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The SEC's Costly Power Grab

The Securities and Exchange Commission's Climate Disclosure Risk Proposal Threatens an End-Run around Congress on Climate Policy

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The concept known as environmental, social, and governance (ESG) investing has gained an increasingly high profile in recent years, with advocates producing a large volume of publications, conferences, corporate policies, and even entire new organizations dedicated to advancing it. The general premise of ESG theory is that corporations should deemphasize their traditional responsibility to maximize value for shareholders and instead make new, binding commitments to multiple alternative stakeholder groups. Some of those stakeholder groups are traditional and easy to define, like employees and suppliers, while others are more amorphous, like "the local community," "the global environment," or "society at large."[1]

The most high-profile topic under the umbrella of ESG theory is climate change.[2] While there is no single source of authority for what qualifies as an ESG issue, the primacy of climate change has been widely championed by ESG advocates, including organizations dedicated to the integration of climate change goals into corporate and government policy, such as the Task Force on Climate-Related Financial Disclosures.[3]

ESG advocacy has long involved both independent and overlapping efforts by government agencies, nonprofit organizations, corporations, and trade associations. For example, many ESG frameworks are based on the Sustainable Development Goals developed by the United Nations and promoted by UN-affiliated organizations like the Principles for Responsible Investment.[4] In the U.S. and the European Union, many environmental and social activist organizations such as Ceres, As You Sow, and the Natural Resources Defense Council have influenced the direction of current voluntary frameworks and now support having such rules mandated by government agencies.[5] Non-profit organizations led by business executives and CEOs, like the World Economic Forum and the Business Roundtable, have also endorsed the adoption of ESG goals related to climate change and environmental sustainability.[6]

In the United States, on March 21, 2022, the Securities and Exchange Commission (SEC) published a notice of proposed rulemaking that would require public companies to make detailed public disclosures of their energy use and planning for climate change-related financial risks. The public comment period for this proposal closes on June 17, 2022.[7]

The proposed rule is the result of a process that included an earlier request for information (RFI) initiated by Commissioner (then Acting Chair) Allison Herren Lee on March 15,

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2021.[8] The SEC received a large volume of submissions in response to that request and subsequently produced its current notice of proposed rulemaking on climate disclosure. Unfortunately, this proposal includes or endorses many of the deficiencies noted in many of the submitted comments. The current proposed rule would dramatically—and in unprecedented fashion—expand the SEC's regulatory authority and impose an extraordinary burden on American employers for little to no environmental benefit. The top five problems with the proposed rule are described below.

1. The Commission Lacks the Statutory Authority to Enact This Rule. The current proposal goes beyond the agency's legitimate powers and is a dramatic change to its standard operating procedure. The SEC's existing authority to require public companies to make disclosures of financially material information does not extend to environmental and social topics like climate change. Congress has acted multiple times since the SEC was created to give it additional authority to require disclosures on additional specific topics. It has done this because the SEC does *not* have plenary authority to make such additional demands on its own. Congress can act at any time to legislate further on climate change and on the financial system, but it has not done so in this case.[9]

Section 13(a) of the Securities Exchange Act of 1934 gives the SEC authority to prescribe rules that are "necessary or appropriate for the proper protection of investors and to insure fair dealing in the security," but does not mention advancing non-financial policy goals, as the agency is currently attempting to do with climate change. SEC Rule 10b-5 also stipulates a definition of "material," parallel to that formulated by the Supreme Court in *TSC Industries Inc. v. Northway Inc.* (1976): that materiality applies to information about which there is "a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered."[10] Again, no mention of non-financial public policy goals as a basis for creating a new disclosure requirement.

Given how widely and frequently bills related to greenhouse gases, environmental quality, and energy use have been proposed and debated in Congress over the years, the SEC's lack of specific authority over climate is not an oversight. It is a conscious policy choice by the legislative branch of government. It is not the place of the SEC to overrule Congress, no matter how pressing the agency's commissioners believe the issue to be. Even someone who supports more corporate disclosure of climate-related data should acknowledge that the SEC currently lacks statutory authority to issue such a requirement.

2. Requiring Subjective and Disparaging Disclosures Is Unconstitutional. In addition to lacking statutory authority for issuing the current rule, the SEC also risks violating the First Amendment rights of regulated firms. The disclosures that the SEC is proposing would constitute compelled speech on the part of public companies.[11]

The federal government's authority to compel speech by corporations is generally limited to information that is "purely factual and uncontroversial."[12] That is clearly not the case with the proposed climate rule.

Such a regulation is especially questionable when it would require a firm to make a statement about itself that is both subjective and disparaging. Since the entire point of requiring disclosure of climate-related information is to drive capital away from energy-intensive firms, the disclosures themselves are inherently disparaging.

There is strong precedent for federal courts taking these First Amendment protections seriously. In *National Association of Manufacturers v. SEC* (2016), a federal appeals court invalidated the "conflict minerals" disclosure mandate in Section 1502 of the Dodd–Frank Wall Street Reform and Consumer Protection Act on compelled-speech grounds. The court held that requiring manufacturers to declare their products to be "conflict-free"—specifically, regarding involvement in the Congolese civil war—carried ideological and moral implications that went beyond the agency's power to compel commercial speech.[13] The opinion read:

> By compelling an issuer to confess blood on its hands, the statute interferes with that exercise of the freedom of speech under the First Amendment.[14]

Even when the ostensible rationale for regulation is sympathetic, the federal government does not have unlimited authority to compel public disclosure of information from corporations.[15]

3. The Proposed Disclosures Are Climate Policy Masquerading as Materiality. Companies subject to SEC regulation have long had to disclose financially material information about their structure, operations, and plans for the future. That information doesn't have to fall into any specific topic or category; anything that could affect the value of the firm's shares in the future can be considered material. In recognition of this, the SEC uses a "principles-based" approach to materiality, by which a company's management draws attention to the risks and opportunities that it considers most important to that particular company. This allows for, as the SEC's Walter Hinman described in a 2019 speech, a disclosure regime that "keeps pace with emerging issues ... without the need for the Commission to continuously add to or update the underlying disclosure rules as new issues arise."[16]

Unfortunately, the new proposal would go in the opposite direction. By introducing specific, prescriptive requirements rather than ones based on general materiality principles, the agency is trying to suggest that anything climate-related should be considered presumptively material. As SEC Commissioner Hester Peirce put it, the rule "tells corporate managers how *regulators*, doing the bidding of an array of non-investor stakeholders, expect them to run their companies."[17] [Emphasis in original]

Climate-related financial risk that is truly material, as some might well be, is already covered by existing SEC rules and guidance. What the agency is now proposing is to impose substantive environmental regulation thinly disguised as financial reporting. That does not protect investors. Instead, it picks legal, but politically disfavored, industries and targets them for destruction.

4. The Rule Does Not Pass Any Reasonable Cost-Benefit Test. The SEC admits that the costs associated with complying with the proposed rule would be "significant," but tries to downplay the burden by pointing to the large volume of information that some companies already voluntarily disclose. That may count in the agency's favor in terms of relative costs incurred, but it also cuts against the agency's claims of benefits generated.

The SEC cannot credit the proposed rule for all of the climate-related information disclosed in the future by public firms. At best, the rule can only take credit for the additional increment of information that would have gone undisclosed in its absence. The agency acknowledges that voluntary climate disclosure is widespread and increasing, so future compliance costs can only be spread across the small additional benefit conveyed by the new rule. Given the trajectory of climate disclosure over the past few years, the difference between voluntary and mandatory disclosure will be far too small to justify the costs involved in the current proposal.

But even this stance—that companies that already disclose climate-related risks will only face a small burden—fundamentally misunderstands the incentive structure that firms would face under the rule going forward. The legal and reputational threat of being officially found non-compliant dramatically increases the amount of time, money, and professional expertise required, compared to voluntary disclosures. Even when it comes to specific quantitative requirements like measuring greenhouse gas emissions, the agency's proposal states, "we are unable to fully and accurately quantify these costs."[18] The fact that the SEC staff is forced to admit this after more than a year working on this proposal signals that they are not taking the rule's cost-benefit analysis seriously.

The agency also insists that firms report on their internal management processes, which suggests that climate policy should be developed and approved at the highest possible level—involving the input of senior executives—in order to be considered legitimate. This will also increase the costs of compliance and pull corporate managers away from their functional, product-focused roles within the company. Traditional accounting and audit assurance could also suffer as the personnel involved in those functions take their focus off of the firm's financials in order to comply with the SEC's new requirements for climate-related topics.

The SEC's proposal also notes that companies will see additional indirect costs in terms of "heightened litigation risk and the potential disclosure of proprietary information."[19] That includes revealed trade secrets, disclosure of companies' most profitable customers and markets to competitors, and exposure of operating weakness to competing firms and labor unions.

The costs of complying with this rule—which will almost certainly run into billions of dollars per year—will be piled on top of the existing array of federal regulations with which firms must already comply. Managers of public companies already work under a staggering burden of federal and state requirements. That accumulated weight has significant economic effects on individual firms, particular industries, and the U.S. economy as a whole. Recent research by scholars affiliated with the Mercatus Center at George Mason University also suggests that regulatory growth within an industry disproportionately burdens small businesses relative to their larger competitors.[20]

The Competitive Enterprise Institute's Wayne Crews estimates that the current total cost burden of U.S. federal regulation comes to nearly $2 trillion per year.[21] That accumulated burden also harms innovation, kills jobs, and slows economic growth, resulting in a smaller economy and lower investment returns. [22] The SEC's own estimates suggest that the overall cost of disclosure and compliance for public companies will rise from approximately $3.8 billion per year to over $10.2 billion—a more than 250 percent increase, based on this rule alone.[23] The agency has in no way demonstrated that the massive burden it is seeking to impose would generate equivalent benefits.

5. Estimates of Climate Change Risks, Both Physical and Political, Are Wildly Exaggerated. Advocates of climate risk disclosure often hype the physical dangers posed by climate change and the future financial liability that that physical risk might cause. In case after case, however, the underlying analyses rely on overheated climate models that dramatically overestimate future warming and thus its hypothetical downstream economic impacts.

For instance, a 2018 study by Ross McKitrick of the University of Guelph in Ontario and John Christy of the University of Alabama in Huntsville found that the most frequently used climate models predicted significantly more warming than scientists have observed in the actual temperature record. They conclude: "Comparing observed trends to those predicted by models over the past 60 years reveals a clear and significant tendency on the part of models to overstate warming."[24] Any economic forecasting based on such assumptions will therefore dramatically overstate the long-term downside risk from production and use of hydrocarbon energy.

One of the reasons for the overheated models is that they are based on inflated emission scenarios. Before scientists can estimate how much warming we will see in the future, they have to make assumptions about what volume of greenhouse gases will be emitted over the next several decades. As Roger Pielke, Jr. of the University of Colorado Boulder and Justin Ritchie of the University of British Columbia wrote in 2021, the emissions scenarios used by the United Nations Intergovernmental Panel on Climate Change (IPCC) are based on assumptions that are no longer realistic—and perhaps never were. For instance, the IPCC's most frequently relied upon scenario assumes that global per capita coal use will grow six-fold by 2100, despite most energy researchers agreeing that coal consumption has already peaked and will likely continue to decline. Major changes in the global energy mix, including a shift from coal to natural gas, have gone largely unrecognized by the emissions scenarios that are still being used by the U.N. and many climate modelers.[25]

In addition, those analyses also ignore the dramatic long-term decline in weather-related mortality during the past century. The total number of deaths from climate-related events such as wildfires, floods, hurricanes, and other natural disasters has decreased by approximately 99 percent over the past century, even as the Earth's population has increased by 400 percent. Statistician Bjorn Lomborg points out that misleading estimates of increasing weather-related disasters are due in part to better global communications and record-keeping—that is, the same impacts, in many parts of the world, would have simply gone unrecorded in previous eras.[26] The next 100 years are far more likely to resemble this staggering increase in human well-being, made possible by economic growth and innovation, than the predictions of widespread doom advanced by climate alarmists.

This is also true of the relative economic impact of extreme weather events. Recent research by European researchers Giuseppe Formetta and Luc Feyen demonstrates "a clear decreasing trend in both human and economic vulnerability, with global average mortality and economic loss rates that have dropped by 6.5 times and nearly 5 times, respectively, from 1980-1989 to 2007-2016." Also, while there is still a significant gap between resilience to extreme weather in rich and poor countries, that gap is narrowing over time, creating "a convergence in vulnerability between higher and lower income countries."[27]

On a related note, the frequent suggestion that hurricanes and wildfires are becoming more expensive generally ignores changes in economic development, population growth, and residential construction trends. Such disasters have a bigger price tag today because there are more people and structures in harm's way—due to more residences being built on the coasts and in exurbs nearer to the urban-wildlife interface—not because their intensity or frequency is actually greater.[28]

Disclosure activists also overestimate the costs of climate change by underestimating mankind's demonstrated capacity for adaptation. Predictions of higher future temperatures often come with extremely large estimates of future financial impact. But many such studies simply use linear extrapolations to calculate estimated future impacts, while assuming no efforts being made to adapt to those changing conditions. That is like assuming that sea level rise would cause mass drowning because people living in coastal areas would simply sit in place and let the water rise over their heads. As a 2018 Manhattan Institute study points out:

> Many recent temperature-study-based estimates of climate-change cost overextend models constructed from small short-term effects and make untenable no-adaptation assumptions; the large harms that they forecast often represent aggregations of implausible local predictions. When results do account for adaptation and are presented in context, they point toward low and manageable climate-related costs.[29]

Moreover, as disclosure advocates exaggerate the certainty and magnitude of climate change risk, they also overestimate the prospects for dramatic policy change. Far from being inevitable, the chances of Congress enacting a carbon tax, a national cap-and-trade program, or a national "clean electricity standard" are extremely small. After the midterm elections in November 2022 and the start of the 118th Congress, they will likely be smaller still. If anything, the odds of such major legislation advancing today are slimmer than at almost any point since President Bill Clinton endorsed the Kyoto Protocol in 1997.[30]

Comments Submitted by the Competitive Enterprise Institute. In addition to the analysis of the SEC's notice of proposed rulemaking described above, similar problems were noted in two comment letters submitted by the Competitive Enterprise Institute in June 2021 in response to the agency's initial request for information. One letter, by Richard Morrison, focused on the finance and regulation issues involved.[31] The other, by Marlo Lewis, focused on the climate science and energy issues. Each was co-signed by several other free-market advocacy organizations.[32]

Finance, Regulation, and Corporate Governance. The first letter addressed regulatory burdens, information markets, and the limits of producing valuable data via threat of punishment, and included the following points.

The SEC does not have statutory jurisdiction to require climate-specific disclosure and it is inappropriate for a finance agency like the SEC to be making environmental policy. While the agency's mission must respond to changing market and finance industry conditions, it cannot be infinitely elastic. As the SEC acknowledges, many firms are already choosing to disclose climate-related data, which means that demand for such information and a market for disclosure already exist. Moreover, expanding the agency's jurisdiction into this new realm could open the floodgates for unbounded mission creep into other areas as well—and not just by the SEC, but by other agencies relying on the SEC's current expansion of its own authority as precedent.

A climate disclosure mandate would constitute an attempt to sneak climate policy that failed in Congress through the backdoor of the rulemaking process. Congress' past actions on this topic are key. The types of climate policy "progress" that the SEC is seeking to implement via rulemaking have repeatedly been rejected legislatively. From the non-ratification of the Kyoto Protocol in 1997 to the Green New Deal's dim prospects on Capitol Hill, major climate change legislation has been rejected again and again by Congress. New rules being proposed by the SEC are likely to be climate change activism in a finance regulation wrapper, an attempted end-run around Congress rather than a serious effort to protect investors.

Scientific uncertainty and the extremely long time horizons involved make it impossible for firms to make useful projections about any individual corporation's climate impact. On a long enough timeline, all seemingly smart business decisions become falsified by unknowable variables. It is certainly possible that changes in global weather patterns over the next several decades might make certain investments less valuable in 2100 than they would otherwise have been, but that does not mean investors should steer capital away from such activities immediately. The break-even point for climate-sensitive investments might not be for 10, 20, or 50 years down the road.

Advocates of climate disclosure argue that it is validated by enthusiasm in the finance industry, but that enthusiasm is largely self-serving. Mandatory disclosure that would impose burdens on *all* public companies but deliver benefits to *some* investment and accounting firms will be popular with the latter, but that doesn't validate the policy as a whole. The SEC's job is not to shift costs away from ratings agencies and asset management analysts and onto individual firms just because the agencies and analysts in question would prefer such an outcome.

A regulatory mandate will result in the production of many new reports and filings, but that information will not likely be useful in decision-making. A spreadsheet with dozens of rows of figures may look impressively precise, but that apparent precision will not count for anything if the parties sharing it do not agree on the meaning of what is being measured. This illusory precision can help create a consistent data set, but will only distort decision-making and lead investors astray if it is accepted as the truth simply because of its apparent uniformity and thoroughness. Competitive Enterprise Institute founder Fred L. Smith, Jr. referred to this elevation of numbers above context and values as "SONKing"—the Scientification of Non-Knowledge.[33]

Mandating disclosure by corporations of subjective and disparaging information is also an unconstitutional violation of First Amendment protections. As noted, in *National Association of Manufacturers v. SEC*, a federal appeals court invalidated the conflict minerals disclosure requirement of the Dodd–Frank Wall Street Reform and Consumer Protection Act based on compelled speech grounds.[34] Any climate disclosure mandate that the SEC adopts will likely involve similar violations, especially since the disclosure of any information unpopular with climate activists will be inherently disparaging.

The letter also addressed additional topics in the RFI, including how to manage changes to the disclosure regime over time, the questionable advantages of global standards, the use of a "comply or explain" enforcement framework, and whether climate change concerns should be part of a broader ESG regulatory framework.

Climate Science and Energy. CEI's second letter responding to the SEC's March 2021 request for information, focusing on climate science and energy policy, featured the following arguments.

Climate risk assessments typically depend on multiple assumptions fraught with uncertainties. Speculative risk estimates are of little financial value to investors. Evaluating climate risk involves forecasting macroeconomic energy demand, guessing on the success of carbon regulation and future technologies, modeling the relationship between atmospheric gas concentrations and global temperatures, predicting how temperature rise will change the Earth's climate system, and calculating how those changes impact physical economic assets. The task is far beyond the skills of most investors and finance analysts, even with all of the data that would be available under optimal compliance expectations of the proposed rule.

Most climate-related risk assessments are based on models and assumptions biased toward the most extreme predictions. That taints many climate risk exposure analyses, even those with a granular, asset-specific focus. That bias toward extreme and unlikely climate scenarios naturally produces more alarming predictions of financial risk and misleads firms and investors as to what sort of mitigation policies might yield a positive cost-benefit outcome.

Recent and predicted damage by extreme weather events is frequently misattributed to climate change and fails to account for changes in population, wealth, and development patterns. When we adjust the damages for historical weather events to today's population and level of development, the analysis changes completely. For example, there has been no trend in normalized U.S. hurricane damages since 1900. That result is consistent with meteorological data, which show no long-term trend in the frequency and strength of U.S. landfalling hurricanes. As a 2018 study published in the Bulletin of the American Meteorological Society notes: "While neither U.S. landfalling hurricane frequency nor intensity shows a significant trend since 1900, growth in coastal population and wealth have led to increasing hurricane-related damage along the U.S. coastline."[35]

The kind of climate risk analysis that the SEC would require presents unduly pessimistic "sustainability" predictions and radically underestimates society's capacity for adaptation. Deaths from climate-related threats have declined dramatically over the last century, and even in recent decades, the warmest in the instrumental record, mortality and economic loss data point to an increasingly sustainable civilization. For example, data from Munich Re and Aon, two companies that track natural disaster losses for the global reinsurance industry, indicate that the economic impact of weather-related losses declined from about 0.3 percent of global GDP in 1990 to about 0.25 percent in 2019.[36]

The SEC's ostensible goal of protecting shareholder value is directly at odds with the goals of climate activists, which is to throttle capital flows and business opportunities to disfavored firms and industries. The proponents of climate risk disclosure are not merely chroniclers of transition and liability risks, but market players actively engaged in magnifying those risks. Politically, the function of climate risk disclosure is to extract confessions from fossil fuel companies that their business models are unsustainable in a carbon-constrained world. Such confessions could decapitalize the companies, as investors and banks tend to shun businesses perceived to lack assets of durable value. This could cause millions of investors to experience severe financial losses based entirely on political expectations rather than on any actual physical risk.

The SEC's policy orientation emphasizes risks from climate change, but ignores the significant risks to consumers, shareholders, and the U.S. economy arising from poor climate policy. Abundant, reliable, and affordable energy is a valuable societal asset. Even the most efficient, least distortionary decarbonization policies begin to yield negative returns long before they get to a "net zero" target, causing massive job loss, reduced household incomes, reduced GDP, and massive increases in household electricity costs.[37]

Contrary to ESG advocates' claims that the SEC's interest in this issue is merely maintaining fair and orderly markets, the SEC's proposed actions are more likely to cause a dangerous malinvestment bubble in green energy firms and technologies, which will inevitably burst and leave investors worse off in the long run.

Conclusion. The Securities and Exchange Commission has decided to go in a radical and misguided new direction with its current proposed climate disclosure rule. This foray into environmental policymaking by proxy is outside the SEC's jurisdiction and competency.

Worse, it threatens to impose massive, widespread costs on U.S. public companies for the benefit of a small handful of the largest asset management, accounting, and consulting firms. The staggering volume of resulting bureaucratic busywork will cost billions of dollars and generate little useful information that could not have been produced by market forces and voluntary disclosure.

That would be bad enough. But the assumptions underlying the rule and the incentives it will create will actually accomplish the exact opposite of its goal—that is, it will result in capital allocation decisions that will increase risk and result in lower returns for investors. The SEC is attempting to take a level playing field for different firm types and energy sources and tilt it in a particular political direction, despite ample evidence that current climate models and emissions scenarios are overstating risk and understating resiliency.

The agency should abandon this rulemaking and restate its current position that climate-related risks need only be disclosed by registrant firms if they meet the traditional definition of being financially material to investors.

Notes

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