] *See*, Guttentag, *On Requiring Public Companies to Disclose Political Spending*, *supra* note 19, at 606.
[23] *Id.*
[24] Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211 (1950).

that take down an entire state's power grid for days.[25] I believe such disclosures would be consistent with the requirements of the APA and most likely material to a reasonable investor, even though the later may not be required.

II. THE SEC'S DISCRETIONARY AUTHORITY

The SEC must not only determine that it has legal authority to mandate non-material climate change disclosures, as discussed above, but also whether it wants to use its discretionary rule-making power in this regard. Legally, there is nothing that compels the SEC to take up non-material mandatory climate change disclosures. Or, if it did, for a majority of commissioners to approve a proposed rule on such disclosures. Nevertheless, the SEC is under tremendous pressure to do so. This pressure is coming not just from climate activists and Democratic members of Congress,[26] but also from large investment advisers, rating agencies, consultants, proxy advisers, and those lawyers and auditors in the compliance field[27] who will profit handsomely from these disclosures.[28] They specifically would like to see disclosures in the area of standardized climate-change reporting data as a means to facilitate the providing of Environmental, Social, and Governance ("ESG") ratings and the setting up of ESG investment funds. These funds generate significantly higher management fees for the investment advisers who set up and manage them and added income for those related parties who are needed to set up the new funds.[29] Unfortunately, such disclosures also create significant compliance costs for the disclosing

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[25] Wikipedia, *2021 Texas power crisis* (accessed Sept. 14, 2021), https://en.wikipedia.org/wiki/2021_Texas_power_crisis. [https://perma.cc/46V2-Q3CV]

[26] U.S. SEC. & EXCH. COM., *Comments on Climate Change Disclosures*, https://www.sec.gov/comments/climate-disclosure/cll12.htm. [https://perma.cc/Z8NM-JU8P]

[27] *Id.*

[28] *Id.*

[29] For example, mutual funds and ETFs that track indices structured for the ESG investor can typically charge significantly higher fees than funds and ETFs that plain vanilla indices like the S&P 500. *See*, Bernard S. Sharfman, *ESG Investing Under ERISA*, YALE J. ON REG. ONLINE at 127-28 (2020), https://digitalcommons.law.yale.edu/jregonline/6/. *See also*, Aswath Damodaran, *The ESG Movement: The "Goodness" Gravy Train Rolls On!* (Sept. 14, 2021), https://aswathdamodaran.blogspot.com/2021/09/the-esg-movement-goodness-gravy-train.html, for an excellent diagram of the interested parties that would financially benefit by increased levels of ESG investing.

companies. For example, it has been reported that PricewaterhouseCoopers (PwC) is planning on hiring 100,000 new employees and investing $12 billion over the next five years in order to help meet its clients' ESG reporting requirements.[30]

In coming to a decision on the use of its discretion, I suspect that at least some of the SEC commissioners will be influenced not only by the pressure described above but also by the notion that such disclosures will help mitigate climate change. The incorporation of this well-intentioned presumption may encourage those commissioners to test the limits of their legal authority. However, before going to that extreme, I urge each commissioner to take a critical look at the empirical evidence, not just the marketing hype that is coming out of the investment industry. If they can find good empirical evidence demonstrating that investment in ESG funds provide a significant benefit in mitigating climate change, then it may be appropriate, again depending on what the law allows, for the SEC to take a broad-based approach to its new disclosure rules. However, if such empirical evidence exists, it has yet to be published.

Experts that understand the data on ESG funds acknowledge the lack of an empirical connection.[31] In a recent LinkedIn post by noted finance professor Alex Edmans of the London Business School, he agreed with my comment "that ESG investing doesn't mitigate climate change."[32] He then referenced with approval another comment on his post by Ashley Hamilton Claxton, Head of Responsible Investment at Royal London Asset Management: "ESG data is not data, it's opinion. We can't and shouldn't claim direct impact in secondary markets. Investors are one cog in the wheel that turns the global economy. You can't change the world or fix climate change by buying and selling shares and bonds."[33]

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[30] Jessica DiNapoli, *PwC planning to hire 100,000 over five years in major ESG push*, REUTERS (June 15, 2021), https://www.reuters.com/business/sustainable-business/pwc-planning-hire-100000-over-five-years-major-esg-push-2021-06-15/.
[31] Bernard Sharfman, *The 'sustainable' investing fad is based on a Wall Street-created myth*, BUSINESS INSIDER (Oct. 23, 2021), https://news.yahoo.com/sustainable-investing-fad-based-wall-120200460.html.
[32] Alex Edmans, *Is sustainable investing really a dangerous placebo? A response to Tariq Fancy:*, LINKEDIN, https://www.linkedin.com/posts/aedmans_is-sustainable-investing-really-a-dangerous-activity-6849251042517901312-b31f/. [https://perma.cc/SF9Z-EHK2]
[33] *Id.*

This understanding is also shared by Bill Gates,[34] Professor Alicia Munnell,[35] and Tariq Fancy,[36] among others.

But doesn't ESG investing increase the cost of debt and equity financing for high carbon emissions companies and reduce the cost for low carbon emissions companies, resulting in a desirable reallocation of capital? In theory, yes, but in reality it does very little. This is because the major effect is on the secondary market, where securities are traded but no new money is being raised. As explained by Tariq Fancy, BlackRock's former chief investment officer for sustainable investing, investing in ESG funds does not provide new funding for those companies that would help mitigate climate change. "Instead, the money goes to the seller of the shares in the public market."[37]

Moreover, there are still plenty investors out there who are willing to invest in the securities of high carbon emissions companies, allowing those companies to raise new funds at less than onerous rates. For example, if ExxonMobil, a company under attack for its policy of refusing to move into low carbon energy production[38] and lobbying against legislation to mitigate climate change,[39] were to make a $2 billion debt offering with a maturity of 30 years, it would probably only have to pay an interest rate of around three percent per year.[40]

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[34] Greg Williams, *Bill Gates has a plan to save the world. Will the world listen?*, WIRED (Feb. 15, 2021), https://www.wired.co.uk/article/bill-gates-interview-climate-crisis. [https://perma.cc/FP2J-PECW]

[35] Patrick Donachie, *A Blue Wave May Derail DOL's Rule on ESG in Retirement Plans*, WEALTHMANAGEMENT.COM (Oct. 28, 2020), https://www.wealthmanagement.com/regulation-compliance/blue-wave-may-derail-dols-rule-esg-retirement-plans. [https://perma.cc/9HBZ-XWXJ]

[36] Tariq Fancy, *The fairytale of sustainable investing*, RESPONSIBLE INVESTOR (June 8, 2021), https://www.responsible-investor.com/articles/tariq-fancy-the-fairytale-of-sustainable-investing. [https://perma.cc/S76T-7ZYK]

[37] *Id.*

[38] Bernard S. Sharfman, *The Illusion of Success: A Critique of Engine No. 1's Proxy Fight at ExxonMobil*, forthcoming, HARV. BUS. L. REV. ONLINE (2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3898607. [https://perma.cc/H3FE-RSCY]

[39] Jeff Brady, Exxon Lobbyist Caught On Video Talking About Undermining Biden's Climate Push, NPR (July 1, 2021), https://www.npr.org/2021/07/01/1012138741/exxon-lobbyist-caught-on-video-talks-about-undermining-bidens-climate-push. [https://perma.cc/L5SS-2WKD]

[40] On Oct. 25, 2021, Exxon's outstanding $2.75 billion debt offering with a maturity of 2051 and a coupon rate of 3.452% was yielding 3.04%. *See* Markets Insider

Finally, and perhaps most importantly, Mr. Fancy observed that "one lesson COVID-19 has hammered home is that systemic problems—such as a global pandemic or climate change—require systemic solutions. Only governments have the wide-ranging powers, resources and responsibilities that need to be brought to bear on the problem."[41] Moreover, he concluded that a focus on ESG investing harms mitigation efforts "by creating a *societal placebo* that *delayed* overdue government reforms."[42] That is, this focus has reduced our sense of urgency to advocate for strong governmental actions that will have a real impact on mitigating climate change. Mr. Fancy refers to this as a "deadly distraction."[43]

Mr. Fancy's argument suggests that before the SEC gets caught up in the ESG investing craze by promulgating mandatory climate change disclosures and thereby reinforcing the belief that investors can help mitigate climate change while at the same time earning market rate returns or better, the SEC should thoroughly evaluate and come to the determination, not just having the wish or belief, that this should be the expected result of its actions. If not and the SEC still decides to follow

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(accessed Oct. 25, 2021),
https://markets.businessinsider.com/bonds/finder?p=2&borrower=76157.

[41] Tariq Fancy, *BlackRock hired me to make sustainable investing mainstream. Now I realize it's a deadly distraction from the climate-change threat*, THE GLOBE & MAIL (March 25, 2021; updated March 30, 2021),
https://www.theglobeandmail.com/business/commentary/article-sustainable-investing-is-a-deadly-distraction-from-actually-averting/?utm_medium=Referrer:+Social+Network+/+Media&utm_campaign=Shared+Web+Article+Links. [https://perma.cc/ZP87-R6B2]

[42] *Id.*

[43] *Id.* The view that ESG investing can be harmful to society is not Mr. Fancy's alone. According to prominent finance professor Aswath Damodaran of the Stern School of Business at New York University:

> In keeping with my belief that you learn more by engaging with those who disagree with you, than those who do, I have tried my best to see things through the eyes of ESG true believers, and I must confess that the more I look at ESG, the more convinced I become that "there is no there there". More than ever, I believe that ESG is not just a mistake that will cost companies and investors money, while making the world worse off, but that it create more harm than good for society.

Aswath Damodaran, *The ESG Movement: The "Goodness" Gravy Train Rolls On!* (Sept. 14, 2021), https://aswathdamodaran.blogspot.com/2021/09/the-esg-movement-goodness-gravy-train.html**.** [https://perma.cc/V98P-PJPM] through on promulgating such disclosures, then it may have helped create another "deadly distraction."[44]

III. SUMMARY

No doubt there are investors out there who want to make their investment decisions based on how much a particular company is impacting the environment and would benefit if the SEC were to require mandatory climate change disclosures that go beyond adequately informing them of the firm specific investment risks they are taking on. However, investing based on non-financial climate change disclosures is a matter of investor preference, not one of investor protection. Therefore, the SEC cannot make such disclosures mandatory. If it were to do so these would be arbitrary and capricious acts under the APA and therefore outside the SEC's authority. Finally, the SEC needs to understand, in weighing the use of its discretion in this area of rule-making, that the mitigation of climate change will not be the result of new climate change disclosures and may even be detrimental to the ability of our federal government to adequate address the issue of mitigation.

[44] Fancy, *supra* note 41.