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Beyond Scope: How the SEC's Climate Rule Threatens American Markets

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Chairman McHenry, Ranking Member Walters, Vice Chair Hill, and members of the Committee on Financial Services: Thank you for inviting me today to discuss the SEC's Climate Disclosure Rule. I am an Assistant Professor of Finance and the Brownlee O. Currey Jr. Dean's Faculty Fellow at Vanderbilt University's Owen Graduate School of Management. I have been a tenure-track faculty member since 2017. The views expressed are solely mine and do not represent those of Vanderbilt University.

Over 2012 to 2018, I served as a financial economist and expert consultant in the Division of Economic and Risk Analysis at the U.S. Securities and Exchange Commission ("SEC"). My research and cost-benefit analyses have been cited in numerous SEC rulemakings.[1] I have published scholarly articles in law reviews on performing cost-benefit analyses of rulemaking activities (White, 2015; 2016). My peer-reviewed papers evaluate the impact of SEC rule changes and appear in leading finance and accounting journals. Recently, a U.S. Court of Appeals cited my critique of the SEC's economic analysis on a stock buyback disclosure rule, resulting in the rule being vacated.[2] Thus, my expertise centers on analyzing and assessing the economic impact of changes in securities laws.

In my testimony today, I will analyze the economic analysis underlying the SEC's climate-related disclosure rule, including its purported costs and benefits. I will highlight specific shortcomings in the SEC's economic analysis and conclude that the final rule lacks a fully justified cost-benefit analysis. Unless these concerns are addressed, I fear the rule will increase the registrants' compliance costs without corresponding benefits to justify such increases. <u>It is my opinion that the adopted rule on climate-related disclosure will ultimately harm capital formation, deter companies from going public, reduce employment, and limit investment opportunities for ordinary investors</u>.

1. Background Information on the SEC's Climate-Related Disclosure Rule

The SEC recently promulgated rule amendments that will require registrants to include specific climate-related information in their registration statements and annual reports. These amendments were titled, "The Enhancement and Standardization of Climate-Related Disclosures for Investors" (89 FR 21668; March 28, 2024) ("Final Rule"). I briefly review the new reporting requirements below.

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[1] *See* "Credit Risk Retention," Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; SEC; Federal Housing Finance Agency; and Department of Housing and Urban Development (79 FR 77602; December 24, 2014); "Accelerated Filer and Large Accelerated Filer Definitions," SEC (85 FR 17178; March 26, 2020); "Publication or Submission of Quotations Without Specified Information," SEC (85 FR 68124; October 27, 2020); and "Share Repurchase Disclosure Modernization," SEC, (88 FR 36002; June 1, 2023).

[2] *See* Chamber of Commerce of the USA v. SEC, Docket No. 23-60255 (5th Cir. May 16, 2023). The "Share Repurchase Disclosure Modernization" rule was vacated by the U.S. Court of Appeals for the Fifth Circuit on Dec. 19, 2023, because the SEC "acted arbitrarily and capriciously, in violation of the APA (Administrative Procedure Act), when it failed to respond to petitioners' comments and failed to conduct a proper cost-benefit analysis." My joint analysis with Professor Craig Lewis provided three suggestions as to how the SEC could quantify the rule's effect. The Fifth Circuit's opinion notes that the SEC never considered our suggestions and that, "All three suggestions address costs and benefits the SEC identified in the proposed rule." Specifically, the court opinion states that "[a]ll three suggestions provide quantification of the rule's expected costs and benefits—the very same costs and benefits the SEC assert 'cannot be quantified.'"

Under Regulation S-K of the adopted rule, registrants must disclose their climate-related risk governance practices, including which board committees or subcommittees oversee these risks. Registrants will also be required to disclose if and how their directors are monitoring advancement towards publicly stated climate-related objectives, targets, or transition strategies.

The final rule requires that registrants describe any processes it has for identifying, assessing, and managing material climate-related risks. Registrants must identify and disclose climate-related risks and impacts on business strategy, business model, outlook, and financial statements. These include the *physical* impacts of the climate relating to (acute) severe weather events and (chronic) longer-term weather patterns and related events, and whether this risk is categorized as acute or chronic. It also includes the potential *transition* to a lower carbon economy, which includes risks related to regulatory, technological, market, liability, reputational, or other transition-related factors.

Large accelerated filers ("LAFs") and accelerated filers ("AFs") must report Scope 1 and 2 greenhouse gas ("GHG") emissions and provide attestation reports for these disclosures, with phased-in compliance dates. Initially, these reports require "limited assurance" from third parties, which increases to "reasonable assurance" for LAFs after four years. Attestation providers must also meet specific expertise and independence criteria.

The rules require registrants that set climate-related targets or goals to disclose certain information about those targets or goals if it has materially affected or is reasonably likely to materially affect the registrant's business, results of operations, or financial condition. Registrants are expected to face additional audit costs due to the final rules, which are distinct from the mandatory assurance fees related to GHG emissions disclosure.

The amendments require registrants to potentially disclose scenario analysis if it is used to assess potentially material climate-related risks to their business. If scenario analysis identifies a likely material climate-related risk, registrants must describe each scenario, including the parameters, assumptions, and analytical choices, along with the expected material financial effects.

While the final rules make some modifications from the SEC's 2022 proposal, the SEC did not fully incorporate comments from market participants on how to construct the disclosure obligations. Instead, the final rule has double-digit instances where the SEC notes that "we decline" to follow or recognize suggestions recommended by commenters.

2. Estimated Costs of the SEC Rule

The final rules will introduce several new disclosure requirements for SEC registrants. As a result, these registrants will incur higher costs of SEC reporting, which could be substantial. The expenses of complying with the new rule can be partitioned into direct and indirect costs, which I detail below, including a discussion of the SEC's quantification when available.

2.1. Direct costs

The direct costs of the rule for registrants include the following disclosures:

- Regulation S-K
  - governance and oversight of climate-related risks (Item 1501)
  - actual and potential material impacts of climate-related risks on the strategy, business model, and outlook (Items 1502(a) through (e) and (g))
  - risk management (Item 1503)
  - scenario analysis (Item 1502(f))
  - targets and goals (Item 1504)
  - material Scope 1 and 2 emissions metrics (Item 1505)
  - attestation of Scope 1 and 2 emissions disclosure (Item 1506)
- Regulation S-X disclosures of financial statement effects of climate-related events
- Incremental audit fees

The costs of the climate disclosure rules will differ widely based on the size, industry, complexity, and other attributes of SEC registrants. In **Table 1**, I replicate the SEC's estimate compliance costs in the final rule. Excluding GHG emission disclosure, the SEC's economic analysis projects a compliance cost of $872,000 for the first year, followed by a cost of $597,000 annually in the subsequent years. This estimate leads to an aggregate compliance expense of $6,200,000 across the rule's first decade.

Table 2 reports the SEC's estimated compliance costs for Scope 1 and 2 emission disclosures for LAFs and AFs. The SEC estimates an additional $151,000 in the initial year of reporting and $167,000 in annual costs for both disclosing Scope 1 and 2 GHG emissions and for auditor attestation of these disclosures. Thus, the steady-state annual disclosure costs for these registrants were estimated by the SEC to be $764,000.

The SEC reports that the final rule increases the annual cumulative burden for registrants from $5.0 billion to $5.9 billion, which is an 18 percent increase. In the dissenting statement, SEC Commissioner Peirce notes that the final rule's estimate of the cumulative external cost burden on public companies under the Paperwork Reduction Act ("PRA") declined from $6.4 billion annually in the proposing release to $0.6 billion for climate-related disclosures on Forms S-1 and 10-K.[3] I replicate these estimates in **Table 3**, which are adjusted for the updated hourly professional costs of $600 per hour. The totals are plotted in **Figure 4**. These estimates reflect a more than 90 percent decrease from the proposing release and are not explained by the SEC in the PRA discussion or the economic analysis.

The SEC likely significantly underestimates the compliance costs for the new climate-related disclosure rules. This is a common issue with wide-ranging changes in regulatory obligations. For example, a 2009 SEC study shows that compliance costs for Section 404(a) of the Sarbanes-Oxley Act of 2002 were 367% higher than the SEC's estimate in the final rule.[4]

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[3] *See* Statement by Commissioner Hester M. Peirce, "Green Regs and Spam: Statement on the Enhancement and Standardization of Climate-Related Disclosures for Investors," (Mar. 6, 2024), available at https://www.sec.gov/news/statement/peirce-statement-mandatory-climate-risk-disclosures-030624.

[4] *See* SEC, SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, September 2009, Table 8, http://www.sec.gov/news/studies/2009/sox-404_study.pdf.

Further, the significant changes in the final rule, coupled with the lack of reopening of the comment period, prevented market participants from evaluating and offering updated compliance cost estimates in light of these changes. To facilitate a more accurate assessment of the direct compliance costs, the SEC could have reopened the comment period to request cost estimates reflective of the revised provisions, such as the removal of Scope 3 GHG disclosures.

Consistent with this notion, I am concerned by the apparent uptick in rushed economic analyses and rulemaking at the SEC. Indeed, SEC staff in the Division of Economic and Risky Analysis reported concerns in 2022 over an aggressive rulemaking agenda and the rapid development of high-profile rules that face significant stakeholder pressure.[5] Conducting thorough and meticulous cost-benefit analyses for substantial regulatory changes is a task that should never be hastened.

2.2. Indirect costs

The final rules could lead to several indirect costs, including an increased litigation risk for registrants. The SEC designates the new disclosures as "filed," which is subject to liability under the Securities Act of 1933 and Exchange Act of 1934. Although the disclosure rules offer safe harbor provisions for some forward-looking statements, they may still lead to expanded legal liability. The climate disclosures will take place in registration statements and annual reports. Thus, registrants could be subject to allegations that their climate disclosures contain materially misleading statements or omissions, in violation of securities laws.

Another concern is that disclosing such granular climate-related information could reveal proprietary information to business competitors. Essentially, forcing the disclosure of sensitive and detailed information could expose confidential aspects or trends of a registrant's operations, business strategies, or production processes. This puts public companies at a disadvantage versus private ones, further raising the costs of being public and incentivizes firms most sensitive to climate risks to go or remain private.

A third potential indirect cost is investors' tendency to overly fixate on salient information in SEC filings. This aspect is often overlooked in cost-benefit analyses (including the SEC's final rule on climate-related information) despite its common occurrence after prescriptive disclosures. Boone, Starkweather, and White (2024) demonstrate that simplifying multifaceted Environmental, Social, and Governance ("ESG") disclosures into a single metric can lead to unintended outcomes, as investors tend to overemphasize the importance of this information due to the salient nature of metrics that have high prominence, contrast, or surprise. This study further shows that narrative disclosures fail to overcome the unintended impacts of highly salient ESG disclosures. In my opinion, this issue is likely to occur with the SEC's final rule, especially as it pertains to GHG information.

[5] *See* SEC, "The Inspector General's Statement on the SEC's Management and Performance Challenges, October 2022," (Oct. 13, 2022), available at https://www.sec.gov/files/inspector-generals-statement-sec-mgmt-and-perf-challenges-october-2022.pdf.

3. Purported Benefits of the SEC Rule

The SEC claims that the primary benefit of the rule is to provide comparable, consistent, and reliable disclosures of climate-related information. However, the economic analysis fails to demonstrate *how* the proposal will generate comparable, consistent, and reliable disclosures.

For example, the economic analysis suggests, "*This information will enable investors to better assess material risks in climate-related reporting and facilitate comparisons across firms and over time*."[6] However, it remains ambiguous which specific material information is presently not reported in a consistent manner and will be addressed by this rule amendment.

Moreover, the SEC's economic analysis acknowledges that "*research shows that publicly available climate-related information is reflected in asset prices, which is an indication that such information affects the prices at which investors are willing to buy or sell*."[7] If registrants must already disclose material climate-related risks, and studies indicate that these risks are already factored into stock prices, then mandating more granular disclosures will offer limited incremental decision-relevant information. The SEC cannot assert that costs will decrease for registrants already sharing this information—which is already reflected in their stock prices—without conceding that the benefits will also diminish. Such selective discussions in the SEC's economic analysis have parallels with the claims of "cherry picking" climate information that the SEC criticizes in its final rule.

Moreover, if asset prices already incorporate publicly disclosed climate-related information, then the alleged benefits of consistent and comparable reporting are dubious. In other words, what tangible gain will investors receive from this rule if climate-related information is already reflected in stock prices? And at what costs? Despite this limitation of the benefits, the costs of complying with the new regulation are both tangible and significant.

The final rule suggests that "*access to more reliable information could result in cost savings for those investors who collect or organize information about climate-related risks.*"[8] However, it is unclear how mandating disclosures that benefit a specific group of investors, who concentrate on a single risk factor, represents a net gain for all investors. The economic analysis does little to justify why investors with a focus on climate risk should receive preferential consideration over those concerned with other risk factors, such as supply chain disruptions, exchange rate risks, or geopolitical uncertainties.

4. Other Shortcomings in the SEC's Economic Analysis

In this section, I highlight other areas where the SEC's analysis falls short of its own stated guidance on conducting a proper cost-benefit valuation. These points are not meant to be comprehensive. Instead, they identify specific issues that warranted attention prior to the promulgation of the amendments.

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[6] *See* Final Rule at 645.
[7] *See* Final Rule at 646-647.
[8] *See* Final Rule at 650.

4.1. Need for rulemaking assumes issuers are not providing material climate-related disclosures

The final rule and its economic analysis fail to convincingly argue for prescriptive disclosures given the current principles-based disclosure regime already captures material risks relating to climate change. The SEC's interpretive guidance released in 2010 already urges registrants to disclose information on climate risks if they are material to its business.[9]

Thus, the rule is based on the premise that there is a market failure of registrants withholding information on material risks. Yet, the economic analysis provides no quantification of how many registrants fail to provide this information or enforcement actions taken for insufficient disclosure. In fact, academic studies show that issuers responded to the 2010 guidance by strengthening their climate-risk disclosures, especially when they operated in industries where climate factors are more likely to have an impact on their operations (e.g., Kim, Wang, and Wu, 2023). These findings indicate that the current principles-based approach is working as intended, as registrants provide more information when they operate in industries where climate-related factors are more likely to have a material impact on the present value of future cash flows.

The SEC's economic analysis ignores commenter suggestions on the materiality of certain disclosures, such as GHG information, to investors. A classic way to assess materiality is through an even study framework, similar to what the SEC uses in litigation like insider trading cases. Material information should trigger a significant change in the stock price or trading volume upon disclosure. In fact, commenters suggested this approach.[10]

In its economic analysis, the SEC declined to conduct an event study and pointed to "*support in peer reviewed literature for the importance of climate-related disclosures to investors*," noting that "*existing research finds an increase in stock price volatility around the day when GHG or carbon emissions are disclosed in a form 8-K filing*."[11]

But a closer look at the referenced study by Griffin, Long, and Sun (2017) reveals that the authors acknowledge 8-K disclosures indicate that firms deem such information as ex-ante material. Thus, it is unsurprising that information deemed material by managers is indeed material. Importantly, this study does not shed light on whether GHG disclosures are on average material, a point I explore further below.

It is also important to note that the study by Griffin, Long, and Sun is based on data from 2005-2010, which predates the SEC's 2010 interpretive guidance on climate-risk disclosures. Thus, there is no indication that findings from nearly two decades ago reflect current market responses to climate information.

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[9] *See* "Commission Guidance Regarding Disclosure Related to Climate Change," SEC, (75 FR 6290; Feb. 8, 2010), available at https://www.sec.gov/files/rules/interp/2010/33-9106.pdf.

[10] *See*, e.g., Overdahl Report (Jun. 16, 2022), noting that "*The Commission, likewise, could have employed well-known "event study" techniques to assess the price or volume responses to climate-related disclosures, but the Commission did not conduct any such analysis, even though event studies are a standard method of assessing financial materiality*." The Overdahl Report is available at https://www.sec.gov/comments/s7-10-22/s71022-20131892-302347.pdf.

[11] *See* Final Rule at 623.

While the SEC's economic analysis did not include an event study on climate disclosures, another commenter, Professor Daniel Taylor from The Wharton School at the University of Pennsylvania, conducted this analysis and shared the findings with the SEC.[12] He observed that most academic papers cited by the SEC in its proposed rule fail to explore the impact of a registrant's GHG disclosures on its share price or trading volume. Professor Taylor argues that the proposal neither offers nor cites any material evidence of GHG disclosures based on standard "event study" methodology. Instead, he notes that the SEC cites papers that mainly examine the relation between share prices and third-party ESG ratings, which are problematic.

Using standard event study tests, Professor Taylor found no statistically significant impact on stock price or trading volume from GHG disclosures for the average registrant in his sample. This result implies that, on average, the market does not consider GHG disclosures as material to a registrant's valuation.

Overall, the SEC does not offer a convincing argument for deviating from the principles-based disclosure framework of material climate-related risk disclosure.

4.2. Overlooks benefits of a principles-based approach

The SEC received multiple comments advocating for principles-based disclosures in order to adhere with the core principle of materiality of our disclosure system.[13] Despite adjusting some aspects in the final rule, many disclosure requirements still lean towards being prescriptive rather than principle-based.

A principles-based framework helps guard against revealing sensitive information unless it is materially significant. Historically, the SEC has favored the principles-based approach for risk factor disclosures, which helps ensure information is both useful for investors' decision-making and tailored to be specific to the registrant. This approach also aligns with the notion of materiality set forth by the U.S. Supreme Court.

4.3. Minimal analysis of the effects on capital formation

I am also concerned that the SEC has ignored focus on facilitating capital formation. Importantly, the SEC has a tri-fold mission to 1) protect investors, 2) maintain fair, orderly, and efficient markets, and 3) facilitate capital formation. Much of the rulemaking activity has focused on components of the mission not related to capital formation.

I am particularly concerned that the climate-related disclosure rule will heighten the burdens for public companies, especially the smaller ones that are crucial to job creation. I believe that the SEC has concentrated too much on strengthening disclosure requirements in ways that do not benefit capital formation.

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[12] *See* comment letter by Professor Daniel Taylor (Jun. 16, 2022), available at https://www.sec.gov/comments/s7-10-22/s71022-20131668-302058.pdf.

[13] See, e.g., comment letters by Business Roundtable (Jun. 17, 2022), Society for Corporate Governance (Sep. 9, 2022), Bank of America (Jun. 17, 2022). Comment letters may be accessed here: https://www.sec.gov/comments/s7-10-22/s71022.htm.

This concern is informed from my research into the effects of the Jumpstart Our Business Startups ("JOBS") Act of 2012. Lewis and White (2023) show that reduced compliance costs under the JOBS Act led to increases in biotech companies going public and raising capital to invest in innovation. Registrants used compliance savings under the JOBS Act to strengthen investment in product development, which resulted in greater innovation success and reduced startup failures. These benefits occurred without a reduction in financial reporting quality. The SEC should not ignore its important function in helping registrants go public and raise capital to fund new projects.

5. Conclusion

In closing, the SEC's climate-related disclosure rule likely has underestimated costs and overclaimed benefits. These amendments introduce highly detailed climate-related disclosure requirements, which I show are not supported by a thorough and balanced cost-benefit analysis. The final rule mandates extensive mandatory disclosures that will impose substantial direct and indirect costs on registrants.

The purported benefits of the rule—enhanced comparability, consistency, and reliability of climate-related disclosures—are also unsubstantiated. The SEC also relies on outdated studies and ignores suggestions for straightforward assessments (e.g., event studies) as to whether climate information is material. Ignoring commenter suggestions and new quantitative information undermines the SEC's rationale for moving away from a principles-based framework. The final rule mandates numerous prescriptive disclosure requirements while dismissing principles-based ones and will result in substantial increases in the burdens of reporting for public companies, particularly smaller ones. These rules could ultimately stifle public offerings, harm capital formation, and impede economic growth.

6. References

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Table 1. SEC Direct Compliance Cost Estimates

	Item	Annual Cost		First Ten Years	
		First Year [a]	Subsequent Years [b]	Average Annual Cost [c]	Total Cost [d]
Regulation S-K					
Governance, impact of climate-related risks on strategy, business model, and outlook, and risk management disclosure	1501; 1502(a)-(e), (g); 1503	$327,000	$183,000	$197,400	$1,974,000
Scenario analysis	1502(f)	12,000	6,000	6,600	66,000
Voluntary targets or goals	1504	10,000	5,000	5,500	55,000
Regulation S-X		500,000	375,000	387,500	3,875,000
Incremental audit fees		23,000	23,000	23,000	230,000
Total		$872,000	$592,000	$620,000	$6,200,000

Notes:

[a] Total is computed as: $327,000 (governance disclosure, risk disclosure) + $12,000 (scenario analysis) + $10,000 (target or goal) + $500,000 (Regulation S-X) + $23,000 (audit fees) = $872,000

[b] Total is computed as: $183,000 (governance disclosure, risk disclosure) + $6,000 (scenario analysis) + $10,000 (target or goal) + $375,000 (Regulation S-X) + $23,000 (audit fees) = $592,000

[c] Computed as first year cost plus nine times the annual cost for subsequent years. For example: ($327,000 + $183,000 × 9 years)/10 years = $197,400.

[d] Computed as first year cost plus the annual cost for nine subsequent years. For example: $327,000 + $183,000 × 9 years = $1,974,000

Table 2. SEC's GHG Emission Disclosure Compliance Cost Estimates

	Item	First Year [a]	Subsequent Years [b]
Additional Regulation S-K			
Scope 1 and 2 GHG emissions	1505	151,000	67,000
Assurance of Scope 1 and 2 GHG emissions disclosure	1506		100,000
Total		151,000	167,000

Notes:

[a] Computed as the median cost of assessing Scope 1 and 2 emissions ($66,000) divided by the one minus the reduction in cost after the first year: $66,000/ (1-0.56) = $151,364. The value in Table 2 is rounded to the nearest $1,000.

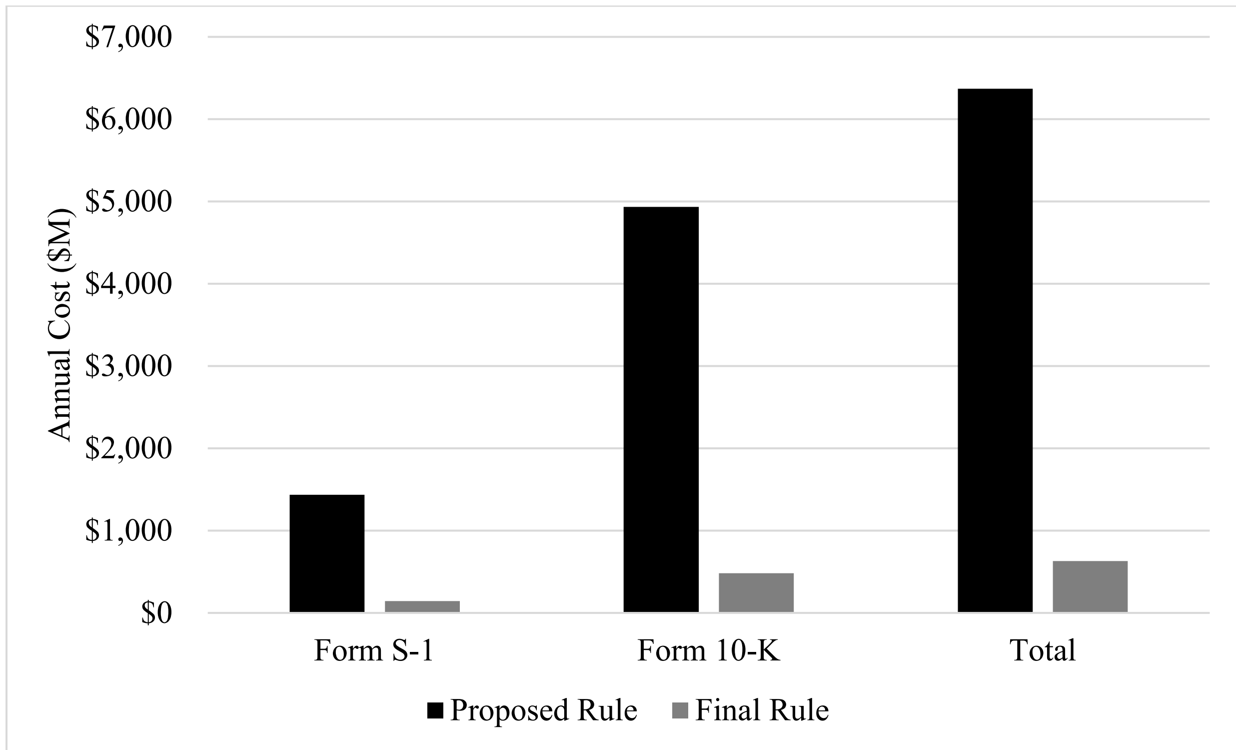
[b] The final rule presents estimates of $50,000 for the cost of limited assurance and $150,000 for reasonable assurance. Thus, I use the midpoint of $100,000 in Table 2.

Table 3. SEC's Estimate of the Annual Cumulative External Cost Burden ($M)

	(1)	(2)	(3)
	Proposed Rule at $400 / hour	Proposed Rule at $600 / hour	Final Rule at $600 / hour
Form S-1	$957.7	$1,436.6	$144.7
Form 10-K	3,288.8	4,933.2	483.8
Total	$4,246.5	$6,369.8	$628.5

This figure plots the SEC's estimate of the cumulative external cost burden on public companies from the proposed and final climate-related disclosure rule using Paperwork Reduction Act estimates for Forms S-1 and 10-K. Column (1) presents the estimates from PRA Table 4 (Requested Paperwork Burden under the Proposed Amendments) of the Proposing Release. Column (2) scales these estimates at the updated hourly rate of $600 per hour. Column (3) presents the estimates from PRA Table 6 (Calculation of the Incremental and Aggregate Change in Burden Hour and Cost Estimates of Current Responses Resulting from the Final Rules) from the Final Rule. All values are presented in millions of U.S. dollars ($M).

Figure 1. Annual Cumulative External Cost Burden Estimates by the SEC



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