european corporate governance institute

Saving Climate Disclosure

Law Working Paper N° 675/2023
April 2023

Scott Hirst
Boston University, Harvard University and ECGI

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ECGI Working Paper Series in Law

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For helpful suggestions and discussions of this project, I am grateful to Lucian Bebchuk, John Cannon, Emiliano Catan, John Coates, Madison Condon, Larry Cunningham, Elisabeth de Fontenay, Luca Enriques, Ofer Eldar, George Georgiev, Jeffrey Gordon, Jill Fisch, Colleen Honigsberg, Keith Hylton, Robert Jackson, Gary Lawson, Kobi Kastiel, Yoon-Ho Alex Lee, Josh Mitts, Christopher Robertson, Sarath Sanga, Gabriel Rauterberg, Holger Spamann, Roberto Tallarita, David Walker, and David Webber, and to participants in the Boston University Faculty Workshop. For excellent research assistance I thank Garret Podolan and Jaclyn Rothenberg.

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Abstract

Designing a regulatory response to climate change is one of the defining challenges of our era. In an attempt to address it, the Securities and Exchange Commission (SEC) has recently proposed a historic rule requiring climate-related disclosure by companies, resting squarely on the rationale of "investor demand." The proposed climate disclosure rule has met with an unprecedented response, some of it reflective of investor demand, but also including a broad array of opponents critical of the rule, who cast doubt on the rule's validity. A judicial challenge is all but inevitable. This Article explains that the best way for the SEC to save climate disclosure and to protect investors is to let them decide. That is, the SEC should let companies opt out of all or part of their climate disclosure obligations if sufficient investors have voted to allow it to do so. This "investor-optional" approach would result in three important improvements necessary to save climate disclosure and best protect investors. First, it would make the design of the SEC's rule consistent with the SEC's core claim that there is investor demand for climate disclosure; if this is indeed the case, a mandatory rule is not necessary, creating a logical inconsistency that threatens the validity of a mandatory rule. Second, making climate disclosure investor-optional would circumvent claims that the rule is invalid, which—to the extent they apply at all—apply only to a mandatory disclosure rule. Third, an investor-optional rule would better protect investors than a mandatory rule, reducing their net costs, while preserving their benefits. As a result, the SEC is required to consider an investor-optional rule, and having done so, it will be difficult for the SEC to justify adopting a mandatory rule instead. As well as explaining why the SEC should let investors decide about climate disclosure, the Article explains how the SEC should design the rule to ensure that it best protects investors. Letting investors decide would have benefits beyond climate, not only for other "ESG" disclosure rules, but for the SEC's regulatory program more generally, and thus also for investors.

Keywords: climate change, greenhouse gas emissions, disclosure, mandatory disclosure, judicial review, administrative procedure act

JEL Classifications: K22, K23, G38

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SAVING CLIMATE DISCLOSURE

*Scott Hirst**

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Designing a regulatory response to climate change is one of the defining challenges of our era. In an attempt to address it, the Securities and Exchange Commission (SEC) has recently proposed a historic rule requiring climate-related disclosure by companies, resting squarely on the rationale of "investor demand." The proposed climate disclosure rule has met with an unprecedented response, some of it reflective of investor demand, but also including a broad array of opponents critical of the rule, who cast doubt on the rule's validity. A judicial challenge is all but inevitable.

This Article explains that the best way for the SEC to save climate disclosure and to protect investors is to let them decide. That is, the SEC should let companies opt out of all or part of their climate disclosure obligations if sufficient investors have voted to allow it to do so. This "investor-optional" approach would result in three important improvements necessary to save climate disclosure and best protect investors. First, it would make the design of the SEC's rule consistent with the SEC's core claim that there is investor demand for climate disclosure; if this is indeed the case, a mandatory rule is not necessary, creating a logical inconsistency that threatens the validity of a mandatory rule. Second, making climate disclosure investor-optional would circumvent claims that the rule is invalid, which—to the extent they apply at all—apply only to a mandatory disclosure rule. Third, an investor-optional rule would better protect investors than a mandatory rule, reducing their net costs, while preserving their benefits. As a result, the SEC is required to consider an investor-optional rule, and having done so, it will be difficult for the SEC to justify adopting a mandatory rule instead. As well as explaining why the SEC *should* let investors decide about climate disclosure, the Article explains *how* the SEC should design the rule to ensure that it best protects investors. Letting investors decide would have benefits beyond climate, not only for other "ESG" disclosure rules, but for the SEC's regulatory program more generally, and thus also for investors.

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INTRODUCTION

Designing a regulatory response to climate change is one of the defining challenges of our era.[1] In an attempt to address it, the Securities and Exchange Commission (SEC) has recently proposed a historic rule (hereinafter, the "Proposed Rule").[2] The rationale for the rule rests squarely on the claim made by the SEC that there is substantial "investor demand" for that disclosure.[3] To meet this demand, for the first time, all companies registered with the SEC would be required to disclose their climate risks and related information, both in their annual reports, and in registration statements.

The required disclosure would include the company's direct greenhouse gas emissions ("Scope 1" emissions), their emissions from purchased energy ("Scope 2" emissions), and their indirect emissions from upstream and downstream activities ("Scope 3" emissions) if material, or if they have set a target for such emissions.[4] They would also need to disclose the effects of climate-related events and transition activities on line items in their financial statements, as well as how they would affect their business, and how they identify, assess, and govern climate-related risks.

The proposed climate disclosure rule has met with an unprecedented public response.[5] Much of the response has reflected investor demand for a climate disclosure rule. But the Proposed Rule has also been attacked by a broad array of opponents. These include one of the SEC's own Commissioners, as well as members of Congress, state governors and attorneys general, industry groups, lawyers, academics, and many others.[6] These opponents question the level of investor demand for climate

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[1] *See, e.g.*, Elisabeth Rosenthal, *U.N. Chief Seeks More Climate Change Leadership*, N.Y. TIMES (Nov. 18, 2007), https://www.nytimes.com/2007/11/18/science/earth/18climatenew.html [https://perma.cc/Q944-UEH6] (defining climate change as the "the defining challenge of our age"). *See also* Roberto Tallarita, *The Limits of Portfolio Primacy*, 76 VAND. L. REV. (forthcoming 2023), https://ssrn.com/abstract=3912977 [https://perma.cc/XXXX-XXXX] (manuscript at 1).

[2] *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (proposed Apr. 11, 2022) [hereinafter, "Proposed Rule"]. At the time the substance of this Article was finalized for publication, in December 2022, the SEC had not yet adopted a final version of the Proposed Rule.

[3] *See infra* Section II.A.

[4] *See infra* Section I.A.

[5] *See infra* notes 53-59 and accompanying text.

[6] *See infra* notes 54-58 and accompanying text.

disclosure, and argue that the Proposed Rule is likely to be invalid. A challenge to the validity of the Proposed Rule in federal court seems all but inevitable.[7]

The SEC, its supporters, and its opponents, all presuppose that climate regulation should be structured as a uniform, mandatory rule, that binds all registered companies to disclose all of the information stipulated in the Proposed Rule. Their debate has focused on comparing the Proposed Rule to the status quo, of no specific climate disclosure requirements.

As this Article explains, this is a false duality. Largely ignored have been the many ways that a climate disclosure rule could be designed with some kind of optionality for companies or investors, allowing them to opt out of, or opt in to, disclosure requirements. The lack of consideration of these alternative rule designs is especially troubling, because—as this Article demonstrates—at least one such design is likely to be better for investors than the SEC's mandatory Proposed Rule.

This Article explains that the best way for the SEC to save climate disclosure and to protect investors is to let them decide. That is, the SEC should let companies opt out of all or part of their climate disclosure obligations if sufficient investors have voted to allow it to do so.[8] Several important features of this design would protect investors from the possibility that directors and officers of the company would opt out of disclosure requirements against the interests of investors. Most importantly, the opt-out would have to have been approved by holders of a majority of the equity capital of the company that voted on the opt-out, and the vote would have to have taken place after the company had gone public.[9] In addition, structuring the optionality as an opt-out from disclosure, rather than an opt-in to disclosure, would make it most likely that investor votes would be initiated where appropriate, because directors and managers—those best able to initiate investor votes—would have incentives to do so whenever they believed investors would support an opt-out. This "investor-

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[7] *See, e.g.,* Jacqueline Vallette & Kathryne Gray, *SEC's Climate Risk Disclosure Proposal Likely to Face Legal Challenges*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 10, 2022), https://corpgov.law.harvard.edu/2022/05/10/secs-climate-risk-disclosure-proposal-likely-to-face-legal-challenges/ [https://perma.cc/F4PH-3G9Y].

[8] For a discussion of why the rule should be structured as an *opt-out* rule, rather than an opt-in rule, see *infra* Section I.B.

[9] For a discussion of the optimal design of the opt-out, see *infra* Part V.

optional" approach is therefore likely to be the best approach to climate disclosure that incorporates optionality.

This Article compares these two rule designs through the lens of three questions. First, which of the two designs is more consistent with the SEC's rationale for the rule? Second, which is more likely to survive appellate court review? And third, which is likely to be better for investors? These questions are closely intertwined: a climate disclosure rule is likely to be invalid if it is not consistent with the SEC's given rationale of investor demand, or if it is worse for investors than an alternative designs. And increasing the likelihood of validity will result in greater benefits for investors. This Article strongly suggests that an investor-optional rule is likely to be better than a mandatory rule in each of these three dimensions, corresponding to three clear and compelling reasons why the SEC should make the Proposed Rule investor-optional.

The first reason why the SEC should make the Proposed Rule investor-optional is that it would make the design of the rule consistent with the SEC's core justification for the rule—that there is investor demand for climate disclosure—and resolve the uncertainty about the level of investor demand for climate disclosure.[10] This is important because the logical inconsistency between the SEC's rationale and its choice of a mandatory design risks the Proposed Rule being adjudged arbitrary and capricious. In addition, opponents have raised uncertainties regarding the actual level of investor demand for climate disclosure, which are difficult to rebut for a mandatory rule, undermining the SEC's basis for implementing the Proposed Rule.[11] Investor optionality would thus overcome these two major threats to the Proposed Rule.

Investor demand is inconsistent with mandatory disclosure, but entirely consistent with an investor-optional rule. If there is indeed broad support for climate disclosure among investors, there is no need for climate disclosure to be mandatory. If the SEC's claims of broad investor demand were true, then investors would not allow the companies they invest in to opt out of an investor-optional rule. Indeed, compared to the alternative of an investor-optional rule, a mandatory rule is only necessary if a majority of investors *do not* demand climate disclosure.

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[10] *See infra* Part II.
[11] *See infra* Section II.E.

Investor optionality would also address the underlying uncertainty regarding the level of investor demand for particular climate disclosures.[12] Opponents of the Proposed Rule have argued that the SEC's claims of investor demand are overstated—that companies already provide much of the information investors would demand, that investors do not actually demand all of the information that the Proposed Rule includes (especially given the costs of producing that information), and that the views of the investors cited by the SEC in the Release are not representative of the views of a majority of investors.[13] An investor-optional design would not only reconcile the competing claims of the SEC and its opponents, it is the *only* way to reconcile these claims, and the only practical way to resolve the uncertainty regarding the level of investor demand.[14] Investor optionality would condition disclosure on investor demand. If investors do not demand certain types of climate disclosure at a particular company, they will opt out, and companies will not be required to produce it. The disclosure obligations that remain will be the ones investors actually demand.

The second reason why the SEC should make the Proposed Rule investor-optional is that it would circumvent the most important attacks on the Proposed Rule, which—to the extent they apply at all—apply only to a *mandatory* disclosure rule. The Article addresses four arguments for the invalidity of the Proposed Rule raised by its opponents; for each of these, investor optionality would act as a shield against invalidity. And if the SEC chooses to make its final rule mandatory, investor optionality could also act as sword against the validity of that mandatory rule.

One argument raised by opponents of the Proposed Rule is that *climate disclosure is compelled speech*, and therefore in violation of the First Amendment rights of companies.[15] An investor-optional rule would circumvent this argument, because it would no longer *compel* speech. Instead, companies would be able to opt out of the disclosure obligation. Investor optionality would also answer a novel variation on the compelled speech argument put forward by Sean Griffith, who suggests that mandatory climate disclosure would be subject to heightened scrutiny because it is "controversial."[16] Investor-optional disclosure would only be required

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[12] *See infra* Section II.B.
[13] *See infra* Section II.B.
[14] *See infra* Section II.D.
[15] *See infra* Section III.A
[16] *See id.*

where investors had not opted out of it. If they have not done so there would be a reasonable, probative—and uncontroversial—basis to conclude that they regard such disclosure as appropriate.

A second argument raised by opponents of the Proposed Rule is that *climate disclosure is not material*, because a reasonable investor would not consider it relevant to their investing decisions.[17] Opponents of the Proposed Rule couple this with an additional claim that the SEC does not have the authority to require the disclosure of matters that are not material, and thus argue that climate disclosure falls outside the SEC's authority. Investor optionality would circumvent this argument, because if climate disclosure were not material to investors in a particular company, they would allow it to opt out of that obligation. That investors do not opt out of particular climate disclosure obligations is thus reasonable and probative evidence that they consider the information material.

Two related arguments for invalidity make the claim that *the SEC does not have statutory authority to require climate disclosure*.[18] One of these claims is based on the argument that climate disclosure is not part of the category of disclosure that the SEC is authorized to require under the Securities Act of 1933 or the Securities Exchange Act of 1934.[19] However, the matters required to be disclosed under those statutes (and by subsequent amendments) can be understood as those matters that investors are likely to consider material in making investment or voting decisions. Under an investor-optional rule, the only disclosure obligations that companies would be required to follow would be those that investors had not allowed the company to opt out of, and thus, that they are likely to find material for making investment or voting decisions. A related claim is that the Proposed Rule would implicate the recently-recognized "major questions" doctrine—thereby requiring explicit congressional authorization for climate disclosure—because it represents a broad claim of authority by the SEC, departing from its past practice and regulatory norms.[20] Allowing investors to opt out would circumvent this claim, by limiting the scope of the Proposed Rule, and by making it very clear that its purpose is to protect

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[17] *See infra* Section III.B.

[18] *See infra* Section III.C.

[19] Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2021); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78qq (2021).

[20] *See infra* Section III.C.

investors, thereby substantially circumventing the case that the major questions doctrine applies.

A fourth type of argument for invalidity is that *the SEC has not conducted appropriate or sufficient economic analysis* of the Proposed Rule to show that the (uncertain) benefits of disclosure outweigh its claimed costs.[21] Making the Proposed Rule investor-optional would make it much easier for the SEC to demonstrate that it had conducted appropriate economic analysis. Investor optionality would cap the costs of the Proposed Rule to a particular company at the relatively small cost of opting out of disclosure obligations. The benefits of climate disclosure would thus be much easier to justify compared to those opt-out costs, rather than in comparison to the much more substantial costs of gathering and preparing climate disclosure information. And because of the possibility for investors to opt out of disclosure, the very structure of an investor-optional rule would make clear that any disclosure that companies did not opt out of had greater benefit to investors than its costs.

As well as being a shield against these attacks, investor optionality could also operate as a sword against a mandatory climate disclosure rule.[22] The Administrative Procedure Act requires the SEC to consider reasonable alternatives to its proposed rules.[23] Investor optionality is a reasonable alternative to mandatory disclosure, as it is not only consistent with the SEC's rationale for promulgating a climate disclosure rule, but it would be *better* for investors than mandatory disclosure. If the SEC *does* consider the investor-optional alternative to mandatory disclosure, then it would need a good reason to nonetheless adopt a mandatory final rule. But the arguments made in this Article that investor optionality would be better for investors will make it very challenging for the SEC to justify a mandatory rule. If it were to do so without adequate justification, its rulemaking would be arbitrary and capricious, and therefore subject to invalidation under the Administrative Procedure Act.[24]

The third main reason why the SEC should make the Proposed Rule investor-optional is that it would be better for investors than a mandatory rule. The basic reasoning is straightforward. If all climate disclosure in the Proposed Rule has greater benefits for investors in all companies than its

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[21] *See infra* Section III.D.
[22] *See infra* Section III.E.
[23] *See infra* notes 196-201 and accompanying text.
[24] *See infra* note 206 and accompanying text.

costs, then no companies will opt out, and an investor-optional rule would be no worse than a mandatory rule. But if any disclosure under the Proposed Rule had greater costs than benefits to investors in any company, investors in that company would opt out of such disclosure, making an investor-optional rule less costly—and better for investors—than a mandatory rule.

Of course, this reasoning is only correct if several important assumptions underlying it are also valid.[25] These include the assumptions that investors are likely to vote for outcomes that are best for investors; that opt-outs will be initiated when they are likely to be beneficial for investors; that the costs to different investors of opt-outs are likely to be roughly commensurate; and that the aggregate costs of opt-out processes are likely to be less than the overall benefits from an investor-optional rule. The Article considers each of these the assumptions, and demonstrates why they are reasonable, and why they unlikely to be inaccurate in ways that would undermine the claim that investor optionality would be better for investors than a mandatory rule.[26]

The most reasonable case for a mandatory rule to be better for investors than an investor-optional rule revolves around externality benefits.[27] The base case for investor optionality being better for investors than a mandatory rule focuses on the costs and benefits to investors in the disclosing company. However, a mandatory rule will be better for investors if the externality benefits from particular companies disclosing climate-related information to investors outside those companies are greater than the net costs of that disclosure to investors in the disclosing companies. Demonstrating the magnitude of these externality benefits to investors in other companies would be the best way for the SEC to justify the choice of a mandatory rule over an investor-optional rule.

However, there are several reasons why externality benefits to investors in other companies are likely to be small.[28] Critically, the great majority of the investors in a company deciding whether to opt out are likely to internalize the cost of an opt-out decision on investors in other companies, *because they are the same investors*. Institutional investors in a company hold broadly diversified portfolios, so they are also the investors in many other companies. One group of outside investors in other companies whose

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[25] *See infra* Section IV.B.
[26] *See id.*
[27] *See infra* Section IV.C.
[28] *See id.*

views may not be fully internalized are socially responsible investors that exclude environmentally-unfriendly companies from their portfolios. However socially responsible investors currently make up less than 2% of equity capital in U.S. companies. And even if investors in the company differ substantially from those outside the company, several market mechanisms are likely to cause the investors in the company to internalize many of the benefits of disclosure to investors outside the company.

An additional way in which investor optionality would be better for investors than a mandatory rule is through the additional information it would provide.[29] Opt-out decisions by companies, or their absence, would provide a granular, automatic, observable, timely, and incontrovertible metric regarding the value and effectiveness of the Proposed Rule. This would not only assist other companies and investors with their own decisions regarding opt-outs, it would also allow the SEC to determine if parts of the Proposed Rule should be amended or repealed. However, the benefits to investors from an investor-optional rule would not be dependent on such amendment (which might nonetheless involve considerable delay). Any disclosure requirements that investors believed were not appropriate would effectively be self-repealing, because investors would permit companies to opt out of those requirements.

Having explained *why* the SEC should let investors decide about climate disclosure, the Article explains *how* the SEC should design the rule to ensure that it best protects investors.[30] Investor optionality is structured as an opt-out from disclosure, rather than an opt-in to disclosure, so that directors and managers—who have the greatest ability to initiate votes of investors—have incentives to initiate votes whenever investors are likely to approve them. Two additional features are necessary for investor-optional disclosure to be better for investors than a mandatory rule: opting out must require approval, after a company has gone public; and it must be approved by shareholders holding a majority of the equity capital of the company. To create an optimal rule, opt-outs should also sunset after a certain period of time, such as five years, giving investors an opportunity to change their minds regarding the opt-out. To avoid potential entanglements with state law rules, rather than *requiring* a vote of investors with the specified characteristics, the SEC should allow companies to opt out if they have

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[29] *See infra* Section IV.D.
[30] *See infra* Part V.

disclosed that the company has had a meeting that satisfies those criteria. And given the possibility that even an opt-out rule could be invalidated by a hostile court, the SEC should hedge by *also* allowing companies to opt in to climate disclosure if their investors approved.

The impact and implications of investor optionality are substantial, both for climate disclosure and beyond.[31] The Article offers some tentative predictions regarding the likely impact of making the Proposed Rule investor optional, including which companies are likely to have investors that would favor opting out, and from which parts of the Proposed Rule.[32] Comment letters by the largest investors suggest that they are unlikely to support opting out of the entirety of the Proposed Rule, but that they might be willing to opt out of requirements that certain companies disclose Scope 3 emissions and the effects of climate change on line items in financial statements. Given that these investors hold substantial stakes in the great majority of large companies, it is only at microcap companies—where these investors are less likely to hold substantial stakes—that opt-outs from disclosure in general may plausibly occur. Investors in these companies might be influenced against opting out by the possibility of signaling effects. And even if they did opt out, these companies represent a very small fraction of the U.S. capital markets.

The clearest implication of this Article is that the SEC should not simply assume that rules governing corporations should be mandatory, but should instead consider alternative rule designs, such as investor optionality. Beyond climate disclosure, investor optionality would be most obviously beneficial for other "ESG" rules that the SEC may be considering, for which the same rationale will apply.[33] In other work, I have explained how this principle potentially applies to all SEC rules regulating companies for the protection of investors.[34] The Article develops some boundary conditions for determining which other SEC rules are most likely to benefit from investor optionality. The most benefit would be for new rules where there

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[31] *See infra* Part VI.

[32] *See infra* Section VI.A.

[33] For the list of ESG and other rules that the SEC expects to consider, see SEC, *Agency Rule List - Spring 2022*, https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235 [https://perma.cc/DA9A-6S8E] (listing the SEC's proposed agenda, including "Human Capital Management Disclosure").

[34] *See generally* Scott Hirst, *The Case for Investor Ordering*, 8 HARV. BUS. L. REV. 227 (2018).

is considerable uncertainty regarding the likely benefit of the rule for investors, or where those benefits are likely to vary across companies or investors. For established rules where there is likely to be little investor support for opting out, there would be little benefit from making the rule investor-optional. These boundary conditions assuage potential concerns that investor optionality could be a "slippery-slope:" in most cases, it is instead likely to be a "sticky slope."

One additional benefit of letting investors decide would be for SEC rulemaking. Not only would investor optionality reduce the risk of invalidation of their rules, it would reduce the cost of rulemaking, by making it easier to conduct the economic analysis necessary to support its rulemaking. This would be beneficial no matter the view one takes regarding SEC rulemaking—it would either reduce the cost of making the same number of SEC rules, or allow the SEC to make more rules for the same cost. It would also facilitate experimentation with potential policies, and the quality of information that such experimentation would provide. These improvements to SEC rulemaking would redound to investors, through better regulation.

The Article is structured as follows. Part I describes the SEC's Proposed Rule, and the important questions about its design that it leaves unanswered. Part II explains how taking investor demand seriously requires the SEC to adopt an investor-optional rule, to avoid the inconsistency between the investor demand rationale and mandatory disclosure, and to resolve the uncertainty regarding investor demand. Part III explains how making the Proposed Rule investor-optional would circumvent the major claims that the Proposed Rule is invalid, and also how choosing a mandatory rule over an investor-optional design could be grounds for invalidity. Part IV demonstrates why an investor-optional rule would be better for investors than a mandatory disclosure rule. Part V explains how the SEC should design investor optionality to best protect investors. Part VI considers the impact and implications of investor optionality, both for climate disclosure and beyond.

I. SEC CLIMATE DISCLOSURE & ITS DESIGN

The key message of this Article is that the SEC can and should save its proposed climate disclosure rule, by improving the design of the rule. Section I.A introduces the Proposed Rule, including the regulatory

background to the rule, the content of the rule, and the response it has received. Section I.B turns to the important question of the *design* of the Proposed Rule—whether it should be mandatory or permit some optionality, and if the latter, how such optionality should be structured.

A. The SEC's Climate Disclosure Rule

The stakes for the validity of the SEC's Proposed Rule could not be higher. Designing a regulatory response to climate change is one of the defining challenges of our time, and a "wicked problem par excellence."[35] Limiting the effects of climate change is an obvious public good, which cannot be overcome by private action alone and requires regulatory intervention.[36] But even though the fact of climate change is beyond reasonable doubt, there is a substantial disagreement over regulatory solutions. The challenge of passing comprehensive legislation to address climate change has made agencies like the SEC a major focus of attempts to develop and implement regulatory solutions.[37]

The current regulatory landscape for climate disclosure by companies is sparse.[38] Since 1982, companies have been required to disclose information relating to litigation and business costs arising from compliance with laws

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[35] Franz Wohlgezogen, Angela McCabe, Tom Osegowitsch, & Joeri Mol, *The Wicked Problem of Climate Change and Interdisciplinary Research: Tracking Management Scholarship's Contribution*, 26 J. MGMT. & ORG. 1048, 1048 (2020).

[36] For an in-depth consideration of climate change as a public good, see Marco Grasso, *Climate Change: The Global Public Good* (Univ. Milano-Bicocca, Dep't Economics Working Paper, Paper No. 75, May 2004), http://repec.dems.unimib.it/repec/pdf/mibwpaper75.pdf [https://perma.cc/D6PL-2HMG]. For the foundational model explaining the under-production of public goods, see Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STATS. 387 (1954).

[37] The inclusion of climate-related spending in the recently-proposed Inflation Reduction Act of 2022 suggests some progress, but commentators have pointed out the need for more comprehensive—and legislatively challenging—regulation. *See, e.g.*, Tyler Cowen, *Democrats' Climate Bill Is a Clean Energy Dream. That's Not Enough.*, BLOOMBERG (Aug. 2, 2022, 6:30 AM), https://www.bloomberg.com/opinion/articles/2022-08-02/democrats-climate-bill-is-a-clean-energy-dream-that-s-not-enough [https://perma.cc/7UHT-W8YY] (describing three key ways in which additional legislation is required to combat climate change).

[38] For a description of the regulatory background on climate disclosure prior to the Proposed Rule, see Working Grp. on Secs. Disclosure Auth., Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors 2–5 (June 16, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20131670-302060.pdf [https://perma.cc/VNM5-6ZYP].

protecting the environment.[39] Climate-related issues that are financially material to the company are required to be disclosed in the same way as any other financially material matters.[40] However, existing rules do not impose specific legal obligations to disclose climate-related risks.[41] Instead, many companies voluntarily disclose some information regarding their emissions and climate-related risks, often in response to pressure from their investors or consumers.[42]

To fill the regulatory gap, the SEC's March 21, 2022 release (the "Release") put forward its Proposed Rule, entitled *The Enhancement and Standardization of Climate-Related Disclosures for Investors*.[43] If approved, the Proposed Rule would add new parts to the SEC's regulations that are applicable to public companies registered with the SEC.[44] Companies would be required to file climate-related information as part of annual reports and registration statements, and in the financial statements that are included in those documents.[45] The content of the required disclosure would consist of the following:

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[39] *See* Environmental Disclosure, Exchange Act Release No. 33–6130, 44 Fed. Reg. 56924, 56926(Oct. 3, 1979). *See also* Proposed Rule, *supra* note 2, at 21338 (describing the current regulatory landscape).

[40] *See* Commission Guidance Regarding Disclosure Related to Climate Change, Exchange Act Release No. 33–9106, 75 Fed. Reg. 6290, 6292 (Feb. 8, 2010). *See also* Proposed Rule, *supra* note 2, at 21338 (describing the SEC's 2010 guidance).

[41] *See, e.g.*, Richard M. Schwartz & Donna Mussio, *Distilling the SEC's Climate Change Guidance*, DIRECTORSHIP 1 (Apr. 2010), https://www.friedfrank.com/siteFiles/Publications/1E05462EBF810B60ABB76C635C57A56B.pdf [https://perma.cc/VHG6-KGZV] (analyzing the SEC's 2010 guidance and explaining that it "does not create new legal requirements").

[42] For a discussion of voluntary disclosure, see Hans B. Christensen, Luzi Hail, & Christian Leuz, *Mandatory CSR and Sustainability Reporting: Economic Analysis and Literature Review*, 24–32 (Nat'l Bureau of Econ. Rsch., Working Paper No. 26169, 2019).

[43] Proposed Rule, *supra* note 2. The Proposed Rule followed a previous implemented comments previously solicited by the SEC. *See* SEC Comm'r Allison Herren Lee, SEC, PUBLIC INPUT WELCOMED ON CLIMATE CHANGE DISCLOSURES, SECURITIES AND EXCHANGE COMMISSION (Mar. 15, 2021), https://www.sec.gov/news/public-statement/lee-climate-change-disclosures [https://perma.cc/G9UM-BNYH].

[44] Large accelerated filers would be required to commence filings for their 2023 fiscal years; accelerated filers for their 2024 fiscal year, and smaller reporting companies for the 2025 fiscal year, assuming in each case that the Proposed Rule becomes effective in December 2022. Companies required to disclosed Scope 3 GHGs would have an additional year to do so from those dates. *See* Proposed Rule, *supra* note 2, at 21346.

[45] Specifically, the Proposed Rule would add a new subpart to Regulation S–K, 17 CFR 229.1500–1507, and a new article to Regulation S–X, 17 CFR 210.14–01 and 02. *See* Proposed Rule, *supra* note 2, at 21345. Larger companies—those considered accelerated

1. The oversight and governance of climate-related risks by the registrant's board and management;
2. How any climate-related risks identified by the registrant have had or are likely to have a material impact on its business and consolidated financial statements, which may manifest over the short-, medium-, or long-term;
3. How any identified climate-related risks have affected or are likely to affect the registrant's strategy, business model, and outlook;
4. The registrant's processes for identifying, assessing, and managing climate-related risks and whether any such processes are integrated into the registrant's overall risk management system or processes;
5. The impact of climate-related events . . . and transition activities . . . on the line items of a registrant's consolidated financial statements and related expenditures, and disclosure of financial estimates and assumptions impacted by such climate-related events and transition activities[;]
6. Scopes 1 and 2 [greenhouse gas (GHG)] emissions metrics, separately disclosed, expressed, [b]oth by disaggregated constituent greenhouse gases and in the aggregate, and [i]n absolute and intensity terms;
7. Scope 3 GHG emissions and intensity, if material, or if the registrant has set a GHG emissions reduction target or goal that includes its Scope 3 emissions; and
8. The registrant's climate-related targets or goals, and transition plan, if any.[46]

The SEC's authority and rationale for the Proposed Rule are central to the question of the Proposed Rule's validity.[47] The SEC put forward the Proposed Rule based on its authority under the Securities Act of 1933, and the Securities Exchange Act of 1934 to promulgate disclosure rules that are

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filers and large accelerated filers—would be required to provide third-party attestation of their reports. *Id.* at 21346.

[46] *Id.* at 21345 (footnotes omitted). Scope 3 GHGs would not be required by smaller reporting companies, and their disclosure by other companies would be subject to a safe harbor. *Id.* at 21346.

[47] *See infra* Section II.A.

"necessary or appropriate in the public interest or for the protection of investors."[48] Both statutes also require the SEC to take into account whether the rules "will promote efficiency, competition, and capital formation."[49]

In the Release, the SEC justifies imposing the requirement to disclose climate-related information because that information "may be material to investors in making investment or voting decisions,"[50] and thus "many investors—including shareholders, investment advisers, and investment management companies" currently demand the information.[51] Despite this demand, the SEC explains that "existing disclosures of climate-related risks do not adequately protect investors," because they are insufficient or incomplete, because they are not consistent or comparable with those of other companies, and because they are not subject to a full range of liability and other regulatory provisions.[52] Part II discusses the implications of this "investor demand" rationale for the design of the Proposed Rule.

The SEC's Proposed Rule has received an unprecedented public response, with more than 14,000 comments submitted.[53] Responses have

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[48] *See* Securities Act of 1933, 15 U.S.C. § 77g (2021); Securities and Exchange Act of 1934, 15 U.S.C. §§ 78l, 78m, 78o (2021). *See also* Proposed Rule, *supra* note 2, at 21335 (recognizing this as the basis of the SEC's authority for the rule).

[49] *See* 15 U.S.C. § 77b(b); 15 U.S.C. § 78c(f). *See also* Proposed Rule, *supra* note 2, at 21335 (recognizing this additional requirement).

[50] Proposed Rule, *supra* note 2, at 21335 ("We are proposing to require disclosures about climate-related risks and metrics reflecting those risks because this information can have an impact on public companies' financial performance or position and may be material to investors in making investment or voting decisions.").

[51] *Id.* ("For this reason, many investors—including shareholders, investment advisers, and investment management companies—currently seek information about climate-related risks from companies to inform their investment decision-making.").

[52] *Id.*

[53] Jacob H. Hupart, et al., *What Public Comments on the SEC's Proposed Climate-Related Rules Reveal—and the Impact They May Have on the Proposed Rules*, MINTZ (July 20, 2022), https://www.mintz.com/insights-center/viewpoints/2022-07-20-what-public-comments-secs-proposed-climate-related-rules [https://perma.cc/R6TZ-J2TQ] ("Few, if any, of the SEC's rule proposals have ever received such voluminous, significant, and diverse comments.").

come from academics;[54] think tanks and industry organizations;[55] corporations;[56] investors;[57] state and federal representatives;[58] and many

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[54] *See, e.g.*, Jill E. Fisch & Cynthia A. Williams, PETITION FOR RULEMAKING ON ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) DISCLOSURE (Oct. 1, 2018), https://www.sec.gov/rules/petitions/2018/petn4-730.pdf [https://perma.cc/FF78-C7LR]; John Amour, Luca Enriques & Thom Wetzer, *Mandatory Corporate Climate Disclosure: Now, but How?*, 2021 COLUM. BUS. L. REV. 1085 (2021); Christensen, Hail, & Leuz, *supra* note 42; Madison Condon, *Market Myopia's Climate Bubble*, 2022 UTAH L. REV. 63 (2022); Lawrence A. Cunningham et al., Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (Apr. 25, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20132133-302619.pdf [https://perma.cc/6SEJ-NHG2]; Sean J. Griffith, Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 1, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20130040-296591.pdf [https://perma.cc/4DKZ-GJEU].

[55] *See, e.g.,* Evan Williams & Tom Quaadman, *The Proposed SEC Climate Disclosure Rule: A Comment from the U.S. Chamber of Commerce*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jul. 13, 2022), https://corpgov.law.harvard.edu/2022/07/13/the-proposed-sec-climate-disclosure-rule-a-comment-from-the-u-s-chamber-of-commerce/ [https://perma.cc/NF5Q-FZLM]; Bus. Roundtable, Comment Letter on Request for Public Input on Climate Change Disclosures (June 11, 2021), https://www.sec.gov/comments/climate-disclosure/cll12-8906771-244124.pdf [https://perma.cc/PR9Y-WWP3]; Nat'l Ass'n of Mfrs., Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 6, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20130306-296969.pdf [https://perma.cc/A7FZ-R8NN].

[56] *See, e.g.,* Citigroup Inc., Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 17, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20132291-302823.pdf [https://perma.cc/LV35-QDPJ]; Exxon Mobil Corporation, Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 17, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20132323-302882.pdf [https://perma.cc/TPY6-G5Q2]; General Motors Company, Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 17, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20132298-302830.pdf [https://perma.cc/S73B-MD6C]; Walmart Inc., Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 17, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20132116-302601.pdf [https://perma.cc/Y9MC-8MRW].

[57] *See, e.g.,* BlackRock, Inc., Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 17, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20132288-302820.pdf [https://perma.cc/46XW-C37P]; State Street Corporation, Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 17, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20131965-302424.pdf [https://perma.cc/TR76-VNZV]; Fidelity Investments, Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 17, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20132177-302674.pdf [https://perma.cc/XL26-3MXQ]; Tchrs. Ins. & Annuity Ass'n of

others.[59] These responses include both vociferous support, and strong opposition.[60] Among other things, critics have argued that the Proposed Rule is outside the SEC's legal authority; and that it would impose extensive and unreasonable costs on companies.[61] Commentators have suggested that a challenge to the validity of the Proposed Rule in federal court is all but inevitable.[62]

B. The Design of Climate Disclosure

The debate regarding the SEC's regulation of climate risks has focused on whether or not the SEC should regulate climate disclosure, and, to a lesser extent, on the information that should be included if it does.[63]

America, Comment Letter on Request for Public Input on Climate Change Disclosure (June 11, 2021), https://www.sec.gov/comments/climate-disclosure/cll12-8907502-244231.pdf [https://perma.cc/6FT3-3S69]; Vanguard Grp., Inc., Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 17, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20132302-302834.pdf [https://perma.cc/XH6D-PWJJ]; Cap. Rsch. & Mgmt. Co., Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 17, 2022).

[58] *See, e.g.*, W. Va. Off. of Att'y Gen., Comment Letter on Climate Change Disclosure (June 14, 2021), https://www.sec.gov/comments/climate-disclosure/cll12-8915606-244835.pdf [https://perma.cc/QA24-XUMZ]; Members of the U.S. Senate, Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (Apr. 5, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20122544-278541.pdf [https://perma.cc/23EN-S9BF]; Governs Spencer Cox, Kay Ivey, Mike Dunleavy, Doug Ducey, Asa Hutchinson, Brad Little, Kim Reynolds, Tate Reeves, Mike Parson, Greg Gianforte, Pete Ricketts, Doug Burgum, Kevin Stitt, Kristi Noem, Greg Abbott & Mark Gordon, Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (May 31, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20129962-296336.pdf [https://perma.cc/K5HL-UTVA]; U.S. Senate Comm. on Banking, Hous., and Urban Affs., Comment Letter on Request for Public Input on Climate Change Disclosures (June 13, 2021), https://www.sec.gov/comments/climate-disclosure/cll12-8911330-244285.pdf [https://perma.cc/X39U-RP89].

[59] For a detailed analysis of comment letters responding to the Proposed Rule, see Hupart et al., *supra* note 53.

[60] The great majority of comment letters (84%) were submitted using form letters provided by various organizations, of which a strong majority (88%) supported the Proposed Rule. *Id.*

[61] Hupart et al. estimate that 32% of letter opposing the Proposed Rule claim that the Proposed Rule is outside the SEC's authority, and 21% argue that the Proposed Rule will impose extensive and unreasonable costs on companies. *See id.*

[62] *See, e.g.*, Vallette & Gray, *supra* note 7.

[63] For contributions to the debate focusing on whether the SEC should regulate climate change disclosure, see, e.g., Fisch & Williams, *supra* note 54 (arguing in favor of SEC

Virtually ignored has been the appropriate "design" of the climate disclosure rule that the SEC would impose—whether the rule should mandate disclosure for all companies, or whether it should involve some type of optionality, allowing companies or investors to opt out of the rule, or opt in to the rule.[64]

The SEC's Proposed Rule presupposes, without additional examination or justification, that the SEC's climate disclosure rule should be uniformly mandatory—that all companies to which it applies would be required to disclose the information stipulated in the Proposed Rule.[65] Advocates for climate disclosure generally make a similar assumption, comparing a mandatory rule to the status quo.[66] Opponents of the Proposed Rule also do not suggest an alternative, but prefer that the status quo be maintained, with no climate disclosure regulation.[67]

But simply comparing the mandatory Proposed Rule to the status quo implies a false duality. It ignores the multiplicity of ways that a climate disclosure rule could be designed with some kind of optionality for companies and investors, such as allowing companies or investors to opt

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regulation of climate change disclosure); Cunningham et al., *supra* note 54 (arguing against SEC regulation of climate change disclosure). For analyses of the content of SEC climate change disclosure, see, e.g., Amour, Enriques & Wetzer, *supra* note 54 at 1133-42; Madison Condon, Sarah Ladin, Jack Lienke, Michael Panfil & Alexander Song, *Mandating Disclosure of Climate-Related Financial Risk*, 23 N.Y.U. J. LEGIS. & PUB. POL'Y 745 (2022).

[64] Opt-in and opt-out rules are both types of "private ordering." That category would also include the status quo of no regulation, whereby companies can decide whether to voluntarily disclose climate-related information.

[65] The Proposed Rule would "accommodate" certain categories of companies, especially smaller companies, by exempting them from certain disclosure requirements. In particular, small reporting companies (SRCs) would not need to disclose Scope 3 emissions, and attestation requirements would apply only to accelerated filers and large accelerated filers. The requirements would also be phased in, becoming applicable to large accelerated filers first (in 2024), and SRCs last (in 2026). *See* Proposed Rule, *supra* note 2, 21345-46.

[66] *See, e.g.*, Amour, Enriques & Wetzer, *supra* note 54 at 1107-24 (making "The Case for Mandatory Corporate Climate Disclosure" as compared to the status quo); Condon, *supra* note 54, at 69–70 (discussing the SEC's work preparing "proposed rules for mandatory climate risk disclosure."); Condon, Ladin, Lienke, Panfil & Song, *supra* note 63, at 749 (indicating that the article "details the need for new, mandatory disclosure requirements and makes recommendations for crafting them").

[67] For example, the comment letter authored by Larry Cunningham and 21 other law and finance professors argues against the Proposed Rule, but does not suggest an alternative formulation. *See* Cunningham et al., *supra* note 54.

out of climate disclosure, or to opt in to it.[68] Each of these alternatives differ from *both* the status quo and the Proposed Rule in important respects, including the level of disclosure that is likely to result, and the costs and benefit to investors from that disclosure. The lack of consideration by the SEC or its opponents of alternative rule designs is troubling because, as this Article demonstrates, at least one kind of optionality is likely to be better for investors than the SEC's mandatory Proposed Rule. The focus of this Article is on comparing the Proposed Rule to one such kind of optional rule, which I refer to as "investor optionality," whereby companies could opt out of climate disclosure if investors approve.[69] The remainder of this Section explains *why* this Article focuses on that comparison, rather than comparing the Proposed Rule to another of the many possible rule designs.

The question of whether the Proposed Rule would be better than the status quo of no climate regulation has been extensively and amply analyzed.[70] Views have been expressed by the SEC itself,[71] as well as by many of those submitting detailed comments to the SEC in response to the Proposed Rule.[72] This Article does not presume to add to that discussion. Instead, the Article takes as a given that there should be *some* form of SEC regulation of climate disclosure, and analyzes *how* that climate disclosure should be designed.[73]

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[68] An important precursor to this Article is the discussion of optionality in agency rulemaking (and SEC rulemaking in particular) by Alex Lee, one version of which (described by Professor Lee as a "menu-of-options" approach) is very similar to that which I refer to here as "investor optionality." *See generally* Yoon-Ho Alex Lee, *An Options Approach to Agency Rulemaking*, 65 ADMIN. L. REV. 881 (2013).

[69] Investor optionality, as the term is used in this Article, would also involve the additional features described in *infra* Part V.

[70] For an extensive discussion of the need for climate disclosure, see generally Condon, *supra* note 54. For discussions of mandatory sustainability disclosure, see Amour, Enriques & Wetzer, *supra* note 54; Christensen, Hail & Leuz, *supra* note 42; Condon, Ladin, Lienke, Panfil, & Song, *supra* note 63.

[71] *See, e.g.*, Proposed Rule, *supra* note 2, at 21413 (describing the "Baseline . . ." for the SEC's economic analysis, consisting of "the current regulatory and economic landscape with respect to climate-related disclosures.").

[72] *See supra* notes 54-59.

[73] Because of my presupposition that some form of SEC regulation is appropriate, I generally avoid the use of the term "private ordering." Private ordering generally refers to the involvement of private actors (in this case, companies or investors) in regulation. *See* Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 319 (2002) (referring to private ordering as "[t]he sharing of regulatory authority with private actors"). This would include the status quo of no regulation, where company managers choose whether to disclose climate-related information. The discussion of "no regulation" private ordering

This Article focuses on the investor-optional alternative, rather than other possible optional rules, because it includes important guardrails that are important to protect investors.[74] The most important constraints on optionality in the design proposed here are that the option should be to opt out of disclosure, rather than to opt in, and that the opt out should be approved by investors. Together, these features mean that investor optionality has the greatest likelihood of benefiting investors more than a mandatory rule. The remainder of this Article substantiates this claim, and considers the importance of the individual features.[75] But before moving on, I first briefly explain the reasoning why investor optionality is likely to better for investors than other designs, such as an opt-out rule without investor approval, and opt-in rule, or the status quo of no regulation.

The comparison of mandatory rules and private ordering has a storied history, including in corporate law,[76] and with respect to securities regulation.[77] The key insights motivating the reasoning in this Article can be traced to foundational work by Ian Ayres and Robert Gertner explaining that in many cases it would be optimal to design rules as "penalty defaults," that the parties would not want, so that at least one of the private parties

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has overshadowed other kinds of private ordering, obscuring the possibility and importance of optionality within an SEC rule, both with respect to the Proposed Rule, and in other regulatory instances. *See, e.g.*, Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329 (2010).

[74] For a discussion of those guardrails, see *infra* Part V.

[75] *See generally infra* Parts II-IV (substantiating the claim that an investor-optional rule is likely to be better than a mandatory rule); *infra* Part V (discussing how investor optionality should be designed). *See also infra* notes 89-97 and accompanying text (discussing why an opt-out structure is likely to be better than an opt-in structure).

[76] Mostly notably, this was a central question in the debate regarding the appropriate role of mandatory rules versus "contractual freedom" in corporate law. For an early argument in favor of private ordering, see Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989). A number of important contributions to this debate were also part of the same 1989 symposium; for a summary, see generally Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

[77] For key contributions to this debate advocating for the ability of corporations to choose alternative disclosure regimes, see generally Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) (defending the importance of mandatory disclosure rules). For a summary of this debate, see generally Merritt B. Fox, *The Issuer Choice Debate*, 2 THEORETICAL INQUIRIES L. 563 (2001).

involved would have an incentive to opt out.[78] Lucian Bebchuk and Assaf Hamdani applied this insight to state corporate law rules, explaining that for corporate law rules, efficient rules would be those where corporate *managers* have an incentive to opt out.[79] This follows from the fact that managers control the machinery and resources of the corporation, so it is much easier and less costly for them to initiate an opt-out decision.[80] In contrast, investors bear their own costs, and face a classic collective action problem.[81] Of course, to protect investors where their incentives did not align with those of managers, investors would have to approve such opt-outs.[82]

This line of reasoning leads to the conclusion that many SEC rules regulating corporations could also be optimally designed be more restrictive of managers, but to allow the corporation to opt out if shareholders approved.[83] This Article applies that particular insight to the issue of SEC climate disclosure.[84] My earlier work explains the conditions for the insight to hold for SEC rules more generally.[85] Approval by investors was not reasonable when the securities rules were initially implemented, because of

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[78] *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989).

[79] *See generally* Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489 (2002).

[80] This is also the basis for the assumption that opt-out decisions will generally be initiated when it is optimal to do so, as described in Section IV.B.2. For the reasons outlined here, the same assumption would be much less likely to apply for an opt-in rule.

[81] For a discussion of investors' collective action problem and its effects on initiation of corporate changes, see generally Scott Hirst, *Incentivizing Investor Initiation*, 48 J. CORP. L. (forthcoming 2023) (manuscript) (available at https://ssrn.com/abstract=3778436 [https://perma.cc/H4PV-CRG5]).

[82] For applications of the investor approval requirement see generally Bebchuk & Hamdani, *supra* note 79 (considering corporate law rules); Hirst, *supra* note 34 (considering SEC rules).

[83] *See generally* Hirst, *supra* note 34. This conclusion can also be seen as an instantiation of a proposal made by Alex Lee, whereby agency rules would allow "contingent ex post exemptions." *See* Lee, *supra* note 68, at 923–32. In this case, the contingency would be the approval of an opt-out by investors. Indeed, as an example, Professor Lee discusses the SEC's own consideration of an opt-out vote from the SEC's proxy access rule. *See id.* at 928. For a further discussion of opting-out in the context of the SEC's proxy access rule, see *infra* notes 90-98 and accompanying text.

[84] Disclosure, including climate disclosure, is a harder case for the application of investor-ordering than rules which do not involve disclosure, such as rules relating to company governance, as they are much less likely to involve positive externalities for other investors, and thus the main potential counter-argument examined in Section IV.C is unlikely to apply.

[85] *See generally* Hirst, *supra* note 34.

the dispersion of shareholders, and therefore their limited likelihood of investing time and effort in making voting decisions, such as whether to opt out.[86] But large, sophisticated institutional investors are now prevalent in contemporary corporate ownership. They have the resources and the incentives to make informed decisions about the companies they invest in. As a result, investor approval of opt-out decisions is now both possible and reasonable.[87]

This reasoning explains why an investor-optional rule would be better than an optional rule that did not require investor approval, or an opt-in rule.[88] It therefore also explains why an investor-optional rule would be better than the status quo of no company climate disclosure regulation: with no substantive regulation, companies will only disclose where their managers so choose, which is unlikely to be sufficient to protect investors.[89]

The superiority of an opt-out rule over an opt-in rule, or over no regulation, can be seen from the results of the SEC's failed 2010 "proxy access" rule.[90] That rule required companies to allow shareholders to include nominees in a company's proxy statement, if they had held 3% of the company's shares for more than three years, and satisfied certain procedural requirements.[91] Despite considering both an opt-in and an opt-

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[86] *See id.* at 270–71.

[87] *See id.* at 260–61.

[88] Although an opt-in rule would not be as good for investors as an opt-out rule, it is likely to be better than no rule at all, as discussed further in Section V.F.

[89] One way of answering the question whether that an investor-optional rule is better for investors than the status quo is transitively, i.e., if the Proposed Rule is better for investors than the status quo, and an investor-optional rule is better than a mandatory rule, then an investor-optional rule will also be better for investors than the status quo. A more substantive explanation follows similar analysis to that set out in Section IV.A comparing investor-optional disclosure to the Proposed Rule: Companies for which all or part of the investor-optional rule is no better than the status quo will opt out of those parts, and will be very slightly worse off than under the status quo, to the extent of the cost of opting out. Companies for which parts of the investor-optional rule is better than the status quo will not opt out and will accrue those benefits. An investor-optional rule will therefore be better for investors if the benefit from the rule to investors in any company that does not opt out entirely is greater than the sum for all companies that do opt out, of the costs of the opt out process. As discussed in Section IV.B.4, the opt out costs for each company are likely to be very small, and to the extent there is investor demand for climate disclosure, there are likely to be substantial benefits to investors in many companies from not opting out of a climate disclosure rule.

[90] *See* Facilitating Shareholder Director Nominations, Exchange Act Release No. 33-9136, 75 Fed. Reg. 56668 (Sep. 16, 2010).

[91] *See id.*

out version of the rule, the SEC chose a mandatory rule design.[92] The SEC's mandatory rule was invalidated by the U.S. Court of Appeals for the District of Columbia Circuit.[93] After the decision, the absence of a rule left companies free to "opt-in" to proxy access by amending their bylaws. But relatively few managers voluntarily adopted such arrangements, and generally did so only after sustained pressure from investors, in the form of shareholder proposals requesting such changes.[94] Those that did generally took the parameters in the SEC's invalidated rule as a template for such arrangements.[95] But the result was limited and uneven uptake of proxy access among companies, despite strong investor support for proxy access, and an extensive campaign by investors lasting many years.[96] This result is wholly unsurprising. Collective action problems and agency problems among investors mean that there is likely to be under-initiation of such proposals.[97] Had the rule been structured as an opt-out rule, all of the companies where investors supported proxy access would been bound by the structure immediately, without needing to rely on the delayed and piecemeal efforts investors with limited resources to initiate opt-ins.[98]

II. TAKING INVESTOR DEMAND SERIOUSLY

The SEC has placed investor demand for climate disclosure at the center of its rationale for climate disclosure regulation.[99] As I explain in this Part,

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[92] *See id.* at 56674. For an extended call for the SEC to allow companies to opt out of the rule if their investors approved, see Bebchuk & Hirst, *supra* note 73. For discussion of an opt-out vote as an example of an options approach to rulemaking, see Lee, *supra* note 68, at 928.

[93] *See* Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

[94] For a description of a substantial campaign of shareholder proposals requesting proxy access, the New York City Comptroller's "Boardroom Accountability Project," see, e.g., Nikita Stewart, *City Comptroller Reaches Deals With 5 Companies on Giving Shareholders Say on Directors*, N.Y. TIMES (Mar. 10, 2015), https://www.nytimes.com/2015/03/11/nyregion/city-comptroller-reaches-deals-with-5-companies-on-giving-shareholders-say-on-directors.html [https://perma.cc/8G9T-54YF].

[95] For a summary of proxy access provisions, see Claire Holland et al., *Proxy Access: A Five-Year Review*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 4, 2020), https://corpgov.law.harvard.edu/2020/02/04/proxy-access-a-five-year-review/ [https://perma.cc/PR2Y-LD6J].

[96] *See id.*

[97] For a discussion of these problems, and the resulting under-initiation of corporate change, see generally Hirst, *supra* note 81.

[98] *See* Bebchuk & Hirst, *supra* note 73.

[99] *See infra* Section II.A.

this has important implications for the design of the rule. If it takes investor demand seriously, the SEC should not make its climate disclosure rule mandatory, since that would be inconsistent with broad investor demand. Instead, it should make it investor-optional.[100] Not only would an investor-optional rule be entirely consistent with broad investor demand for climate disclosure, it would also reconcile the competing claims of the SEC and its opponents regarding the uncertain level of investor demand. Should the SEC nevertheless proceed with a mandatory disclosure rule, the inconsistency between that rule design and the broad investor demand on which the SEC has predicated the need for the Proposed Rule provides a potential ground for the Proposed Rule to be invalidated as arbitrary and capricious under the Administrative Procedure Act.[101]

The investor demand rationale is the central part of the SEC's argument that it has authority to require climate disclosure for investor protection. But before moving on to consider the investor demand rationale, it is worth considering a basis for authority, and related rationale, that the SEC chose *not* to follow: the public interest. Both the Securities Act and the Securities Exchange Act give the SEC the power to make rules that are "necessary or appropriate in the public interest or for the protection of investors."[102] The SEC could have chosen to base the need for climate disclosure on the "public interest."[103] Doing so could allow an end run around the points made in this Article, that investor optionality would be better for investors.

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[100] Although multiple different designs incorporating optionality would be consistent with the investor-demand rationale, I focus on the opt-out design described in Section I.B, for the reasons discussed there.

[101] *See infra* Section II.E.

[102] *See* Securities Act of 1933, 15 U.S.C. § 77g (2021); Securities and Exchange Act of 1934, 15 U.S.C. §§ 78l, 78m, 78o (2021). *See also* Proposed Rule, *supra* note 2, at 21335 (recognizing this as he basis of the SEC's authority for the rule).

[103] Indeed, Commissioner Allison Herren Lee had previously pointed out the SEC's public interest authority in remarks discussing climate regulation. *See* Comm'r Allison Herren Lee, SEC, KEYNOTE REMARKS AT THE 2021 ESG DISCLOSURE PRIORITIES EVENT HOSTED BY THE AMERICAN INSTITUTE OF CPAS & THE CHARTERED INSTITUTE OF MANAGEMENT ACCOUNTANTS, SUSTAINABILITY ACCOUNTING STANDARDS BOARD, AND THE CENTER FOR AUDIT QUALITY (May 24, 2021), https://www.sec.gov/news/speech/lee-living-material-world-052421 [https://perma.cc/W9ZM-ZVVL]. And Commissioner Hester Peirce pointed out, the Proposed Rule has the appearance of a rule intended for the public interest. *See generally* Comm'r Hester M. Peirce, SEC, WE ARE NOT THE SECURITIES AND ENVIRONMENT COMMISSION - AT LEAST NOT YET (Mar. 21, 2022), https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321 [https://perma.cc/93RD-5LWQ] (arguing that the Proposed Rule aims "to achieve objectives that are not ours to pursue").

Reasonable arguments could be made about how consumers or citizens would benefit from climate disclosure, given the important part it might play in reducing greenhouse gas emissions, and limiting global warming.[104] These externality benefits would likely be much more significant than the externality benefits (if any) to investors in other companies (discussed in Section IV.C), and potentially sufficient to justify requiring disclosure by all companies without the possibility of opting out. However, the SEC does not discuss the "public interest" in climate disclosure, other than to the extent that it is furthered by protecting investors.[105] It is likely that grounding its authority on investor protection (and not general public interest) was a reasonable strategic decision, aimed at avoiding grounds for the possible invalidation of the Proposed Rule.[106] But the effect of this decision is to prevent the SEC from justifying the Proposed Rule on the basis of the Proposed Rule's benefits for any constituencies other investors.

Section II.A describes the SEC's investor demand rationale and the premises regarding which investors demand climate disclosure, and for what. Section III.B examines the questions and counter-arguments that opponents of the Proposed Rule have raised regarding the investor demand rationale. Sections II.C and II.D explain, respectively, how the investor demand rationale is inconsistent with a mandatory rule, and how an investor-optional rule is not only consistent with the investor-demand

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[104] In addition, this rationale would better reflect the political reality of support for climate from those who wish to impose climate disclosure rules not only to help investors, but as part of an attempt to reduce greenhouse gas emissions, which they believe would benefit society as a whole.

[105] For the six places the SEC references public interest in the Release—all in connection with protection of investors—see Proposed Rule, *supra* note 2, at 21335, 21337, 21340, 21412.

[106] For instance, critics of the SEC's Proposed Rule have pointed to the Supreme Court's view, interpreting similar "public interest" language authorizing rulemaking by the Federal Power Commission, that "[t]his Court's cases have consistently held that the use of the words "public interest" in a regulatory statute is not a broad license to promote the general public welfare. Rather, the words take meaning from the purposes of the regulatory legislation." *See* Bernard Sharfman & James Copland, Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors 4 (June 16, 2022) (quoting NAACP v. FPC, 425 U.S. 662, 669 (1976)), https://www.sec.gov/comments/s7-10-22/s71022-20131661-302049.pdf [https://perma.cc/XD7T-5CVM].

It is also possible that regulating corporate climate disclosure for the "public benefit" could be seen as a major transformation in the SEC's regulation (which is currently focused on investor protection), and thus a "major question" that is subject to the "major questions doctrine," discussed further in Section III.C.

rationale, but would reconcile the competing claims of the SEC and its opponents. Section II.E explains the risks for the SEC of not taking the investor demand rationale seriously.

A. The Investor Demand Rationale and Its Premises

The SEC's central rationale for promulgating the Proposed Rule is the "growing investor demand for climate-related risk disclosure and related information."[107] Indeed, the Release is replete with references to "investor demand" for that information, with more than forty such mentions.[108]

The investors that the SEC refers to are generally large investment managers, public pension funds, and socially responsible investment managers. For instance, the Release refers prominently to the "733 global institutional investors" that were signatories to the Global Investor Statement to Governments on Climate Change.[109] Particular investors mentioned in the Release include BlackRock (mentioned eleven times), the New York State Comptroller (fourteen times), and Trillium Socially Responsible Investing (nine times).[110]

Despite its reliance on "investor demand" to justify the Proposed Rule, the SEC does not closely examine the nature or detail of the claimed demand in the Release. Key aspects of investor demand are discussed only in general terms in the Release, or not at all, including which particular investors demand climate disclosure (with little attention to those that do not); what information those investors demand; and from which companies.[111] The generality of these claims makes it hard to evaluate or falsify the SEC's arguments about investor demand, and especially, to understand whether

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[107] Proposed Rule, *supra* note 2, at 21340–43 (describing "The Growing Investor Demand for Climate-Related Risk Disclosure and Related Information").

[108] This includes all references to cognates of "demand," where the sentence makes clear that the "demand" is from investors. *See id.* at 21334–35, 21337–38, 21340–41, 21355, 21362–63, 21377, 21381, 21394, 21424–25, 21434, 21436, 21441, 21443, 21462, 21468. *See also* Cunningham et al., *supra* note 54, at 3 (suggesting that the Release "refers to "investor demand" 54 times).

[109] Proposed Rule, *supra* note 2, at 21340.

[110] These citation counts are drawn from the analysis of the Release's citation patterns in Cunningham et al., *supra* note 54, at 20.

[111] The SEC's most granular claims involve listing particular investor groups that "criticized the current disclosure practice . . . because it has not produced consistent, comparable, reliable information for investors and their advisors, who otherwise have difficulty obtaining that information" (*see* Proposed Rule, *supra* note 2, at 21339), and listing climate initiatives among investors that have pushed for more information. (*see id*, at 21340-41.

investor demand is likely to differ among different investors, or for disclosure from different companies.[112] Nevertheless, the way in which the SEC makes its claims, and the evidence it uses to support them, allows an inference to be drawn about its likely views on who demands climate information.

The SEC's support for the investor demand claim focused squarely on institutional investors.[113] The main part of the SEC's evidence for the "growing investor demand for climate-related risk disclosure and related information" is a series of major climate-related initiatives by groups of institutional investors.[114] The SEC refers to a large majority of institutional investors surveyed in 2021 considering climate change their highest engagement priority.[115] The SEC also references climate change being the top priority for engagement by two large investment managers, BlackRock and State Street Global Advisors (SSGA).[116] Even when the SEC implicitly refers to demand from retail investors it is considering them as investors in mutual funds.[117] With the exception of those investors, and several more whose comments are referred to in footnotes, the SEC does not specify which investors demand climate disclosure, or the proportion of the equity capital of U.S. companies that they represent. Nevertheless, its claim seems to be that there is broad and growing support from institutional investors.[118] The SEC's focus on institutional investors as providing the basis for the investor demand rationale has important implications for the arguments

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[112] The SEC could have attempted to generate this information by conducting a comprehensive survey of investors, but there is no mention in the Release of any attempt to do so.

[113] The discussion in this Article is focused on equity investors, rather than creditors. This is consistent with the arguments presented in this Article, as only equity investors generally have voting rights. But it raises the question whether debt investors *should* have voting rights. This applies not just to opt-out decisions, but is a broader question of corporate law, and beyond the scope of this Article.

[114] The SEC lists the Global Investor Statement to Governments on the Climate Crisis, the UN Principles for Responsible Investment, the Net Zero Asset Managers Initiative, the Climate Action 100+, and the Glasgow Financial Alliance for Net Zero. *See* Proposed Rule, *supra* note 2, at 21340–41. *See also id.* at 21425 (listing the Climate Disclosure Project, The Global Investor Coalition on Climate Change, The institutional Investors Grp. on Climate Change, and the Transition Pathway Initiative).

[115] *See id.* at 21425.

[116] *See id.*

[117] *See id* at 21429 (referencing "flows into mutual funds with environmental goals in their investment mandates . . .").

[118] *See, e.g., id.* at 21443 ("[A] sizeable and growing portion of global investors … is demanding robust disclosure around its impacts . . . .").

regarding the design of the climate disclosure rule, which I return to below.[119]

B. The Uncertainty About Investor Demand

A major potential issue with founding the authority for the Proposed Rule on investor demand is there the SEC's analysis leaves significant uncertainty regarding the level of investor demand for climate change, and what exact disclosure a majority of investors would require from particular companies. Indeed, critics of the Proposed Rule have raised significant questions that bear on the SEC's investor demand rationale.[120] They have argued that companies already disclose climate-related information to the extent that investors require it, and therefore, there is no unmet investor demand for additional disclosure.[121] They argue that the SEC's claims of investor demand are overstated, because the demand from investors cited by the SEC comes from an outspoken minority of institutional investors, and that a majority of investors do not demand additional disclosure.[122] They also argue that investor demand is not identical across companies or for different types of disclosure: for some companies, some kinds of climate disclosure is not as important to the investors in those companies, and may not be sufficiently valuable to justify the cost of producing it.[123] Critics further claim that even if a majority of investment managers do demand some climate disclosure, the views of those managers do not necessarily reflect those of their beneficial investors, which (they claim) are the relevant group of investors that should be considered.[124]

The SEC's Release does not provide sufficient evidence to rebut these claims, or to resolve their inconsistency with the SEC's investor demand rationale. As critics point out, many of the institutional investors mentioned

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[119] *See infra* Sections II.C-II.D.

[120] For many of these comments, see *supra* notes 54-58 and accompanying text.

[121] *See, e.g.*, Cunningham et al., *supra* note 54, at 8–11 (describing the "ample supply of climate disclosure).

[122] *See, e.g., id.* at 3–5 (discussing "subgroup[s] of investors the [Proposed Rule] unfairly favors").

[123] *See, e.g.*, Nat'l Ass'n of Mfrs., *supra* note 55, at 24 (arguing for more lenient treatment of small, newly public, mid-size, and recently acquired issuers); *id.* at 32 (arguing against a one-size-fits-all threshold for disclosure).

[124] *See, e.g.*, Cunningham et al., *supra* note 54, at 5–7 (discussing that the views of individual investors are not canvassed in the Proposed Rule, and suggesting that the SEC "ask institutions "demanding" [climate disclosure] whether they have polled their individual clients, the ultimate investors, to determine whether they agree on the desirability or need for such information.").

in the Release, and many of those investors involved in the major initiatives the Release relies on, are non-U.S. investors, and so much of the large amounts of capital mentioned by the SEC as supporting disclosure are likely to be invested outside the U.S. capital markets.[125] This is not to say that the claims of critics are accurate, just that the SEC does not provide a means of reconciling the competing claims, leaving real uncertainty about the actual level and details of investor demand.

C. Investor Demand and Mandatory Disclosure

A major problem with the SEC's reliance on investor demand as the rationale for its Proposed Rule is that it is inconsistent with the SEC's choice of a mandatory rule design—it does not justify the choice of a mandatory disclosure rule over an investor-optional rule. As I explain below, this provides grounds for the potential invalidation of the rule.

The reason is straightforward. If there is broad support from institutional investors for climate disclosure, then there is no need for a mandatory rule. An investor-rule would be sufficient, because the majority of investors supporting disclosure would prevent the company from opting out of the requirement.[126]

In order to justify the choice of a mandatory rule rather than an investor-optional rule, the SEC would have to argue that there are sufficient companies where a majority of investors would be willing to opt out of some or all of the climate disclosure requirements. If that is the case, it *could* (but would not necessarily) justify a mandatory rule to protect a minority of investors in a company that do demand climate disclosure, or investors outside the company that would prefer that the company discloses climate-related information. These involved difficult and nuanced balancing questions, which I analyze in detail in Section IV.C. Here I merely point out that the SEC has not made these arguments in supporting the Proposed Rule. To do so would require considerable analysis of the specifics of investor demand—which investors support climate disclosure of what matters, and

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[125] *See, e.g.*, *id.* at 3 (stating that "[t]he Proposal does not . . . indicate the portion of the reported assets invested in SEC registrants as compared to other investments around the world," and giving examples of non-U.S. investors among the seven most relied-upon in the Proposed Rule).

[126] A mandatory rule is much more consistent with the situation where a majority of investors do not demand climate disclosure, or where the level of demand for climate disclosure is uncertain. But these are not the grounds the SEC has put forward for the Proposed Rule. *See infra* notes 102-103 and accompanying text.

at how many companies. The broad generalities of the SEC's claims of investor demand provide no such specifics.

It is important to note that the SEC's claim of investor demand does justify the imposition of *some* SEC rule, compared to the status quo of no climate disclosure regulation. The mere existence of an SEC rule on climate disclosure provides at least three valuable features that benefit corporations and investors, irrespective of whether or not the rule is mandatory. First, an SEC rule provides a reasoned and thoughtful *choice of standard* for corporate arrangements, which serves as a focal point for centralization and standardization of arrangements across corporations, and thus, network externality benefits to all that adopt the arrangement.[127] Second, it also *implements* these standardized arrangements.[128] Implementation will often be costly, difficult, and impractical for investors, and managers will often lack incentives to implement rules that are against their own private incentives.[129] Implementing a rule for all companies, all at once, eliminates duplication of implementation costs.[130] Third, an SEC rule also provides a centralized means of *enforcement*.[131] This would be difficult or impossible for companies to duplicate. Finally, among companies for which the rule does apply, there is *standardization and centralization of filings*.[132] It is completely reasonable for investors to demand these features, and for the SEC to provide them, as each of them would be costly, difficult, or impossible for investors to implement on their own. However, each of these features are also available in an investor-optional disclosure rule.

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[127] For a discussion of the coordination function of law in establishing focal points, see generally Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649 (2000).

[128] If not implemented by the SEC, these arrangements would need to be implemented on a company-by-company basis, either by each company's managers, or by their investors. *See* Hirst, *supra* note 34, at 239 (discussing the economies of scale in implementation from a mandatory rule).

[129] For a discussion of the limitations to the implementation of corporate changes by investors and managers, see Hirst, *supra* note 81, at 8–23. *See also supra* Section I.B.

[130] By implementation costs I refer to the costs to a company of putting a rule in place for that company, not the cost of actions that the company takes to *comply* with that rule.

[131] *See* Securities and Exchange Act of 1934, 15 U.S.C. § 78u (2021) (authorizing investigations of violations by the SEC, and sanctions).

[132] For an argument for the centralization of voluntary filings on the SEC's EDGAR database, see generally Andrew W. Winden, *Jumpstarting Sustainability Disclosures*, 76 BUS. LAW. 1215 (2021).

D. Investor Demand and Investor optionality

In contrast with a mandatory rule, an investor-optional rule is entirely consistent with the investor demand rationale. If a substantial majority of investors in companies demand climate disclosure, those companies will not opt out of climate disclosure, and their demand for disclosure will continue to be met. But investor optionality is also consistent with the claims of the critics of the SEC's Proposed Rule, in a way that a mandatory rule is not. Critics have argued that there is less investor demand for climate disclosure than the SEC has claimed, and that much of that demand is likely to be satisfied by existing disclosure.[133] Under an investor-optional rule, if investors do not actually require or demand all or part of the climate disclosure in the Proposed Rule, and if they believe the production of that disclosure will be more costly to them than the value it would provide, the company could opt out of the obligation to disclose such information.

By conditioning climate disclosure on investor demand, investor optionality thus resolves the tension between the competing claims of the SEC and its critics on the central questions of *whether* investors actually demand climate disclosure, and *what* disclosure they actually demand. That is, no matter which of the two sides is correct in its claims regarding investor demand for particular climate disclosures (or the lack thereof), an investor-optional rule would satisfy that side.[134] For this reason, investor demand is not a compromise position; it gives both sides what they want, assuming their claims are accurate. Because investor optionality would thus be consistent with the claims of the critics of the Proposed Rule (again, if those claims are accurate), it is also possible that it would lead many of them to drop their opposition to the Proposed Rule.

Investor optionality is also the *only* practical way to resolve the tension between the two positions. The only alternative method would be for the SEC to undertake a rigorous and comprehensive survey of investors to determine which investors demand what climate information. But this would be impractical—time consuming, costly, and challenging to implement. And even if it were carried out as well as possible, gaps—and

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[133] *See, e.g.*, Cunningham et al., *supra* note 54, at 2 (arguing that there is insufficient investor demand to justify the SEC's authority to promulgate a mandatory climate disclosure rule).

[134] This would be what Alex Lee describes (with respect to the use of options in rulemaking) as allowing the "parties to 'agree to disagree.'" *See* Lee, *supra* note 68, at 904.

doubts—are likely to remain.[135] In contrast, allowing investors to opt out of climate disclosure would reveal, for every company that proposed an opt-out, whether a majority of investors actually supported all of the climate disclosure requirements at that particular company.[136] If there were sufficient investor demand at that company, it would be required to disclose. If investors at the company believed that the costs of disclosure exceeded the benefits, they would opt out.[137]

E. The Risks of Not Taking Investor Demand Seriously

If the SEC does not take investor demand seriously by adopting an investor-optional rule, and instead makes its final rule mandatory, it would arm opponents of climate disclosure with a serious claim that the final rule would be invalid under the Administrative Procedure Act.[138] As I discuss further in Part III.E, the Administrative Procedure Act requires a reviewing court to set aside regulations that are "arbitrary or capricious."[139] The U.S. Court of Appeals for the District of Columbia Circuit has interpreted this standard as including decisions that result from "illogical" or inconsistent reasoning.[140] For the reasons outlined above, the investor demand rationale is inconsistent with the choice of a mandatory rule over an investor-optional rule, and such a choice would thus be "illogical."

If or when its final rule is challenged, the SEC will be forced to double down on its investor demand rationale to justify its statutory authority to promulgate the final rule, against critics' challenges of invalidity. But doing so would spotlight the question of the appropriateness and logical consistency of the decision to choose a mandatory rule over an investor-optional rule. Conversely, because investor demand is at the heart of several strong defenses against claims of invalidity made regarding the Proposed

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[135] For instance, two major problems are that it would be very difficult, or impossible, to ask an investor to evaluate the applicability of the rules to *every* company in its portfolio; and that responses could be mere "cheap talk," as there would be no consequences for overstating or understating preferences. For a discussion of cheap talk, see generally Joseph Farrell & Matthew Rabin, *Cheap Talk*, 10 J. ECON. PERSPS. 103 (1996).

[136] An opt-out vote would also avoid the cheap-talk problem mentioned in Sharfman & Copland, *supra* note 135 because it would have actual consequences, determining whether the information is disclosed or not, and because investment managers are required to publicly disclose their votes, so they could be held accountable for them.

[137] This reasoning relies on the assumptions examined in *infra* Section IV.B.

[138] 5 U.S.C. §§ 551–559.

[139] 5 U.S.C. § 706(2)(A).

[140] *See* Am. Fed'n of Gov't Emps., Loc. 2924 v. Fed. Lab. Rels. Auth., 470 F.3d 375, 380 (D.C. Cir. 2006).

Rule, the inconsistency between the investor demand rationale and the mandatory nature of the SEC's rule will make it harder for the SEC to defend its rule against those claims of invalidity.[141] Given its reliance on the investor demand rationale, choosing a mandatory rule over an investor-optional rule therefore locks the SEC into a no-win position in the all-but-inevitable judicial review of its final rule.

III. CIRCUMVENTING CLAIMS OF INVALIDITY

Many groups and individuals have argued that if the SEC adopted the Proposed Rule, it would be invalid. However, as this Part explains, if those arguments apply at all, they apply only to a mandatory climate disclosure rule. Making the Proposed Rule investor-optional would thus circumvent each of the main challenges to the validity of the rule. Sections III.A-III.D summarize the most important claims of invalidity made by opponents of the Proposed Rule and explain how investor optionality would circumvent each of them. In many cases, this is because an investor-optional rule would only apply where there was demonstrated investor demand for climate disclosure. Section III.E explains that investor optionality would also operate as a sword, as well as a shield. Failure by the SEC to consider investor optionality is likely to be a strong ground for invalidating the SEC's final rule. And if the SEC does consider investor optionality but nonetheless decides to make its final rule mandatory, it will face a high bar to justify that decision. If it cannot, the final rule would be subject to invalidation.

Because investor optionality would circumvent important arguments of invalidity, it would be the best way for the SEC to protect investors.[142] That is, if the SEC's claims of substantial investor demand are true, then investors will expect significant net benefits from a rule standardizing climate disclosure and providing for enforcement (whether or not that rule is mandatory).[143] The expected net benefit for investors is a function of the

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[141] For a discussion of these claims generally, and how the Proposed Rule would be much better equipped to withstand them if it were investor-optional, see *infra* Sections III.A-III.D.

[142] By arguing that investor optionality would circumvent claims of invalidity I do not mean to suggest that it is certain that a claim of invalidity against an investor-optional rule on these grounds would fail. For further discussion of this point, see *supra* note 148.

[143] A generalized version of this argument is Alex Lee's discussion of how an "options approach" to rulemaking by the SEC would "increase the net expected benefit of going forward with a rule." Lee, *supra* note 68, at 887.

likelihood of the rule being implemented. That benefit to investors would be almost entirely eliminated if the Proposed Rule were invalidated.[144] Designing its Proposed Rule in such a way as to minimize the likelihood of invalidation is consistent with the investor demand rationale and should be an important part of the SEC's calculus.[145]

Before turning to consider the potential grounds on which opponents have claimed that the SEC's rule may be invalid, I note that by repeating these claims, I do not necessarily endorse them. A number of respected commentators have argued that many of these claims are inaccurate.[146] I take no position on the correctness of either the claims of invalidity, or these counter-claims, other than to recognize that the uncertainty regarding which are correct creates consequent uncertainty about the validity of the Proposed Rule. The uncertainty regarding the validity of the Proposed Rule is accentuated by the fact that appellate courts have shown an increasing willingness to overturn long-settled precedent.[147] Therefore, there remains *some reasonable risk* that an appellate court might uphold one or more of

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[144] There may remain some benefits to investors even if the rule were invalidated. First, there is some possibility that the SEC could reintroduce the Proposed Rule in a way that overcame the sources of invalidity, leaving some expectation of those benefits. Second, even if the rule were never implemented by the SEC, the choice of a standard may give both a focal point, and normative support, for investors seeking to implement disclosure on a company-by-company basis by private ordering, as was the case after the SEC's proxy access rule was invalidated. For a discussion of the benefits of including a back-stop opt-in rule that would apply if other parts of a final rule were invalidated, see *infra* Section V.F.

[145] For the SEC, weighing the potential invalidity of the Proposed Rule in a nuanced fashion is likely to be challenging. While it is required to disclose the factors it considers in choosing a rule, any acknowledgment of potential vulnerabilities of the Proposed Rule could provide a pathway for attack by opponents of the Proposed Rule. This may explain why the SEC's Release insists that it has statutory authority for the Proposed Rule, without even recognizing any claims to the contrary.

[146] *See, e.g.*, Jill E. Fisch & George S. Georgiev et al., Comment Letter on Proposed Rule for Enhancement and Standardization of Climate-Related Disclosures for Investors (June 6, 2022), https://www.sec.gov/comments/s71022-20130354-297375.pdf [https://perma.cc/C9AE-EKVG]; John C. Coates, Comment Letter on Proposed Rule for Enhancement and Standardization of Climate-Related Disclosures for Investors (June 1, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20130026-296547.pdf [https://perma.cc/ZK82-WW4R]; Working Grp. on Secs. Disclosure Auth., *supra* note 38.

[147] The recently-endorsed "major questions" doctrine seems particularly well suited to this purpose. For further discussion of the major questions doctrine, see *infra* Section III.C. For a discussion of the "discursive appropriation" of certain positions by appellate courts in a very different context, see Jonathan Feingold, *Reclaiming Equality: How Regressive Laws Can Advance Progressive Ends*, 73 S.C. L. REV. 723, 742-47 (2022).

the claims of invalidity, notwithstanding the strength of the arguments of those defending the Proposed Rule.[148]

A. The Claim that Climate Disclosure is Compelled Speech

Many critics of the Proposed Rule have argued that the statements it would require regarding climate change would be compelled speech, in violation of the First Amendment rights of companies.[149] But this compelled speech claim applies, if at all, only to a mandatory rule. I do not engage deeply with this claim here, because investor optionality would circumvent this line of attack in a very straightforward way: disclosure would no longer be *compelled* speech. Companies would not be compelled to speak, because they could opt out of the requirement.[150]

Sean Griffith has put forward a novel variant on the compelled speech invalidity claim, arguing that past Supreme Court decisions subject compelled speech to heightened scrutiny where it is "controversial."[151] As well as the simple point that speech would not be "compelled," investor optionality provides an additional strong response to Professor Griffith's contention. Professor Griffith concedes that "[d]isclosure mandates that are uncontroversially motivated to protect investors are eligible for deferential judicial review."[152] Investor optionality would only require disclosure where investors had not opted out of it, creating a reasonable, probative—and uncontroversial—basis to conclude that investors regarded the disclosure as appropriate for their protection.

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[148] Indeed, for the same reason, even if the SEC adopts an investor-optional disclosure rule, there remains some residual risk that an appellate court would invalidate the rule, notwithstanding the reasons presented in this Article why the most important claims of invalidity would not apply to such a rule.

[149] *See, e.g.*, Griffith, *supra* note 54; Cunningham et al., *supra* note 54, at 14-15; Nat'l Ass'n of Mfrs., *supra* note 55, at 50; Peirce, *supra* note 103; W. Va. Off. of Att'y Gen., *supra* note 54, at 3.

[150] Technically, the company may need to engage in some modest amount of speech to opt-out—at a minimum, by putting forward a proposal in its proxy materials for investors to vote on. The requirements of proxy statements would also require a certain amount of description of the proposal. *See* 17 C.F.R. § 240.14a-101, Item 20 (requiring companies to describe the substance of matters proposed at meetings). This would also require the company to expend some amount of resources to avoid speech, though as discussed in *infra* Section IV.B.4 , the incremental cost to the company of preparing and including such information is likely to be very small.

[151] *See* Griffith, *supra* note 54, at 2.

[152] *See id.*

Of course, investor optionality would protect investors by only permitting opt-outs where investors had approved them, thus allowing investors to place limits on the speech of their companies. But the ability of investors to limit the speech of the corporations they invest in is uncontroversial, and was recognized by the Supreme Court in *Citizens United v. Federal Election Commission*.[153]

B. The Claim that Climate Disclosure May Not Be Material

Another set of attacks on the Proposed Rule are based on the claim that disclosure of climate-related information is not material. One version of this attack is that the SEC does not have the power to require disclosure of non-material matters, so cannot require disclosure of greenhouse gas emissions. Another version of this attack is that, because the information is not material to investors, the Proposed Rule cannot be "necessary or appropriate . . . for the protection of investors", and therefore falls outside the SEC's authority.[154]

Critics cite the standard definition of materiality, put forward in *TSC Industries, Inc. v Northway, Inc.*, where the Supreme Court held that a matter is "material" if it "would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available."[155] Critics claim that the climate disclosure required by the Proposed Rule is not material, because reasonable investors would not consider it in making investment decisions.[156]

Leaving aside the validity of this claim, whether investors would or would not consider such emissions is an empirical question. Many investors have advocated for a climate disclosure rule, which suggests that a reasonable investor *would* consider it in their investment decisions.[157] The

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[153] *See* Citizens United v. Fed. Election Comm'n, 558 U.S. 310, 362 (2010) ("There is, furthermore, little evidence of abuse that cannot be corrected by shareholders "through the procedures of corporate democracy.") (citation omitted).

[154] *See, e.g.*, Peirce, *supra* note 103 ("The further afield we are from financial materiality, the more probable it is that we have exceeded our statutory authority.").

[155] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). *See also* Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988) (citing *TSC Industries, Inc. v. Northway, Inc.*).

[156] *See, e.g.*, Peirce, *supra* note 103.

[157] *See, e.g.*, Tchrs. Ins. & Annuity Ass'n of America, *supra* note 57; Legal & Gen. Inv. Mgmt. America, Comment Letter on the Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (May 31, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20129965-296443.pdf

SEC has used these letters to support its claim that there is investor demand for climate disclosure. Nevertheless, critics of the rule have argued that investors supporting climate disclosure are not representative of investors in general, and so (presumably) their views should not be probative in determining the views of a "reasonable investor."[158]

Investor optionality provides a compelling answer to this line of attack: it lets investors in a particular company *actually decide* whether a particular company is obligated to disclose its emissions. If investors in a particular company do not consider particular climate-related information material, they can authorize the company to opt out of its obligations to disclose that information. Conversely, that a majority of investors in a particular company *do not* support opting out of emissions disclosure can be taken as reasonable and probative evidence that the information is material to a reasonable investor, and therefore, that the SEC is entitled to require its disclosure.[159] Indeed, a decision by investors whether or not to opt out of climate disclosure is likely to be *much better* evidence of the views of reasonable investors on the materiality of climate-related disclosure than the assertions of the SEC in the Release, or those of critics of the Proposed Rule, or even than the views of an appellate court reviewing the validity of the climate disclosure rule the SEC eventually adopts.

C. Claims that the SEC Lacks Statutory Authority

Critics have made two different arguments that the SEC lacks statutory authority to require climate disclosure. One argument is that climate disclosure is not part of the category of disclosure that the SEC is authorized to require under the Securities Act of 1933 or the Securities Exchange Act

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[https://perma.cc/3N42-FWL5]; PGIM, Comment Letter on Request for Public Input on Climate Change Disclosure (June 13, 2021), https://www.sec.gov/comments/climate-disclosure/cll12-8911331-244286.pdf [https://perma.cc/X2N3-G43T]; Norges Bank Inv. Mgmt., Comment Letter on Request for Public Input on Climate Change Disclosure (June 13, 2021), https://www.sec.gov/comments/climate-disclosure/cll12-8906851-244201.pdf [https://perma.cc/A662-CM39]; N.Y. State Comptroller, Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 3, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20130550-299408.pdf [https://perma.cc/2RY6-LVRV].

[158] *See, e.g.*, Cunningham et al., *supra* note 54, at 3–5 (arguing that "the most vocal institutions" calling for climate disclosure are not representative).

[159] This evidence is likely to be particularly persuasive as there would be little or no other contrary evidence, specific to the particular company, that the information was *not* material to the investors in the company. I am grateful to David Webber for making clear the importance of this point.

of 1934.[160] A second argument is that climate disclosure is a "major question" which would require express Congressional authorization for rulemaking.[161] Below I consider each of these arguments in turn.

The first of these arguments is based on the claim that the matters that both statutes initially required to be disclosed related to the finances of the company, and to the extent the SEC has since required disclosure of broader matters, those were authorized specifically by statute.[162] Opponents of the Proposed Rule argue that emissions information does not relate to the finances of the company, and so—without explicit statutory authorization—falls outside the implicit ambit of the securities laws.[163]

A group of law professors have challenged the validity of these claims.[164] But even assuming that the claims are valid, they turn entirely on the question of what types of disclosure the securities laws permits the SEC to require. There are a number of different answers to this question.[165] Instead of a narrow definition of financial matters, a better description of the matters required to be disclosed by the Securities Act of 1933 and the Securities Exchange Act of 1934 is *things that investors considered material in making investment or voting decisions.* As well as matters required to be disclosed by the statutes as originally enacted, this category would also other disclosure items that the SEC has subsequently and required without controversy. But there remains the question whether investors consider climate disclosure material for investment or voting decisions. An investor-optional disclosure rule would clearly answer this

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[160] Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2021); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78qq (2021).

[161] *See, e.g.*, Peirce, *supra* note 103; Andrew N. Vollmer, Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (Apr. 12, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20123525-279742.pdf [https://perma.cc/M344-JECW]; Cunningham et al., *supra* note 54.

[162] *See* Vollmer, *supra* note 161, at 10–11 (discussing "statutory authorizations [by Congress] to expand mandatory disclosure beyond the topics already covered in the Securities Act and the Securities Exchange Act.").

[163] *See, e.g.*, *id.* at 6–11 (discussing the "statutory context" for the authorization of SEC rulemaking power).

[164] *See* Fisch & Georgiev, *supra* note 146; Coates, *supra* note 146; George S. Georgiev, *The SEC's Climate Disclosure Rule: Critiquing the Critics*, 50 Rutgers L. Rec. 101 (2022); Working Grp. on Secs. Disclosure Auth., *supra* note 38.

[165] The analysis undertaken by Andrew Vollmer, and the analyses in the comment letters submitted by Professors Georgiev, Fisch, and others, and Professor Coates, are three different examples of such analysis. *See generally* Vollmer, *supra* note 161; Fisch & Georgiev, *supra* note 146; Coates, *supra* note 146.

question, in the same way described in Section III.B: to the extent that investors do not find climate disclosure material, or even sufficiently material that it is worth the cost of disclosure, they can opt out of the rule. Therefore, the fact that a company has not opted out strongly suggests that its investors consider the information material in making financial decisions.[166] Because the information is relevant and material to investors, it is functionally no different from other information that the SEC has required to be disclosed in past rulemaking.

A related argument made by opponents of the Proposed Rule is that climate disclosure relates to a "major question," and is therefore governed by a nascent "major questions doctrine."[167] These opponents claim that for regulators to make rules relating to a major question requires express statutory approval.[168] This argument has gained strength following the Supreme Court's decision in *West Virginia v. Environmental Protection Agency* (hereinafter, "*West Virginia*"), which recognized the major questions doctrine, and applied it to strike down an Environmental Protection Agency (EPA) rule related to climate emissions.[169] A number of commentators have since argued that the major questions doctrine is likely to play a major role in determining the validity of the Proposed Rule.[170]

As articulated in the decision of Chief Justice Roberts, the major questions doctrine describes a "reluctan[ce] to read into an ambiguous statutory text" a delegation to an agency of "highly consequential power beyond what Congress could reasonably be understood to have granted."[171]

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[166] This also depends on the assumption that managers will initiate changes to the applicable disclosure regulation. For a discussion of this assumption, see *infra* Section IV.B.2.

[167] *See, e.g.*, Cunningham et al., *supra* note 54, at 13; Andrew N. Vollmer, Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors 14–15 (May 9, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20128334-291089.pdf [https://perma.cc/M4F8-H54Z].

[168] *See, e.g.*, Cunningham et al., *supra* note 54, at 13; Vollmer, *supra* note 167, at 14–15.

[169] West Virginia v. EPA, 142 S. Ct. 2587 (2022).

[170] *See, e.g.*, Scott Mascianica, Jessica Magee, & Danny Athenour, *The Major Questions Doctrine Raises Major Questions for the SEC's Proposed Climate Rule*, THE TEXAS LAWBOOK (July 21, 2022), https://texaslawbook.net/the-major-questions-doctrine-raises-major-questions-for-the-secs-proposed-climate-rule/ [https://perma.cc/WZZ6-UBTV]; Christina Thomas, Andrew Olmem, & Katelyn Merick, *Supreme Court Decision Casts Doubt on SEC's Climate Proposal and Other Regulatory Initiatives*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July. 12, 2022), https://corpgov.law.harvard.edu/2022/07/12/supreme-court-decision-casts-doubt-on-secs-climate-proposal-and-other-regulatory-initiatives/ [https://perma.cc/J596-K8ZN].

[171] *West Virginia*, 142 S. Ct. at 2609.

In such a case, "something more than a merely plausible textual basis for the agency action is necessary. The agency instead must point to "clear congressional authorization" for the power it claims.[172] This will apply where there is a broad claim of authority by the agency, that represents a substantial departure from past practice and regulatory norms.[173] In a concurring opinion, Justice Gorsuch (joined by Justice Alito) added several additional factors, including whether the matter is of "great political significance" and subject to "earnest and profound debate," and whether the agency "seeks to regulate a significant portion of the American economy" or require "billions of dollars in spending by private persons or entities."[174]

Whether the major questions doctrine could be used to invalidate the Proposed Rule turns on whether the doctrine applies to the facts of the Proposed Rule, and if so, whether the authorization of SEC rulemaking in the Securities Act of 1933 and the Securities Exchange Act of 1934 are sufficiently clear.

Regarding the first question, several commentators have suggested that there is a significant likelihood that the major questions doctrine would apply.[175] They point to the national debate regarding climate change, the impact that the Proposed Rule would have not just on disclosing companies, but on private companies with which they do business, the substantial costs of compliance, and several failed Congressional attempts to pass legislation authorizing the SEC to require climate disclosure.[176] Of course, others have pointed to reasons why the SEC's actions in the Proposed Rule are much narrower than those of the EPA in *West Virginia* to argue that the major questions doctrine would not apply.[177] But it is important to note that the

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[172] *Id.* at 2609.

[173] For a synthesis of the factors relied on by Chief Justice Roberts in his decision, including a "stark departure from past practices and regulatory norms" and the "breadth of the claimed authority," see Dan Farber, *Climate Change and the Major Question Doctrine*, LEGAL PLANET (July 12, 2022), https://legal-planet.org/2022/07/12/the-major-question-doctrine-and-climate-change/ [https://perma.cc/AFN5-EKB6].

[174] *West Virginia*, 142 S. Ct. at 2621 (Gorsuch, J., concurring).

[175] *See, e.g.*, Mascianica, Magee & Athenour, *supra* note 170 (arguing that "if the [SEC] finalizes the rule in similar form, it's likely the Court would find the major question doctrine applies.").

[176] *See* Thomas, Olmem & Merick, *supra* note 170; Mascianica, Magee, & Athenour, *supra* note 170.

[177] *See, e.g.*, Jonathan D. Uslaner & Will Horowitz, *Will the SEC's Proposed Climate Risk Disclosure Rules Survive Supreme Court Scrutiny?*, REUTERS, Aug. 5, 2022, https://www.reuters.com/legal/legalindustry/will-secs-proposed-climate-risk-disclosure-

majority opinion in *West Virginia* characterized the EPA's actions as sufficiently broad to apply the major questions doctrine, even though a much narrower characterization of those actions was available.[178] This suggests a significant possibility that—faced with two conflicting interpretations of the breadth of the SEC's disclosure—a reviewing court could take the more expansive interpretation.

The critical point that the SEC will need to establish is that its disclosure obligations relate to the investor protection, rather than fighting climate change, and that they are closely tailored to protect investor needs.[179] Investor optionality would substantially assist the SEC in making this case. Investor optionality would limit the ambit of the Proposed Rule to companies whose investors were not willing to opt out of the obligation. The Proposed Rule could thus not be characterized as requiring companies to disclose climate risk for the broad purpose of fighting climate change, which could be the subject of national debate. Instead, it would only require companies to give their investors information that the company could very reasonably infer that those investors believed would be material to them. This is consistent with the SEC's past rulemaking, and far from a substantial departure from past SEC actions.

D. Claims Regarding Cost-Benefit Analysis

A further line of attack against the Proposed Rule is that the SEC has not conducted appropriate or sufficient economic analysis of the Proposed Rule—that they have not sufficiently considered its costs, and/or its benefits—and that the economic analysis that the SEC has conducted does not justify the imposition of mandatory climate disclosure.[180] This may be a particularly challenging claim for the SEC to rebut, because there is no agreed-upon understanding of just *how much* cost-benefit analysis is

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rules-survive-supreme-court-scrutiny-2022-08-05/ [https://perma.cc/V42M-JX4N] (suggesting "compelling reasons . . . to believe the Supreme Court's reasoning in West Virginia will not impact the SEC's proposed climate change disclosure rules").

[178] Indeed, Justice Kagan, in her dissenting opinion, made just such a characterization, one that she argued fitted within the EPA's statutory authority. *See West Virginia*, 142 S. Ct. at 2609-2618.

[179] *See* Farber, *supra* note 173 ("The crucial question . . . is whether the SEC can make a convincing case that its goals relate to the securities market, not to fighting climate change . . . . This will require . . . a regulation that is carefully crafted to protect investor needs.").

[180] *See, e.g.*, Cunningham et al., *supra* note 54, at 15–16.

sufficient, and therefore no limit to the potential analysis that could be undertaken.[181]

Commentators have also suggested that the SEC's economic analysis understates the high costs of the Proposed Rule, or that the highly speculative (and unquantifiable) benefits cannot justify the high costs of the Proposed Rule.[182] Similar reasoning has been sufficient grounds to invalidated prior rulemaking by the SEC.[183] On its face, this is also a difficult claim for the SEC to rebut, because the costs of a proposed rule are generally concrete, and thus much easier to quantify.[184] Most costs of the Proposed Rule accrue to particular companies with accounting systems to determine their quantum. In contrast, the benefits from the Proposed Rule that the SEC identifies would accrue to a broad group of investors, which cannot quantify those benefits.[185]

Making the Proposed Rule investor-optional would effectively circumvent these criticisms, for two reasons.[186] First, it would cap the net costs of the Proposed Rule to investors in a particular company at a very low level.[187] If the Proposed Rule imposed greater costs than benefits on investors in the company, and costs (net of benefits) were greater than the cost of opting-out, investors would simply opt out, capping the costs to investors at the relatively low cost of opting out.[188] The maximum overall costs of the Proposed Rule would thus be costs of opt-outs, aggregated over all of those companies that would opt out (or attempt to do so). The per-company costs are likely to be similar and small for each company: they would consist of the marginal cost to the company of including an additional proposal in its annual report, and the marginal cost to the company's

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[181] For a discussion of the challenges of cost-benefit analysis, see generally John C. Coates, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882 (2015).

[182] *See, e.g.*, Cunningham et al., *supra* note 54, at 15–16.

[183] *See, e.g.*, Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

[184] For a discussion of the challenges of cost-benefit analysis for climate disclosure regulation, see Amour, Enriques & Wetzer, *supra* note 54, at 1128-31.

[185] For a detailed study of arguments regarding cost-benefit analysis by the SEC, see Coates, *supra* note 181.

[186] For a prior discussion of how an "options-approach" to rulemaking would help agencies—and the SEC in particular—avoid invalidation or insufficient cost-benefit analysis, see Lee, *supra* note 68, at 928 (discussing how an opt-out would have reduced the likelihood of invalidation of the SEC's proxy access rule).

[187] For a version of these arguments in reference to SEC rulemaking in general, see generally Hirst, *supra* note 34.

[188] *See id.* at 270–71.

investors of voting on that proposal. These costs of opting out could be reliably estimated by the SEC.[189] They are likely to be relatively small, and orders of magnitude less than the amounts the SEC estimated as the costs of gathering and preparing the required climate disclosure information.[190]

Second, by its very design, an investor-optional rule would provide clear evidence that the benefits of the Proposed Rule would exceed the costs.[191] For any company where investors believed that the costs of climate disclosure would exceed the benefits they would receive from disclosure, those investors would allow the company to opt out of the disclosure obligation. Therefore, if a company has not opted out, the benefits of disclosure to investors in the company can be reasonably inferred to be greater than the costs to those investors of such disclosure.[192] Similarly, the overall benefits of the Proposed Rule for all of the companies that did not opt out could reasonably be inferred to be greater than the costs of the rule. Given the very small cost to any companies that do opt out, capped at the cost of the opt out process, it would be straightforward for the SEC to conclude that the benefits to investors of an investor-ordered rule exceeded the costs. The result would be to give much greater confidence to the SEC's economic analysis, and thus reduce the likelihood that a reviewing court would later find it inadequate.[193]

E. Failure to Adequately Consider or Rebut Investor Optionality

Investor optionality could operate not only as a shield for a final rule (if it were so designed), but also as a sword, against a final rule that is *not* investor-optional. There are two ways that failure to take into investor optionality into account could lead to invalidity of a mandatory final climate disclosure rule. First, a final rule adopted by the SEC is likely to be invalid if the SEC does not *consider* an investor-optional rule in its final rulemaking. Second, if the SEC does adopt a mandatory rule rather than an

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[189] For a discussion of the costs of opting out, see *infra* Section IV.B.4.

[190] For the SEC's discussion of the likely costs of climate disclosure, see Proposed Rule, *supra* note 2, at 21339–43. A number of commentators have suggested that these are likely to underestimate the true costs of disclosure. *See, e.g.*, Nat'l Ass'n of Mfrs., *supra* note 55, at 3 (arguing that the Proposed Rule "fails to appropriately take into account . . . the time and cost burden associated with the rule's far-reaching mandates.").

[191] *See* Hirst, *supra* note 34, at 261, 272.

[192] As discussed above, this inference is not certain, but it would be stronger than any competing inference that could be drawn regarding the views of investors in the company regarding climate disclosure. *See supra* note 159.

[193] *See* Hirst, *supra* note 34, at 272.

investor-optional rule, it must adequately justify the grounds on which it chose to do so, and why arguments that investor optionality would be better for investors do not hold. If it cannot, such a mandatory rule is also likely to be invalid.

These two potential grounds for invalidity differ from the arguments outlined in previous sections in that have not yet been argued by opponents of the Proposed Rule, but rather derive from the analysis in this Article. However, opponents of the SEC's rulemaking are likely to use whatever arguments they can find in their attempt to invalidate the SEC's rule. These arguments are unlikely to escape their attention, either from this Article itself, or comment letters submitted to the SEC, or a related blog post, each encapsulating similar arguments regarding investor optionality.[194] If the SEC does not strengthen its Proposed Rule by making it investor-optional, that failure is likely to be used against it by opponents of the Proposed Rule, as a strong argument for invalidation.

The first way in which investor optionality could be used as a basis for invalidating a final, mandatory SEC rule is if the SEC fails to *consider* investor optionality before adopting a final rule. The reasoning is straightforward. Cases interpreting the Administrative Procedure Act have made clear that the SEC is required to consider reasonable alternatives to its Proposed Rules, and especially "less restrictive yet easily administered" regulatory alternatives.[195] Investor-optional disclosure is clearly a reasonable alternative, and also one that is less restrictive, yet easily administered. If the SEC failed to consider investor-optional disclosure, it would therefore be grounds for invalidating the rule the SEC adopts.

There is clear precedent applying this requirement to the SEC and invalidating prior SEC rulemaking for failure to comply. In *Chamber of Commerce of the United States of America v. SEC* (hereinafter, "*Chamber of Commerce*"), the U.S. Court of Appeals for the District of Columbia Circuit invalidated an SEC rule based (in part) on its failure to consider an

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[194] Scott Hirst, Letter to Vanessa A. Countryman, Sec'y, SEC, Regarding Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 17, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20131572-301938.pdf [https://perma.cc/JJ6V-3WYV]; Scott Hirst, *The Proposed SEC Climate Disclosure Rule: A Comment from Scott Hirst*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 11, 2022), https://corpgov.law.harvard.edu/2022/07/11/the-proposed-sec-climate-disclosure-rule-a-comment-from-scott-hirst/ [https://perma.cc/Y2KX-SC24].

[195] *See* Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983).

alternative to the rule, which the Court concluded was a violation of the Administrative Procedure Act.[196] *Chamber of Commerce* relied on a standard set out in the Supreme Court's decision in *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co* (hereinafter, "*State Farm*").[197] The Sixth Circuit has applied the *State Farm* standard to conclude that failures by the regulator to consider "less restrictive, yet easily administered" alternative rules rendered a rule arbitrary.[198]

The Court of Appeals for the District of Columbia Circuit has clarified that the *State Farm* standard does not require the SEC to consider *every* alternative;[199] the SEC would be excused from considering alternatives that are "for whatever reason, unworthy of consideration."[200] But in *Chamber of Commerce,* the Court concluded that the alternative proposed was "neither frivolous nor out of bounds, and the SEC therefore had an obligation to consider it."[201]

As this Article has explained, investor-optional disclosure is also neither frivolous nor out of bounds. Far from being "unworthy of consideration," Part II demonstrates that investor optionality is *more* consistent with the SEC's rationale for promulgating a climate disclosure rule than mandatory disclosure, and Part IV makes the case that it is highly likely to *better* protect investors than a mandatory rule. The Release considered 14 variations on the Proposed Rule, all of which are substantially *less likely* to be better for investors than an investor-optional alternative.[202] Letters submitted in response to the SEC's request for comments on the Proposed Rule have also made clear the reasons why investor-optional would be more consistent with investor demand, and offer better protection for investors, than a mandatory rule.[203] In the past the SEC has considered an opt-out alternative

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[196] Chamber of Com. v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005) ("We conclude the Commission's failure to consider the disclosure alternative violated the APA.").

[197] *State Farm*, 463 U.S. 29.

[198] *See* Cincinnati Bell Tel. Co. v. FCC, 69 F.3d 752, 761 (6th Cir. 1995) (compelling the FCC "to provide a reasoned explanation as to why the less restrictive alternatives . . . are insufficient" and as a result, the rule adopted by the FCC was arbitrary).

[199] *Chamber of Com.*, 412 F.3d at 144 ("To be sure, the Commission is not required to consider ''every alternative . . . conceivable by the mind of man . . . regardless of how uncommon or unknown that alternative'' may be.", quoting *State Farm*, 463 U.S. at 51, 103).

[200] *Chamber of Com.*, 412 F.3d at 144.

[201] *Id.* at 145.

[202] *See* Proposed Rule, *supra* note 2, at 21448–52.

[203] *See* Hirst, *supra* note 194.

to at least one proposed rule, its rule implementing proxy access.[204] All of these facts add weight to the argument that, for the SEC to heedlessly fail to consider the investor-optional alternative would be grounds for invalidating a mandatory rule.

If the SEC *does* consider investor optionality, then in order to nonetheless implement mandatory disclosure it would need a good reason to justify its conclusion that mandatory disclosure would be better for investors than investor optionality. It must "articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"[205] The SEC's rulemaking would be arbitrary and capricious, and therefore, subject to invalidation under the Administrative Procedure Act

> if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.[206]

Two of the arguments made in this Article mean that it is likely to be very challenging for the SEC to satisfy these standards, and to adequately justify implementing a mandatory rule rather than an investor-optional rule. First, as discussed in Part II, a mandatory rule is not consistent with the SEC's claim of investor demand, on which its rulemaking is based. It would therefore be very difficult, or impossible, for the SEC to articulate a satisfactory explanation for choosing a mandatory rule, or a rational connection between investor demand and the choice of a mandatory rule (rather than an investor-optional rule). Rather, given the investor demand

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[204] *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56667, 56679–80 (Sept. 16, 2010). The consideration of opting out included opting out through a bylaw adopted by a shareholder vote, which would be similar to the investor-optional approach proposed here.

[205] Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983) (quoting Burlington Truck Lines, Inc. v. U.S., 371 U.S. 156, 168 (1962)).

[206] *State Farm*, 463 U.S. at 43.

rationale, the choice of a mandatory rule over an investor-optional rule would be inconsistent and illogical.[207]

Second, it is highly likely that investor-optional disclosure will *better* protect investors than mandatory disclosure. Part IV explains why this is likely to be the case, and the very limited circumstances in which it would *not* be the case. As Part IV.C explains, the only ground on which a mandatory rule could be better for investors than an investor-optional rule is if the SEC were to conclude, both that (1) there would be a substantial number of companies where investors would choose to opt out if they were able to do so, and (2) the cost to investors *outside those companies* from the decisions of those companies to opt out would be greater than all of the other benefits to investors from investor optionality, including cost savings from opt-out decisions, and the greater likelihood of validity of climate disclosure rules.[208]

If the SEC implemented a mandatory rule without adducing sufficient evidence to overcome the argument that an investor-optional rule would be better for investors, then its mandatory final rule would be subject to invalidation for being arbitrary and capricious.[209] And if the SEC were to choose a mandatory rule over an investor-optional rule on any grounds that did not relate to investor protection (or to the promotion of efficiency, competition, and capital formation), then its reliance "on factors which Congress has not intended it to consider" would also make their decision subject to invalidation as arbitrary and capricious.[210]

IV. A BETTER RULE FOR INVESTORS

This Part makes the case that investor-optional disclosure is likely to result in *better protection for investors* than a mandatory rule. Obviously, given that its rulemaking power is granted for the purpose of protecting investors, the SEC should implement the version of the rule that would be better for investors. If the SEC nonetheless wished to implement a mandatory rule, it must demonstrate that the mandatory rule would actually be better for investors. This Part explains what the SEC would need to establish in order to demonstrate that, and why it is likely to be very

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[207] *See infra* Section II.E.
[208] *See infra* Section IV.C.
[209] *See State Farm*, 463 U.S. at 43.
[210] *See id.*

challenging. Section IV.A explains that investor-optional climate disclosure would have costs for investors in disclosing companies that are no greater than those imposed by the Proposed Rule, and probably significantly less. Section IV.B explains the assumptions on which this analysis relies, and why they are likely to be reasonable. The critical question regarding whether a mandatory rule or an investor-optional rule will be better for investors thus comes down to potential benefits for investors *outside* the disclosing company, and whether those outweigh the costs of such disclosure to the disclosing company's investors. Section IV.C outlines how this question must be analyzed, including by the SEC if it wishes to implement a mandatory rule. Section IV.D considers additional benefits from the information likely to be revealed by an investor-optional rule.

A. Lower Costs for Investors in Disclosing Companies

This Section makes the straightforward case for why investor-optional disclosure would be better than a mandatory rule for *investors in a company subject to disclosure requirements*. A focus on investors within the company is consistent with a substantial part of the SEC's argument that there is investor demand for climate disclosure: most of that demand is likely to come from investors within the company. This includes information that these investors will use for voting or stewardship purposes, and also in deciding whether to sell their shares.[211] For rules with little or no effects on investors outside the company to which the rule applies, this analysis would be the end of the matter.[212] However, since the Proposed Rule relates to disclosure rule, it is reasonable to consider whether that disclosure may have benefits to investors *outside* the company. Such potential externality benefits are introduced in Section IV.C.

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[211] The Release makes clear that the purpose of the Proposed Rule is to help investors "make investment or voting decisions." Proposed Rule, *supra* note 2, at 21432. Indeed, the SEC includes this phrase 21 times throughout the Release. *See id.* at 21335, 21337, 21341, 21360–61, 21368, 21371, 21373, 21376–77, 21379–80, 213405, 21413, 21425, 21432, 21462.

[212] For instance, that is likely to be the case for governance rules, such as those relating to the composition of the company's board of directors or board committees. This would also include any requirements the SEC might impose in the future regarding board diversity. *See, e.g.*, Andrew Ramonas, *SEC's Board Diversity Drive Runs Risk of More Legal Challenges*, BLOOMBERG L. (Oct. 22, 2021), https://news.bloomberglaw.com/securities-law/secs-board-diversity-drive-runs-risk-of-more-legal-challenges [https://perma.cc/J5RA-YPPM].

When considering only investors in the disclosing company, it is clear why an investor-optional rule will be no worse, and often better, than a mandatory rule. Consider two mutually exclusive and collectively exhaustive scenarios. In the first scenario the benefits of the Proposed Rule for investors in all companies subject to the Proposed Rule are greater than the costs of the Proposed Rule for those investors. In this scenario, no set of rational company investors would approve an opt-out from the Proposed Rule. Thus, the benefits and costs of an investor-optional rule would be identical to those of the Proposed Rule.

Now consider the complementary scenario, where the costs to investors in *at least some* companies of disclosure are greater than the benefits to investors in those companies from disclosure. This is a much more reasonable scenario, because there is likely to be variation among companies in the costs and benefits from disclosure to investors in those companies. The Release itself contemplates such variation, by treating small reporting companies (SRCs) differently from other companies subject to the Proposed Rule.[213] But costs and benefits are also likely to vary among both SRCs and non-SRCs, depending on factors like the level of emissions of the company, the costs to the company of disclosure, and the composition of the company's investors.[214]

At many companies, the benefits to investors from disclosure will still exceed the cost of that disclosure, and investors in those companies will not authorize the company to opt out of the rule. But for those companies where benefits to investors from the Proposed Rule are less than the costs they would bear from the Proposed Rule, then if the Proposed Rule is made investor-optional, investors in those companies will support the company opting out of the Proposed Rule. This will result in lower costs to those investors compared to a mandatory rule. An investor-optional rule would therefore also be less costly than a mandatory rule for investors in the aggregate, across all companies. The upshot is that investor optionality will be no worse (for investors in disclosing companies) than a mandatory rule, and likely better. This is unsurprising, since it follows from the assumption that, where rational investors have the ability to do so, they will act in their own interests.

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[213] Proposed Rule, *supra* note 2, at 21390–91 (describing the proposed exemption of SRCs from the requirement to disclose Scope 3 emissions).

[214] The benefits to investors are also likely to vary based on the composition of the investor base. I discuss the implications of this further in *infra* Section VI.A.

B. The Reasonable Assumptions for Lower Cost Disclosure

The reasoning in Section IV.A makes several additional assumptions, which I examine in turn below.[215] As the discussion shows, not only are these assumptions reasonable, but they are consistent with the SEC's own claims and assumptions, including regarding investor demand. It is therefore unlikely that the SEC could conclude that they were inaccurate in a way that would undermine the base case for investor optionality being better for investors in disclosing companies than a mandatory rule, without also undermining its own rationale for its Proposed Rule.

1. Investors Vote for the Outcomes that Are Best for Investors

The reasoning in Section IV.A assumes that, when deciding whether to opt out of climate disclosure, investors will vote for the choice that will maximize their own future welfare.[216] If they do, they will opt out when the costs to investors exceed the benefits of the rule, and they will choose not to opt out if the benefits exceed the cost.

If investors do not make privately optimal choices, it is possible that an investor-optional rule might be worse at protecting investors than a mandatory rule. Of course, if investors wrongly *failed* to opt out of an investor-optional rule, the disclosure obligation would continue to apply, just as it would for a mandatory rule.[217] So the assumption of privately

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[215] In addition, I assume that the SEC would design the opt-out process in such a way as to be optimally protective of investors, following the approach discussed in Part V. This is not an unreasonable assumption; the design of the rule is entirely within the control of the SEC, and the SEC has strong incentives to design the rule so as to protect investors. Following the approach in Part V would ensure that investors were adequately protected from opt-outs by minority shareholders that control companies with dual-class stock even where investors did not consider it in their best interests to opt out.

[216] Any voting solution conjures the possibility of voting paradoxes, such as that identified by Condorcet, and of Arrow's impossibility theorem. For a discussion of both topics, see, e.g., Eric Pacuit, *Voting Methods*, *in* THE STANFORD ENCYCLOPEDIA OF PHILOSOPHY (Edward N. Zalta ed., Fall 2019 ed. 2019). This a problem common to all corporate voting issues where there is the possibility of a cycle. The Condorcet paradox thus applies if there was a voting choice among multiple different decisions. But because the opt-out vote proposed in this Article would be binary, there is no possibility of cyclicality as in the Condorcet paradox. In addition, the Condorcet paradox is unlikely to hold in elections with large numbers of voters, such as corporate elections. *See* A. S. Tangian, *Unlikelihood of Condorcet's Paradox in a Large Society*, 17 SOC. CHOICE WELFARE 337, 350 (2000).

[217] In such a case, the welfare of investors may be worse than if there was no obligation on the company at all, but that would not be a reason to prefer the mandatory rule over the investor-optional rule.

optimal decision making on the part of investors can only affect the conclusion that investor-optional rules are better for investors if investors would consistently *opt out* of disclosure rules against their own interests.[218] They would only do this if they do not recognize the benefit of climate disclosure for themselves.[219]

But the possibility that investors would opt out against their own interests is contrary to the claims of both the SEC and its opponents regarding the Proposed Rule. The SEC has relied on investor demand for climate disclosure to promulgate the Proposed Rule.[220] Doing so implicitly assumes that investors are able to correctly identify the costs and benefits that climate disclosure would have for them.[221] If so, they can do the same when making opt out decisions.[222] And if the majority of investors do indeed demand climate disclosure, they will not wrongly opt out of it. Opponents of the Proposed Rule acknowledge that many investors support the rule; these opponents are thus more likely to be concerned that investors would *fail* to opt out, rather than *wrongly* opt out. For those investors to *wrongly* opt out it would be necessary that climate disclosure was actually in the interests of those voting to opt out, despite their belief to the contrary.

An additional argument raised by opponents of the Proposed Rule is that investment managers supporting climate disclosure are not following the true preferences of their own investors.[223] One explanation is agency costs of investment managers. It is certainly likely that investment managers

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[218] To make investor optionality worse than a mandatory rule, the extent of sub-optimal decision making would need to be extreme, such that the costs from it outweighed the other benefits of investor optionality.

[219] It is possible that the SEC's choice to have disclosure as the default (rather than no disclosure as the default) may give the case for disclosure extra credibility, and thus bias decisions of investors against opting out. However, this would seem to be unlikely for the large majority of investors that are sophisticated institutions, and able to make their own rational decisions. If, as SEC claims, the decision to impose climate disclosure already follows the preferences of a majority of investors, then there is no room for the choice of a disclosure default to change their views. In any case, any bias would be conservative, making the opt-out rule more like a mandatory rule, albeit reducing the potential cost reductions from companies opting out.

[220] *See infra* Section II.A.

[221] If investors could not identify the costs and benefits that climate disclosure would have for them it would not be reasonable to rely on their demands for such disclosure.

[222] Investors considering opt-out decisions will also have the benefit of the reasoning the SEC has expressed in the Proposed Rule regarding the costs and benefits of climate disclosure, and will be able to assess whether that reasoning applies to the particular company in which they invest.

[223] *See, e.g.*, Cunningham et al., *supra* note 54, at 5–7.

exhibit some agency costs in both their stewardship decisions and their voting decisions.[224] However, the direction in which the SEC's opponents claim those agency costs push investors would make an investor-optional rule *more* like a mandatory rule, rather than worse than a mandatory rule. That is because the agency cost argument of those opponents is that investment managers are more likely to *support* climate disclosure than their own investors would prefer.[225] If this were to lead them to act against the interests of their investors, it would be by *failing* to opt out, not by *wrongly* opting out. This would reduce the extent to which investor optionality is better for investor than a mandatory rule, but would not make investor optionality worse than a mandatory rule.[226]

2. Opt-outs Are Initiated When They Would Be Beneficial

A second critical assumption of the reasoning in Part IV.A is that, where there is a reasonable chance that investors would vote to opt out of climate disclosure, a vote will indeed be initiated to opt out of the disclosure obligation. If such votes are not actually initiated, companies will continue to be bound by those obligations even though they are costly to investors.

It is important to note that the failure of this assumption would not make an investor-optional *worse* than a mandatory rule. At the extreme, if opt out votes were never initiated, the investor-optional and mandatory versions of the rule would be identical. But the extent to which opt-outs from the Proposed Rule are not initiated will reduce the margin by which the investor-optional rule is better than the mandatory rule (all other things being equal).

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[224] For a discussion of agency costs of institutional investors with respect to stewardship decisions, see generally Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017); Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019). For evidence that investment managers do not follow the preferences of their own investors, see Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217 (2018).

[225] For my own argument that investment managers do not follow the preferences of their own investors, see Hirst, *supra* note 224. However, that Article points out that investment managers were likely to be insufficiently supportive of socially responsible matters, like climate disclosure, rather than excessively supportive, as opponents of the Propose Rule argue.

[226] If this objection is indeed correct, it could be overcome by implementing an investor-optional rule in conjunction with stronger requirements or incentives for institutional investors to follow the preferences of their own investors. For such a proposal, see generally *id.*

Opt-outs are likely to be initiated where they are expected to be successful, because the directors and executives of the company have the ability to easily initiate opt out votes, strong incentives to do so if they are beneficial, and no significant incentives *not* to do so.[227] For directors and executives, initiating an opt-out vote would be easy and inexpensive. It would simply require including an additional matter in the agenda and proxy materials for an annual shareholder meeting as part of the registrant's regular annual meeting preparation process. Directors and executives are the ones *most* likely to push for opting out from the company's disclosure obligations. As Nell Minow artfully describes in her comment letter regarding the Proposed Rule, "the only group who can object to the proposed rule are corporate executives and board members . . .".[228] They are the group that are most familiar with the costs of the disclosure. Indeed, many managers and groups associated with managers submitted comments in opposition to the SEC's Proposed Rule on the grounds that it would impose excessive costs on companies.[229] If directors or executives believe that an opt-out is likely to be supported by investors, they therefore have both the ability and the incentive to put forward such an opt-out for a vote.

The only reason that directors and executives might be deterred from initiating opt out votes that they expect to be successful is from a fear of obloquy from doing so. But this possibility seems far-fetched. If shareholders holding a majority of shares (or even a substantial minority) were likely to support the opt out proposal, sufficient for it to be successful, that support would make it unlikely that managers would incur any obloquy were they to do initiate the vote. The possibility of obloquy would only arise if the vast majority of shareholders were against opting out.[230] And if that were the case, there would be no reason for directors and executives to

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[227] Under-initiation of opt-out votes would be likely if investors were required to initiate those opt-out votes, given the costs to investors of initiating shareholder votes, their limited incentives to do so, and their resources constraints. *See* Hirst, *supra* note 81. This is the main reason to make the rule opt-out, rather than opt-in—to give directors and executives the incentive to initiate the voting decision. *See* Hirst, *supra* note 34*;* Bebchuk & Hamdani, *supra* note 79.

[228] Nell Minow, Comment Letter on Proposed Rule for The Enhancement and Standardization of Climate-Related Disclosures for Investors 5 (June 5, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20130308-297032.pdf [https://perma.cc/82P6-ARCH].

[229] *See, e.g.*, Nat'l Ass'n of Mfrs., *supra* note 55, at 49–50.

[230] This would usefully prevent managers from *over*-initiating opt-outs.

initiate the opt out process, as there would be no chance that it would be successful.

3. Roughly Commensurate Costs to Investors

An additional assumption of the reasoning in Section IV.A is that the costs and benefits to different investors from disclosure are roughly commensurate based on their pro rata holdings. This would not be the case if some investors had costs or benefits that were orders of magnitude greater (on a per-share basis) than others. If so, even if a majority of investors preferred to opt out of disclosure, the costs to the minority from such an opt-out might be greater than the benefits to the majority from opting out. Of course, for this to be the case, as the minority got smaller, the greater would have to be their per-share costs. However, while there might be some variation among investors in how much they value disclosure, these amounts are unlikely to vary by orders of magnitude. The main source of value for shareholders will be their future cash flow rights from share ownership, whether from the company or from the sale of their shares, which will not vary among different investors (on a per-share basis). Some investors may have non-pecuniary preferences regarding the actions of the company.[231] It is difficult to compare the value of these preferences to pecuniary preferences, but to the extent it is possible, they are likely to be relatively small.[232] Where an opt-out by the company does not match the preferences of a minority investor, that investor can sell their shares, or shift to an investment manager that does not invest in the company. The ability to do so would place an upper bound on the value of their non-pecuniary preferences.[233] For these reasons, it would be difficult to show that the

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[231] For the general point that investors may have non-pecuniary preferences, see Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, J.L. FIN. & ACCT. 247 (2017); Hirst, *supra* note 224. For an attempt to determine the extent of these preferences, see generally Scott Hirst, Kobi Kastiel & Tamar Kricheli-Katz, How Much Do Investors Care About Social Responsibility? (June 2, 2022) (unpublished manuscript) (available at https://ssrn.com/abstract=4115854 [https://perma.cc/69CZ-ZF7H]).

[232] *See generally* Hirst, Kastiel & Kricheli-Katz, *supra* note 231 (conducting an experiment to estimate the amounts that investors are willing to forgo for social interests).

[233] If sufficient minority investors cared enough about disclosure, they could also "buy" votes to try and block the opt-out decision, by borrowing shares prior to the record date of the meeting. For a discussion of practical challenges to this approach, see generally Scott Hirst & Adriana Robertson, *Hidden Agendas in Shareholder Voting*, 39 YALE J. REGUL. 1161 (2022).

preferences of minority investors against an opt-out were sufficiently strong to outweigh a majority preference in favor of an opt-out.

4. Aggregate Costs of Opting Out Are Less Than the Benefits

A final assumption of the reasoning in Section IV.A is that the cost to investors of the opt out process is relatively small, compared to the benefit gained by those investors. The cost of the opt out process does not refer to the costs of preparing the disclosure itself. Rather, it includes the costs to initiate the vote (described in Section IV.B.2), the cost to investors of deciding how to vote on the opt out proposal, and expenses that the company and investors may invest in trying to persuade other investors to vote in favor of or against the opt out.[234] If these opt out process costs were substantial, and the benefits that resulted from opting out were small, or if opt out votes failed, resulting in no benefit to investors, the costs for a particular company of making an opt-out decision could outweigh the benefits of the opt out itself. If sufficient companies had opt out costs that were greater than the benefits of the opt out, the net cost to those companies from the opt out process could outweigh the other benefits of an investor-optional rule.

However, four factors associated with the nature of opt out voting decisions, and of the investors that would determine the outcome of opt out votes at the great majority of companies means that the costs of opting out are likely to be relatively small, and thus this assumption is likely to be reasonable. First, companies already submit multiple matters to votes each year, and investors that hold portfolios of many companies already vote on hundreds, or thousands, of matters each year. Companies and investors have well-developed processes in place for these votes, designed to reduce their cost.[235] The marginal costs to the company of adding a single additional vote, or to investors of considering a single additional vote, are unlikely to

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[234] It is likely that managers would be better informed about the costs to the company of complying with the disclosure requirements than investors, and would need to communicate these to investors to allow investors to vote in a way that is privately optimal for them.

[235] For companies these include processes for the discussion of matters with advisors, the approval of matters by the board, and the drafting and inclusion of the matter in proxy statements. For investors these include getting advice on the proposal from proxy advisors and using advisors to vote their shares.

be significant.[236] An opt-out vote would be comparable to the marginal cost of a single shareholder proposal, many of which are included in company proxy statements each year under the SEC's Rule 14a-8. To argue that the costs associated with putting forward and voting on a single opt out proposal are substantial would run counter to the continued existence of Rule 14a-8.

Second, the nature of institutional investors, whose votes are likely to be determinative in these matters, means that extensive information campaigns by managers (or other investors) to convince them how to vote are unlikely to be necessary, or even effective. The largest of these investors submitted comments on the Proposed Rule, and thus likely already have well-informed views on the likely effects of the disclosure requirements on their portfolio companies generally.[237] The informational demands of these investors could be satisfied by the company's statement in its proxy statement supporting the opt out proposal, in which managers would articulate the costs of the disclosure to the company. Because these investors are broadly diversified, and because opt out decisions will be very similar in comparable companies, the investors can incorporate information from opt out votes that they have cast in at comparable companies in the past into their decisions.

Third, these investors are likely to take the costs of the opt out process into account. An investor that was focused *only* on a particular opt out vote at a particular company would rationally disregard the costs of the opt out process in deciding how to vote, because those process costs would be "sunk costs" from the frame of the opt out decision—they would be incurred regardless of the decision, and prior to the decision being made. However, the broadly diversified nature of these investors means they will likely also consider the effects of their opt out decision on *other* companies in their portfolio.[238] These investors would rationally also take into account costs

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[236] For the great majority of investors that hold significant portfolios, their voting decisions will be informed by similar decisions at other companies that have faced similar opt-out decisions, reducing the marginal cost of each opt-out decision.

[237] *See, e.g.*, BlackRock, Inc., *supra* note 57, at 1; State Street Global Advisors, *supra* note 57, at 1; Fidelity Investments, *supra* note 57, at 1; Vanguard Grp., Inc., *supra* note 57, at 1; Cap. Rsch. & Mgmt. Co., *supra* note 57, at 1.

[238] That diversified investors would consider the effects of their votes on other companies in their portfolio is consistent with recent work focused on portfolio-level thinking with respect to stewardship decisions. For discussions of this portfolio-level approach, see Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1 (2020); Jeffrey N. Gordon, *Systematic Stewardship*, 47 J. CORP. L. 627 (2022); Tallarita, *supra* note 1.

imposed on investors by the opt out process itself, and whether they are likely to be greater than the benefits of opting out itself. If this were the case, the investors could decide to vote against the opt out. Institutional investors might also use other measures to discourage managers from initiating net-costly opt out processes, or from excessive spending of company resources on information campaigns related to the opt out vote.[239]

Finally, the SEC has the power to design the opt out method so as to reduce the cost as much as possible. Part V considers some features designed to reduce the cost of opting out.[240]

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The realities of manager and investor behavior, and the opt out process, mean that these assumptions are likely to be reasonable, and certainly not so unreasonable that they could invalidate the base case that investor-ordering would be better for investors in companies disclosing climate information than a mandatory rule.

C. Externalities for Investors in Other *Companies?*

The analysis so far has focused on the costs and benefits to investors in a particular company from that particular company disclosing its climate emissions. I turn now to consider how externality benefits *could possibly* alter the conclusion reached above, that investor-optional disclosure would be better for investors than a mandatory rule.[241] This Section explains why the existence of substantial externality benefits to *other investors* would be critical to the SEC's justification for a mandatory disclosure rule. It also explains the significant challenges with establishing substantial externality

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[239] For instance, institutional investors could adopt policies indicating that they would sanction directors that approve costly opt-out decisions, or spend excessively on them, by withholding votes from those directors at the subsequent annual meeting. For an analysis of the use of such "withhold campaigns" to sanction managers for other matters, see generally Yonca Ertimur, Fabrizio Ferri & David Oesch, *Understanding Uncontested Director Elections*, 64 MGMT. SCI. 3400 (2018).

[240] For instance, if opt-out decisions lasted for, say, five years, opting out would require only one vote every five years. For a discussion of such features of the opt-out process, see *infra* Section V.C.

[241] In this Section I focus on the potential positive externalities to investors in other companies from disclosure. But the mere decision of a company whether to opt out will also have effects on other companies that could also be described as externalities—for example, for each company that decides not to opt out, the cost to other companies of opting out may be higher. I discuss this particular issue in Section VI.A.

benefits, and why investors in companies considering opting out of disclosure are instead likely to internalize most of the benefits to investors *outside* the company in making their decision whether to opt out. As a result, any remaining externality benefits to investors outside the company are likely to be relatively limited.

If the SEC is to continue with a mandatory disclosure rule, the existence of sufficient externality benefits is critical—they are the only logical and consistent way to justify the choice of a mandatory rule over an investor-optional rule. For that to be the case, climate disclosure by one company must create externality benefits for investors in *other companies*.[242] Investors in the potentially-disclosing company would also have to choose to opt out; if they did not, there would be no difference between a mandatory rule and the investor-optional rule. But rational investors will only choose to opt out if they consider the costs to themselves of disclosing all or part of the required information are greater than benefits (to such investors) of disclosure. For mandatory disclosure to be better, the cost savings to the investors in the company from opting out must be less than the benefits that investors outside the company would have received from the disclosure. And, aggregated across all companies, the difference must be greater than any other benefits that would accrue from investor optionality, including the reduction in the likelihood of invalidity. This Section considers the factors necessary for these conditions to be satisfied.

It is important to note that, to justify a mandatory SEC rule, the externality benefits must be to *other investors*, not to other members of the public in general. As discussed in Part II, the SEC could have based its rulemaking on a public interest rational. Because it did not, and focused entirely on investor protection and investor demand, it cannot rely on benefits to non-investors to justify the choice of a mandatory rule.[243] I therefore limit my analysis to potential externality benefits to externality benefits to other investors.[244]

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[242] For an extensive discussion of one such externality—more accurate market pricing of climate risks—see generally Condon, *supra* note 54.

[243] For a discussion of positive externalities of climate disclosures generally, see Amour, Enriques & Wetzer, *supra* note 54, at 1122-1124.

[244] If the SEC were to consider the interests of the public at large, it would require a very challenging comparison of the benefits to non-investors from disclosure, to the costs to investors from the disclosure, which would further complicate (and threaten) the SEC's cost-benefit analysis.

If the SEC is to successfully justify a choice of a mandatory rule over an investor-optional alternative, it must be specific about exactly which investors *outside the disclosing company* would benefit from such disclosure, to what extent, and why the disclosing company would not internalize those benefits. The SEC focused on "making voting and investment decisions" as the reason why investors demanded climate disclosure.[245] Of these two purposes, externality benefits can apply only to investment decisions, as voting decisions are not relevant for investors outside the company (who have no right to vote on company matters).[246] Which investors outside the company might benefit from the company's climate disclosure for investment purposes? The two most plausible groups are *potential* investors considering buying a stake in the company, and investors (or potential investors) in other companies seeking an additional point of comparison for their own company.[247]

An important point to recognize in analyzing these groups is that the great majority of investors in a company considering opting out of disclosure will internalize the comparison benefits to investors in other companies, because they are *the same investors*. Most investors hold broadly diversified portfolios. This is especially the case for institutional investors, that are required by law to maintain a broad level of diversification. Index investors hold all companies in the index. And even

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[245] Proposed Rule, *supra* note 2, at 21335 ("We are proposing to require disclosures about climate-related risks and metrics reflecting those risks because this information can have an impact on public companies' financial performance or position and may be material to investors in making investment or voting decisions."). *See also* Amour, Enriques & Wetzer, *supra* note 54, at 1123 (discussing the effects of peer benchmarking and investor pressure in driving emission reductions by companies).

[246] It is suggestive of the fact that the SEC likely considers this to be the most important purpose of climate disclosure for investors that the SEC presents evidence from a survey of institutional investors, making clear that a large majority of them focus on climate change as part of their stewardship of their assets in companies. *See* Proposed Rule, *supra* note 2, at 21425 (discussing the 2021 Institutional Investors Survey). In addition, the SEC's references to both BlackRock and SSGA relate to the importance of climate risk to their stewardship activities. *See id.* at 21425 (discussing climate change as the focus of the asset stewardship programs of BlackRock and SSGA in 2022).

[247] For a discussion of the need for investors in general (including both current investors and potential investors) to have access to climate-related investors, see Condon, *supra* note 54, at 66–76.

most non-index investors have portfolios that have a breadth of coverage close to that of an index.[248]

These investors are likely to decide how to vote on the particular company's opt out decision based on the aggregate effects of the choice on all the companies in their portfolios, rather than merely the effects on the particular company.[249] This will therefore include in their calculus benefits that they receive as investors in other companies, from the particular company's disclosure, which will reduce the extent to which they allow the company to opt out.[250] This is a version of arguments that have been made about the impact of diversified portfolios on stewardship decisions by institutional investors.[251] The fact that the SEC relies on demand from institutional investors to support the case for climate disclosure, and cites their very substantial holdings, means that it is also likely to recognize the internalization of comparability benefits by such investors.[252] The only situation where these investors are unlikely to be dominant is for very small companies that are outside traditional indexes, and that therefore have a smaller proportion of their capital held by institutional investors.[253]

There will be some investors outside the company that may have very different characteristics from the broadly diversified investors within the company. This is most obviously the case with respect to socially responsible investors.[254] However, even though the total capital invested in these funds has been growing in recent years, they still represent a very

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[248] For an analysis of the significant extent to which active managers have portfolios similar to those of index investors, see K. J. Martijn Cremers & Antti Petajisto, *How Active Is Your Fund Manager? A New Measure That Predicts Performance*, 22 REV. FIN. STUD. 3329 (2009).

[249] For discussion of the effects of such consideration, and their desirability, see Condon, *supra* note 238; Gordon, *supra* note 238; Tallarita, *supra* note 1.

[250] For the sake of explanatory simplicity this Section ignores fractional interests. In reality, an investor that has a small interest in the company but a substantial interest in other companies might have more benefit from the disclosure than cost.

[251] *See* Condon, *supra* note 238; Gordon, *supra* note 238; Tallarita, *supra* note 1.

[252] For references by the SEC to the substantial holdings of investors supporting climate disclosure, see Proposed Rule, *supra* note 2, at 21340–41.

[253] For a more detailed discussion of the likely impact of an investor-optional rule, see *infra* Section VI.A.

[254] For an analysis of socially responsible investment funds and their holdings, see generally Quinn Curtis, Jill Fisch & Adriana Z. Robertson, *Do ESG Mutual Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393 (2021).

small fraction of U.S. equity capital, less than two percent in June 2022.[255] For a company that does not meet the investment criteria of such funds, such as one with substantial carbon emissions, the investors in the company are likely to be ones with *less* of a "green" focus than those that choose not to invest in the company. Socially responsible investors outside the company may have greater demands for climate disclosure than those inside the company. However, the critical question is the aggregate value of the climate disclosure to the investors outside the company. If the disclosure would not change the investment decision of those investors, it may not be particularly valuable to them.

Even to the extent that there are companies with a majority of investors that are not diversified, and therefore differ substantially from those outside the company, there are various market mechanisms that are likely to cause investors in the company to internalize benefits to potential investors outside the company.[256] One of the benefits of disclosure promoted by the SEC is that—by reducing uncertainty about a company's climate risks—it would reduce a company's cost of capital.[257] It could also increase the number of investors willing to buy shares in the company, and thus the liquidity of existing investors.[258] It is also possible that if the great majority of companies did not opt out, opting out would be seen as a substantial negative signal, that would impose significant costs on investors in a company. These costs would be factored in by investors in the company, reducing the extent of uninternalized externality benefits.

Even assuming that there were substantial externality benefits to some investors outside the company that are not internalized by investors inside the company, a difficult question arises in comparing those benefits to the

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[255] *See* Alyssa Stankiewicz, *U.S. Sustainable Funds See Outflows for the First Time in Five Years*, MORNINGSTAR (July 27, 2022), https://www.morningstar.com/articles/1104758/us-sustainable-funds-see-outflows-for-the-first-time-in-five-years [https://perma.cc/U3EN-RWF8] (estimating assets in U.S. sustainable funds at $296 billion as of June 2022, compared to $22.8 trillion "in the broader U.S. market.", implying that sustainable funds represent about 1.3% of U.S. equity capital).

[256] Additional groups of investors that is likely to be different from those outside the company (and undiversified), are directors, executives, and controlling shareholders. For a discussion of one important group of controlling shareholders—those with dual-class stock—see *infra* Section V.A.

[257] *See, e.g.*, Proposed Rule, *supra* note 2, at 21413 (discussing the benefit to investors of lowering the costs of capital of disclosing companies).

[258] *See, e.g.*, *id.* (discussing the benefit to investors of lowering improving stock liquidity).

costs borne by the investors in the company. The fact that investors in a company choose to opt out of certain disclosure requirements is concrete evidence that they consider the costs of disclosure to be greater than the benefits. On the other hand, it will often be difficult to put a value on the benefit to a particular investor outside the company of disclosure of that company's carbon risks and related information.[259] The uncertainty of the amount of benefit to outside investors (and whether this is greater than costs to inside investors) would make it particularly hard for the SEC to use this information to justify a mandatory rule for the same reasons discussed regarding concrete costs and speculative benefits in Section III.D.

D. The Informational Benefits of Investor optionality

Investor optionality would also overcome a significant problem with mandatory rules—the lack of information that they provide, and thus the difficulty of evaluating their effects. Investor optionality would have considerable informational advantages over a mandatory rule. It would thus also provide indirect benefits to investors, by allowing to SEC to better evaluate the costs and benefits of climate disclosure and adjust its rules accordingly.[260] Because of the possibility of opting out, the benefits to investors from investor optionality are also less contingent on the SEC adjusting its rules.

Part of the informational benefit from investor optionality would come from the fact that it would provide probative evidence in particular companies that investors demand such disclosure. Because directors and managers can be expected to initiate opt-outs if investors are likely to support them, and because investors would opt out of parts of the rule that they do not support for a particular company, the absence of such an opt-out would provide probative evidence that investors in a particular company demanded that information.[261] A mandatory rule would provide no such information, and rests on the SEC's controvertible belief that investors in that company are likely to demand that information. The benefits of this

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[259] One relevant metric might be the outside investor's willingness to pay for that information. Of course, if the information is unlikely to change the investor's decision then the investor might not be willing to pay very much for it.

[260] In making this argument, this Article follows an earlier recognition and discussion of the benefits to agencies from adopting an "options approach" to rulemaking by Alex Lee. *See generally* Lee, *supra* note 68.

[261] For other implications of this inference, see also *supra* Section II.A and Section II.B.

specific information about investor demand for defending the validity of the Proposed Rule have already been discussed.[262]

An investor-optional rule would also provide considerably more information to the SEC regarding its value and effectiveness than would a mandatory climate disclosure rule.[263] The only method for issuers and investors to modify a mandatory disclosure rule is to lobby the SEC for an amendment.[264] Such lobbying provides some information to the SEC, but it suffers from significant deficiencies. Not all relevant parties are equally motivated to spend their limited resources informing the SEC of shortcomings in its rules, or rebutting claims by others of shortcomings.[265] Some parties may have incentives to misstate or exaggerate the costs or benefits of parts of the Proposed Rule. The best source of information for the SEC would thus be its own efforts to analyze the rule, as part of a structured retrospective analysis of the Proposed Rule. But such a process occurs infrequently, and when it does, is likely to consume considerable SEC resources.[266]

In contrast, investor-optional climate disclosure would provide a metric for the value and effectiveness of the Proposed Rule that is granular, automatic, observable, timely, and incontrovertible.[267] This information would be apparent simply from the behavior of issuers in choosing to opt out of some or all of the requirements of the Proposed Rule.[268] Observing the proportion of issuers that opted out of that part of the Proposed Rule would allow the SEC—and others—to readily ascertain the extent to which issuers and investors believed that certain parts of the Proposed Rule imposed excessive costs (or provided insufficient benefits). This information would be useful for the SEC in deciding whether to amend

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[262] *See supra* Sections III.A-III.C.
[263] *See* Hirst, *supra* note 34, at 274.
[264] *See id.* at 260, 274.
[265] *See id.*
[266] *See id.* at 274.
[267] *Id.*
[268] A potential counter-argument is that, if companies fail to opt out even when it would be beneficial for them to do so (for instance, because investors impose excessive reputational penalties on companies that opt out), then the limited number of opt-outs may make it harder for the SEC to eliminate the climate disclosure rule even though it may be better for investors to do so. However, such a situation could also be interpreted as the SEC taking into account the wishes of investors (expressed through the same reputational penalties) to maintain climate disclosure, and thus acting optimally.

certain parts of the Proposed Rule.[269] It would also be useful for other issuers and investors considering whether their company should opt out of some part of the Rule.

Designing a rule as investor-optional would not obviate the need for retrospective analysis of the rule, but the information it provided would make it easier.[270] This information would come from two places. Most obviously, as discussed above, the SEC would have a ready yardstick for which parts of the Proposed Rule required amendment from the number of companies opting out of the rule. But more importantly, variations in disclosure practices among the companies that were bound by the Proposed Rule and those that had opted out would give the SEC a much stronger basis to analyze the actual effects of the Proposed Rule than with mandatory climate disclosure. This is because mandatory climate disclosure applies uniformly to all corporations, at the same time. As a result, there is no variation among corporations, or across time, that could be associated with changes in outcomes.[271] And the lack of any companies that are *not* bound by the rule means that there is no counterfactual control group against which the "treatment" effect of the rule can be compared.[272]

Investor optionality would also make the benefits of the Proposed Rule to investors less dependent on the SEC amending the rule after such retrospective analysis, because investors could opt out of the rule. SEC regulation could impose costs on investors to the extent that its requirements differ from what investors need at a particular point in time, because of delays in the modification of SEC regulations. Of course, if all parts of the mandatory Proposed Rule are always beneficial for all issuers, there is no need for any modification of the Rule after it is implemented. But even assuming that the Proposed Rule is perfectly designed when it is implemented, circumstances may change in the future that make some parts of it no longer optimal for all companies. And there is some likelihood that some disclosure obligations in the Proposed Rule, while well intentioned,

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[269] This point is an instantiation of a more generalized argument made by Alex Lee, that optionality in rulemaking would be valuable for agencies because it would allow agencies to adjust their rules using information revealed by the exercise of those options. *See* Lee, *supra* note 68, at 929.

[270] *See* Hirst, *supra* note 34, at 274–75.

[271] *See id.* at 271.

[272] *See id.*

may actually prove not to be beneficial for the investors of all companies.[273] In the likely event that one or both of these are the case, investor welfare would only be improved by subsequent amendments to the Proposed Rule to overcome its recognized deficiencies. Because of the delay that is likely to occur before the SEC amends its rules, the costs to investors in the interim may be substantial.[274]

In contrast, an investor-optional rule that was net-costly for investors would effectively be self-repealing. If investors in an issuer believed that a particular requirement was costly, they could simply authorize the company to opt out of that part of the Proposed Rule. This would eliminate or greatly reduce those costs that were incurred by investors before any amendment were made to the rule. It would also have significant benefits for the SEC rulemaking process, including allowing the SEC to focus its limited resources on other matters, further enhancing investor welfare. I discuss these benefits further in Part VI.C.

V. DESIGNING INVESTOR OPTIONALITY

Making climate disclosure investor-optional would immediately shift much of the focus of the rulemaking from the questions of whether to regulate climate disclosure and the content of that disclosure, to the process and conditions required for opting out of the disclosure obligations. This Part therefore discusses the details of *how* the SEC should structure the opt out arrangements of an investor-optional rule.[275]

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[273] For an example of an argument that climate disclosure requirements should vary by industry, see Sarah Grey et al., *ESG Climate Disclosures: Is One Size Fits All Best?*, ARNOLD & PORTER (Jan. 24, 2022), https://www.arnoldporter.com/en/perspectives/blogs/environmental-edge/2022/01/esg-climate-disclosures [https://perma.cc/5NZH-H48B].

[274] The challenges of amending existing rules, together with the SEC's institutional constraints, means that it often does not amend its rules to overcome perceived deficiencies, and even if it does, it rarely acts quickly to do so. For a discussion of the limited number and efficacy of retrospective analyses, see Randall Lutter, *Regulatory Policy: What Role for Retrospective Analysis and Review?*, 4 J. BENEFIT-COST ANALYSIS 17 (2013).

[275] This Section focuses on the design of the climate disclosure rule, rather than the process by which the SEC would adopt a rule that included the design elements discussed here, such as whether the SEC would or would not need to allow additional comments on the opt-out design.

The details of the opt out process are critical to the success of an investor-optional rule.[276] Two of these features, described in V.A and V.B, impose crucial guardrails on the opt out process, without which there is a possibility that an investor-optional rule could be worse for investors than a mandatory rule. If these were not included, it is possible that companies could opt out of disclosure obligations even against the preferences of a majority of those companies' equity capital holders after they go public. If sufficient companies opted out against such preferences, and/or if the costs to investors of those opt-outs were high enough, the aggregate cost of those opt-outs could outweigh the other benefits of investor optionality, making it *worse* for investors than a mandatory rule. This Part also considers several additional features that it would be desirable for the SEC to include, to enhance the investor protection.

A. Approval of a Majority of Equity Capital

A critical requirement for investor optionality is that opt-outs be approved by investors. In order to ensure that investor optionality is better for investors than a mandatory rule, the approval should be by holders of a majority of equity capital voting at a meeting of shareholders, rather than simply by a majority of votes cast.[277] In companies with a single class of shares, these two standards would be the same. But in companies where controlling shareholders have more votes per share than other investors, these enhanced voting rights would allow controlling shareholders to approve opt-outs even when the holders of a majority of the equity capital of the companies were against such opt-outs. If this is the case, such opt-outs could impose significant costs on the holders of the majority of the equity capital in these companies. Requiring approval by shareholders holding securities that constitute a majority of the equity capital of the company would protect other investors against such opt-outs. Because controlling shareholders are likely to be less diversified than other investors,

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[276] For a discussion of the importance of the details of private ordering arrangements, see Bebchuk & Hirst, *supra* note 73, at 347–48.

[277] A possible variation could be for the opt-out to require the votes of a majority of equity capital of the company *outstanding*. Requiring a percentage of equity capital outstanding would impose higher threshold, analogous to the requirement to amend the charter of the company, and would further protect investors, by requiring greater turnout by investors in order to approve the opt-out. For a discussion of issues with investor turnout for charter amendments, see generally Scott Hirst, *Frozen Charters*, 34 YALE J. REGUL. 91 (2017).

they may also be less likely to internalize any externality benefits from disclosure that accrue to investors outside the company.[278] Functionally, this feature of an op-out rule would disregard for the purposes of the opt out approval higher voting rights that certain shareholders might have for elections under state law.[279]

B. Approval of Investors After Going Public

A second way that a poorly designed opt out mechanism would allow an investor-optional mechanism to be *worse* for investors than a mandatory rule is if a company is able to opt out before the company goes public. If that is the case, the opt out decision will be controlled by a different and much smaller group of investors than those that will form the shareholder base of the company after the company's initial public offering ("IPO").[280] As a result, even if the post-IPO investors would benefit from climate disclosure, they could be deprived of it by a pre-IPO opt out.

The impact of this feature will vary between disclosure under the Securities Act of 1933 and the Securities Exchange Act of 1934. Disclosure under the Securities and Exchange Act of 1934, in annual reports on Form 10-K, are post-IPO by definition.[281] Implementing a post-IPO opt out for these disclosures would be straightforward—the opt out could simply be conditioned on an appropriate vote after the company had gone public.

However, this solution would not function for disclosure obligations under the Securities Act of 1933, which are included in registration statements drafted before a company going public.[282] Since these are

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[278] Imposing this constraint would effectively prevent shareholders that control companies through the use of dual-class stock from using their voting power to opt out of climate disclosure. This is an unfamiliar limitation from the point of view of corporate law, which places relatively few limits on the ability of such investors to control companies. For these investors, this version of investor optionality would be no worse than a mandatory rule, which would also deprive them of the ability to opt out, and possibly better, to the extent that they can use their pro rata share of votes in conjunction with the votes of other investors to opt out.

[279] If the SEC were concerned about the abuse of minority shareholders by controlling shareholders that own a majority of company stock, the SEC could impose further constraints on opt-outs, such as requiring a majority-of-the-minority vote in order to opt out. However, I do not propose such a constraint here, as it would effectively disenfranchise the largest shareholders of those companies.

[280] This would also apply to companies that go public through a direct listing, though for simplicity of exposition this Section only refers to those that go public through an IPO.

[281] *See* 17 C.F.R. § 249.310 (2021) (requiring disclosure on Form 10-K).

[282] *See* 17 C.F.R. § 239.11 (2021) (requiring disclosure on Form S-1).

prepared and filed pre-IPO, there are no public shareholders to vote to opt out. This effectively requires the SEC to decide between a mandatory rule for disclosure in registration statements, or allowing companies to opt out based on the vote of a different set of investors than will benefit from the disclosure. Even if the SEC chose the latter option, it is not clear that this would substantially reduce protection for post-IPO investors, since the company would still be obligated to either disclose the information at the end of its fiscal year in which it goes public, or to opt out through a vote of the post-IPO shareholders that *would* benefit from the disclosure.[283]

C. Sunsetting Approval Requirements

A third (but much less likely) way in which an investor-optional rule could be worse than a mandatory rule is if investors that had supported an opt-out later change their preferences in such a way that they *do* prefer to receive disclosure regarding climate emissions. If the cost to those investors from missing out on disclosure that would otherwise have been obligated is greater than the cost savings from investors choosing to opt out, then the investor-optional rule could be *worse* than a mandatory rule.

To avoid this problem, the SEC should impose a "sunset" on the effectiveness of opt out decisions.[284] This could be done by allowing companies to opt out where there had been an investor vote (of the kind described above) within the last five years (or some similar period).[285] For the company to continue to opt out after that period, managers would thus have to resubmit the opt out to a vote of investors at least every five years. This would allow investors to determine whether they wished to continue

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[283] One benefit of allowing companies to opt out of registration statement disclosure before going public is that it may reduce the cost of preparing a registration statement, thereby improving capital formation. This would also be consistent with the rationale of requiring less disclosure for emerging growth companies. *See* 15 U.S.C. § 77b(19) (defining "emerging growth companies").

[284] Alex Lee has previously argued for a sunset approach to creating optionality in SEC rulemaking. *See* Lee, *supra* note 68, at 909. Sunsets have also been proposed for corporate law rules, such as dual-class provisions. *See, e.g.*, Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 617–26 (2017) (discussing arguments for dual-class sunsets, and potential objections).

[285] Structuring the rule in this way would have the additional advantage of allowing companies to opt out of climate disclosure obligations before the rule had come into effect, so any public company whose investors supported opting-out could do so even before they became subject to the obligations, thereby avoiding any costs associated with the disclosure.

the opt out or not, thereby taking into account any changes in investor preferences.[286]

This sunset requirement is similar to the requirement that a company hold a say-on-pay vote at least once every three years,[287] and a vote on the frequency of say-on-pay votes at least once every six years.[288] Functionally, it would have a similar effect to sunsetting the exemptions from certain disclosure obligations for emerging growth companies after five years, except in this case, the exemption could be renewed.[289] Similar sunset arrangements have also been proposed for other corporate governance arrangements.[290]

D. Opting Out by Disclosure of a Vote

One potential vector of attack against an investor-optional climate disclosure rule is the argument that, by making disclosure contingent on an investor vote, it strays into territory that has traditionally been the realm of state law. In *Santa Fe Industries, Inc. v. Green*, the Supreme Court refused to allow a cause of action under Rule 10b-5 for breach of fiduciary duties, in part because "that cause of action [is] one traditionally relegated to state law", suggesting that the party seeking the right of action could instead avail itself of remedies created under state law.[291]

A close reading of that precedent suggests that mere consideration of a shareholder vote for purposes of determining if disclosure is required would not make the rule invalid. The SEC would not be creating a cause of action or a remedy, or doing something already done by state law. State law does not require disclosure of climate emissions, or create a way of opting out of federal disclosure requirements. And many well-accepted SEC rules

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[286] An alternative solution would be to allow investors to opt back in, such as through a shareholder proposal. However, because of the collective action problems of investors, there would likely be under-initiation of opt-back-in votes, even where investors desired that they take place. The opt-back-in approach is therefore likely to be inferior to the sunset approach.

[287] *See* 17 C.F.R. § 240.14a-21(a) (2021).

[288] *See* 17 C.F.R. § 240.14a-21(b) (2021).

[289] *See* 15 U.S.C. § 77b(19)(B) (2021).

[290] *See generally* Bebchuk & Kastiel, *supra* note 284; Robert J. Jackson, Comm'r, SEC, PERPETUAL DUAL-CLASS STOCK: THE CASE AGAINST CORPORATE ROYALTY (Feb. 15, 2018) (transcript available at https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty [https://perma.cc/X3SY-SQR7]).

[291] Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478 (1977) (quoting Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 40 (1976)).

already concern themselves with voting matters that have traditionally been the purview of state law.[292]

Nonetheless, the SEC may wish to avoid entanglement with state law as much as possible. One way to do so would be to avoid any language *requiring* or *obligating* a vote, or any features of a vote. Instead, the SEC could condition the opt out on the registrant having *disclosed* a vote that meets certain conditions. Requiring disclosure of matters submitted to a vote of security holders, and details regarding those matters, is already an established and well-accepted part of the SEC's disclosure requirements.[293]

Conditioning an opt-out on disclosure is also the approach taken by the SEC in its proposed rule regarding investment advisors to provide additional information about their ESG practices.[294] The Proposed Rule requires investment advisers of "ESG-Focused funds" to disclose aggregate GHG emissions.[295] The advisor is not required to make this disclosure for a fund "that affirmatively states in the "ESG Strategy Overview" table . . . that it does not consider the greenhouse gas ("GHG") emissions of the portfolio in which it invests."[296] The SEC could use a similar structure to allow issuers to opt out of their emissions disclosure obligations, if they disclosed that a shareholder vote meeting the conditions described in this Part had taken place.

E. Changes to Disclosure Rules Regarding Shareholder Votes

If the SEC adopts a condition based on a disclosure of a vote of majority of equity capital as suggested in Section V.A, it should also make conforming changes to its rules requiring disclosure of matters submitted to a vote of security holders to also require disclosure of information relevant to opt out votes. Issuers are currently required to disclose matters related to votes of security holders under Item 5.07 of Rule 8-K.[297] This includes the number of votes cast for and against a matter.[298] For the same reasons

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[292] *See, e.g.*, 17 C.F.R. §§ 240.14a-1—240.14a-21 (2021) (regulating the solicitation of proxies).

[293] *See* 17 C.F.R. § 249.308, Item 5.07 (2021) (setting out disclosures required to be disclosed in Form 8-K with respect to submission of matters to a vote of securities holders).

[294] Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36654 (proposed June 17, 2022).

[295] *See id.* at 36749 (proposing the addition of Item 27(b)(7)(i)(E) to Form N-1A).

[296] *See id.* (proposing the addition of Item 27(b)(7)(i)(E) to Form N-1A).

[297] *See* 17 C.F.R. § 249.308, Item 5.07 (2021).

[298] *See id*.

described in Section V.A, it would also be useful for investors to know the number of shares of equity capital that voted for and against the proposal, and that abstained from voting. For companies where each share of equity capital carries the same number of votes, this information is already required to be disclosed;[299] the change would only affect disclosure by companies with unequal voting rights.

Without disclosure of such information, investors in companies with unequal voting rights would be unaware whether an opt-out vote has passed or not, and how close it was to passing. At a minimum, this disclosure should be applied to matters related to opting out from climate disclosure. However, requiring this disclosure for other matters that are voted on would also benefit investors, by making clear when unaffiliated investors disagreed with controlling shareholders.

F. Hedging Opt-Out Rules With an Opt-In Rule

As well as allowing investors to opt out of climate disclosure, the SEC should consider *also* allowing investors to *opt in* to climate disclosure. For the reasons discussed in Section I.B, an opt in rule is likely to be inferior to an opt-out rule. However, the SEC could implement *both* rule designs disjunctively. That is, an issuer could be required to disclose each of the matters set out in the Proposed Rule, *either* if the issuer had not opted out of the rule, as discussed throughout this Article, *or* if there had been a vote of investors opting in to the rule (subject to the same conditions described in Section V.A-V.D).

This would have two benefits. First, it would allow a majority vote of investors to "opt back in" if they had previously voted to opt out of climate disclosure but had changed their views regarding the value of disclosure since that opt out. If so, the opt out could be structured as requiring the disclosure unless the company has disclosed a vote by investors authorizing an opt-out, *and has not disclosed a vote opting back in.*

A second and much more important benefit is that an opt in rule would hedge against the possibility that the opt out rule is invalidated by judicial review, by providing a backstop if that were to occur. Such an opt in rule is more likely to survive judicial review; given the unfettered choice of companies to adopt the rule, it is hard to conceive of a reason why an opt in disclosure rule would be invalidated. Certainly, none of the potential

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[299] *See* 17 C.F.R. § 249.308, Item 5.07(b) (2021).

grounds for invalidation of a mandatory rule raised by opponents (and considered in Part III) would apply to an opt in rule. As a result, even a decision invalidating an opt-out rule is likely to leave an opt in component unaffected, thereby allowing it to remain as a backstop.[300]

The core claim of this Article is that an opt-out rule would be better for investors than a mandatory rule. Suggesting an opt in backstop does not derogate from that claim. Instead, the reasoning for a backstop opt in rule is that it would be better for investors than no rule at all. This is because it would provide an easy mechanism, and a focal point, for investors opting in to the rule if the opt out rule were invalidated.[301] Even though the likelihood of an investor-optional climate disclosure being invalidated is substantially less than the likelihood that a mandatory rule would be invalidated, it is not zero—it is impossible to predict with certainty how a court will treat even an investor-optional rule. So despite the strong reasons why investor-optional rules *should* be valid, it is possible that a court may nonetheless invalidate such a rule. If the SEC had no backstop opt in rule, the situation would return to the status quo. For companies where investors demand disclosure that managers do not provide, the investors must currently engage with directors, and/or put forward a precatory shareholder proposal urging the adoption of climate standards. Creating a simplified method for opting-in to the rule would create a standard arrangement for companies to opt in to. This would result in greater uniformity among companies that had opted-in, and would also make it much easier for investors to opt in.[302]

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[300] If a mandatory rule (or an investor-optional rule) were to be invalidated, the SEC could, of course, always adopt an opt-in rule as a stopgap after the invalidation. But that is likely to take substantial time. Including an opt-in rule in the final rule as a backstop would avoid the lag time, and would therefore provide greater benefit to investors.

[301] For the foundational discussion of focal points, often referred to, eponymously, as Schelling points, see THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT (1960).

[302] The problems that an opt-in arrangement would overcome are demonstrated by the adoption of proxy access arrangements by companies after the SEC's failed proxy access rule. *See also supra* notes 92-97 and accompanying text. Indeed, these problems are likely to be considerably worse for climate disclosure than they were for proxy access. Despite shareholder support for proxy access and pressure on managers to adopt it, managers did not always adopt the arrangements that shareholders requested or that they would have preferred. *See, e.g.*, Holland et al., *supra* note 95. For shareholders to implement a proxy access arrangement through a shareholder proposal to amend a company's bylaws was very difficult, because the detail required was difficult to condense the space constraints imposed by Rule 14a-8. *See, e.g.,* Bebchuk & Hirst, *supra* note 73. Where companies did

VI. THE IMPACT AND IMPLICATIONS OF INVESTOR OPTIONALITY

This Part considers the likely impact of investor optionality on climate disclosure, and its implications beyond climate disclosure. Applying investor optionality to other SEC rules would also benefit investors; Section VI.B considers the potential for such an approach, and its limits. Section VI.C then considers the benefits *to the SEC* from adopting investor optionality more broadly.

A. The Likely Impact of Investor-Optional Climate Disclosure

One of the main aims of this Article has been to lay out the analytical arguments why the SEC should make its Proposed Rule investor optional. However, weighing all of the relevant factors is very challenging to do in the abstract, as it depends substantially on which companies would opt out, and which investors outside the company would have benefited from their disclosure. To analyze the likely impact of investor optionality, this Section anticipates the most likely outcome if an investor-optional rule climate rule is implemented, and compares those to what would be the case under a mandatory rule. Because of the challenges of predicting opt out decisions, this Section limits itself to broad conclusions based on the characteristics and distribution of existing investors, such as which *types* of companies may or may not opt out of climate disclosure, based on assumptions made by the SEC itself regarding the nature of investors demanding climate disclosure.

One key assumption underpinning this analysis is the same as that made by the SEC in its reliance on investor demand: that a broad majority of institutional investors support most parts of the SEC's climate disclosure rule.[303] Institutional investors control substantial majorities of the capital of the great majority of U.S. public companies.[304] This is overwhelmingly true among the largest companies, that make up the bulk of the aggregate market

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adopt proxy access arrangements, there were inevitable variations among companies, making it more difficult for investors to know what arrangements applied to a particular company, or to compare arrangements across companies. *See* Holland et al., *supra* note 95. Proxy access did not involve considerable, detailed disclosure; lack of comparability across companies is likely to be a much more acute problem for a disclosure rule. Including an opt-in rule as a backstop for the situation where other parts of the rule are invalidated would avoid these problems by standardizing climate disclosure for all companies that did opt-in.

[303] *See supra* Section II.A.

[304] For a discussion of the prevalence of institutional investors, and its implications for regulatory design, see, e.g., Hirst, *supra* note 34, at 241–43.

capitalization of U.S. public companies.[305] If the SEC's assumptions are accurate, very few of these companies are likely to have an investor base that would support opting out of climate disclosure entirely.

Comment letters submitted by a number of large institutional investors suggest that they did not support all of the disclosure requirements in the SEC's Proposed Rule. For example, comment letters from BlackRock, SSGA, and Fidelity Investments all expressed opposition to required disclosure of Scope 3 emissions, and to disclosure regarding disaggregated financial statements changes greater than a one-percent threshold.[306] If a reasonable number of other large institutional investors share these views, it is likely that they would be willing to support opting out of those requirements.

One possibility is that these investors might not vote in favor of opting out, even though they believe opting out would reduce costs. This might be the case because it might be more salient for them to support an opt-out vote, rather than stick with the default.[307] My previous work has discussed the possibility of a backlash against institutional investors that exercise too much power.[308] However, it is not clear whether this is likely to push powerful investment managers towards or against opting out.[309] What is clear is that if it pushes them away from opting out, there would be less difference between the situation under investor-optional disclosure and mandatory disclosure.

Any prediction of the likely levels of opt-outs must also consider the signaling effects of an opt-out decision. Given the conclusions above, that a limited number of companies will have investors that will support opt out decisions, any opt-outs that are successful are likely to be relatively salient to observers. If those investors are able to draw a negative inference about the governance of the company from its opt out decision, then they could

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[305] *See, e.g.*, *80% of Equity Market Cap Held by Institutions*, PENSIONS & INVESTMENTS (Apr. 25, 2017), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions [https://perma.cc/54NW-EP7F].

[306] *See* BlackRock, Inc., *supra* note 57, at 8–10; State Street Global Advisors, *supra* note 57, at 3–6; Fidelity Investments, *supra* note 57, at 5–8.

[307] For a discussion of the importance to these investors of minimizing their perceived power, see Bebchuk & Hirst, *supra* note 224, at 2066–71.

[308] *Id.*

[309] For a discussion of the competing incentives of investment managers on public policy matters, see Dorothy S. Lund, *Asset Managers as Regulators*, 171 U. PA. L. REV. (forthcoming 2022) (manuscript at 11–16) (available at https://ssrn.com/abstract=3975847 [https://perma.cc/VQ3H-3UXY]).

sell (or refuse to buy) shares of the company, increasing its cost of capital.[310] If so, company managers would take into account these potential costs when deciding whether to initiate an opt-out decision.[311] It is difficult to predict the extent to which opt-out decisions will be attributable to poor performance, or whether investors will believe claim by managers that companies are opting out for reasons unrelated to governance quality, such as because of the high costs of disclosure. Probably, the signals drawn from opt-outs will vary among investors drawing the signals. This suggests that at least some investors will draw a negative inference about the governance of a company from its opt out decision, and the company will suffer at least some reputational penalty from opting out. If this is the case, it will reduce the extent to which companies opt out of the Proposed Rule. This may result in fewer opt-outs than are optimal. But it would also reduce the extent to which an opt-out rule resulted in substantially less disclosure than a mandatory rule.

The set of companies whose ownership is least likely to be dominated by large institutional investors are microcap companies, those outside the Russell 3000.[312] Because holdings of index funds are based on mainstream indexes like the S&P500 and the Russell 3000, those investment managers have smaller proportional holdings in companies that are not included those indexes, and other investors—which might not derive as much benefit from climate disclosure—will have proportionately larger holdings. If the SEC's views on investor demand are correct, these are the only group of companies for which high levels of opting out is even possible. But it is not clear whether this would occur. If opting out does result in a negative signal that is costly for the company, these companies will be less likely to opt out than they otherwise would be. It is also possible that because these companies are smaller, they may be more likely to internalize the benefits to other investors of climate disclosure, such as through cost of capital, liquidity, or

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[310] That is, there would be a "separating equilibrium" in opt-out decisions, with lower-quality companies opting out, and higher-quality companies not opting out. This differs from a "pooling equilibrium," where the group of companies opting out would include both lower-quality and higher-quality companies, making it impossible to accurately infer the level of quality from an opt-out decision. For the foundational discussion of separating and pooling equilibria, see George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

[311] *See supra* Section III.D.

[312] For a discussion of smaller companies and their ownership, see generally Kobi Kastiel & Yaron Nili, *The Corporate Governance Gap*, 131 YALE L.J. 782 (2022).

signaling.[313] Thus, if opting out were likely to impose costs on the company investors in these companies might be less willing to do so.

Even if these companies did opt out, they constitute a very small proportion of the U.S. capital market.[314] For the great majority of companies, there would be standardization and comparability of climate information. Even if there are externality benefits from disclosure to other investors, the small size and number of these companies may limit the aggregate amount of those benefits that would be foregone by investor optionality.

* * *

The analysis above suggests that, unless the SEC's analysis is radically different from that put forward in this Section, it will find it challenging to justify the choice of a mandatory rule over an investor-optional rule. The SEC would need to show that the benefits of investor optionality were outweighed by the benefits to other investors from disclosure of the particular items for which institutional investors supporting opt-outs, and of broader disclosure by microcap companies.

B. Investor Optionality Beyond Climate Disclosure

The clearest implication of this Article is that the SEC should consider alternatives to mandatory rules, such as investor optionality, in its rulemaking. This Article has focused on the SEC's proposed climate disclosure rule. But the possible application of investor optionality extends beyond climate disclosure. Most obviously, the arguments made in this paper would apply, *mutatis mutandis*, to other rules the SEC is considering regarding disclosure of environmental, social, or governance (ESG) matters.[315] But most of the arguments made in this Article why investor optionality would be better for investors potentially apply to *any* SEC rule imposed on companies for the benefit of investors. This Section considers

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[313] *See supra* note 257-258 and accompanying text (discussing the possibility of internalization through cost of capital of liquidity).

[314] *See supra* notes 303-305 and accompanying text (discussing share ownership).

[315] For a discussion of the ESG and other rulemaking proposals in the SEC's "Reg-Flex agenda" outlining its expected upcoming activities—including rulemaking regarding human capital disclosure, and board diversity—see Cydney Posner, *A Jam-Packed Spring 2022 Agenda for the SEC*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 17, 2022), https://corpgov.law.harvard.edu/2022/07/17/a-jam-packed-spring-2022-agenda-for-the-sec/ [https://perma.cc/85MV-LFX9].

the benefits and boundaries of investor optionality beyond climate disclosure.

Drawing boundaries around the types of rules for which investor optionality would be beneficial is important, because the flip side of the potential applicability of investor optionality to other potential rules is the possibility of a "slippery slope." That is, one potential reason why the SEC might be cautious about making climate disclosure investor-optional is a concern that investor optionality might prompt calls to make future disclosure obligations investor-optional, or even to change existing disclosure rules to be investor-optional. If the SEC is willing to relax its historical practice of only making mandatory rules, this could create a precedent whereby the SEC would face pressure to take a similar approach for other rules. The SEC may be concerned that adopting (or even countenancing) investor optionality might therefore fundamentally undermine its mandatory disclosure regime.

However, clear boundary principles for rules for which investor optionality is likely to be beneficial would substantially alleviate these concerns. As outlined in Parts II and III, the advantages of investor optionality over mandatory rules are likely to be greatest where there is uncertainty about the benefits and costs to investors from a rule, and where investor optionality has additional benefits from reducing the likelihood of invalidation. In addition, where the costs of the opt out process are high, or where there are clear externality benefits to investors *outside* the particular company subject to the rule, investor optionality may be worse than a mandatory rule.

These boundary principles allow the great majority of existing SEC disclosure rules to quickly be dismissed from this slippery slope scenario. Neither of these advantages applies to long-established SEC disclosure obligations. There is little risk of validation of these rules. And for most of these, there is likely to be little demand from investors to opt out of the rules: the fact that companies already have systems to comply with those rules, and that investors have systems that utilize that information, means that the benefits for investors of retaining the rules are likely to outweigh the costs of complying with them. For instance, it is very difficult to imagine the SEC facing pressure to weaken the obligation to provide audited

financial statements. In effect, for these rules, there is actually a *sticky slope*.[316]

There may be a small number of existing rules that are exceptions, where there may be investor demand to opt out of a rule. For a small number of existing rules, investors have raised concerns that the disclosure was not useful, or was excessively costly to produce, or both. Such investor ambivalence has long applied to the SEC's conflict minerals rule, and to a lesser extent, to the disclosure of management attestations of internal control under Section 404 of the Sarbanes-Oxley Act of 2002.[317] As this Article has demonstrated, provided there were robust guardrails to protect investors, investor-optional disclosure of these rules is likely to be *better* for investors than the current mandatory requirement for such disclosure.

New rules that the SEC proposed in the future are likely to benefit much more from investor optionality. This is especially likely where there is real disagreement or uncertainty about the likely benefits to investors from the rule, and where the rule is likely to face the kinds of challenges to its validity outlined in Part III. In some cases, this will be clear to the SEC even before it proposes a rule. But in many cases, it will only become clear that there is substantial disagreement or uncertainty about the benefits to investors after public comments are received pointing that out. Either case should result in the SEC considering an investor optionality alternative, either in its proposing release, or in after receiving comment and before issuing its final rule.[318]

Although this Article has focused on a disclosure rule, disclosure represents the hardest case for the application of investor optionality, because disclosure requirements are the most likely to have externality benefits for investors outside the company subject to the rule.[319] Rules that do not have significant disclosure components thus present a clearer case

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[316] For a discussion of sticky slopes concept, see David Schraub, *Sticky Slopes*, 101 CALIF. L. REV. 1249 (2013).

[317] Pub. L. No. 107-204, 116 Stat. 745, § 404(a) (2002), codified at 15 U.S.C. § 7262(a). For a detailed analysis of the provision and its potential costs, see generally Stephen M. Bainbridge, *Sarbanes-Oxley § 404 at Twenty*, 77 BUS. LAW. (forthcoming 2022) (manuscript) (available at https://ssrn.com/abstract=4201778 [https://perma.cc/8NYG-SUHR]).

[318] The same points made in Section III.E would threaten these rules with invalidity if the SEC did not consider investor optionality.

[319] For a discussion of these potential externalities, see *supra* Section IV.C.

for investor optionality.[320] This would, for example, include rules relating to the composition of boards, such as diversity rules that the SEC is understood to be considering.[321] But it would also include certain existing rules, such as those requiring the inclusion of shareholder proposals in company proxy statements.[322]

C. The Implications of Investor optionality for SEC Rulemaking

Although the focus of this Article is on the benefit of investor optionality for investors, investor optionality is also likely to have four major benefits for SEC rulemaking, which will also redound to the benefit of investors.[323] First, for similar reasons to those outlined in Section III, investor optionality would reduce the likelihood of SEC rules being invalidated.

Second, investor optionality would reduce the cost of SEC rulemaking. For the same reasons outlined in Section III.D, the intensive cost-benefit analysis of SEC rules would be made much easier if they are investor-optional. Because the cost from an investor-optional rule is capped at the cost of opting out, the economic analysis of the cost of a rule can be confined to determining the cost of opting out. Indeed, because the cost of opting out is likely to be related to the opt out voting process, and not to the nature of the rule itself, the analysis of costs of each investor-optional rule would be very similar. Building on analyses of this question from previous rulemakings would reduce the burden of the SEC's economic analysis, and would allow them to refine the analysis further. And the fact that a similar analysis would apply to each rule means the risk of a court invalidating the rule for insufficient cost-benefit analysis would be much lower.

Third, the lower cost of investor-optional rules would reduce the cost of SEC rulemaking.[324] No matter the position one takes on SEC rulemaking, making rules investor-optional would thus be better than mandatory rules.[325] For those that believe that the SEC should spend less on

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[320] This includes the SEC's failed proxy-access rule. For a discussion of how that rule could have been better structured as an investor-optional rule, see Bebchuk & Hirst, *supra* note 73.

[321] *See supra* note 315 (describing the contents of the SEC's "Reg-Flex" agenda).

[322] *See* 17 C.F.R. § 240.14a-8 (2022).

[323] The discussion of these implications is based substantially on my earlier analysis in Hirst, *supra* note 34, at 272.

[324] *Id.* at 270.

[325] *Id.*

rulemaking, investor optionality would reduce the cost of making a fixed number of rules.[326] For those that prefer that the SEC expand its rulemaking, investor optionality would allow the SEC to do more rulemaking with the same fixed set of resources.[327]

Fourth, investor optionality would allow the SEC to more easily experiment with potential rules. Previous work has argued that regulators should undertake experiments to assess the effects of a potential regulation before adopting it.[328] Those authors proposed that the SEC treat some companies (ideally, chosen randomly) differently from similar companies, to assess the effects on those "treated" companies.[329] One obvious issue with this is that if the treatment is effective, it will either disadvantage the treated companies, or possibly, disadvantage the untreated companies. Imposing costs on either group of companies would be, by its very nature, arbitrary and capricious, and subject to potential invalidation under the Administrative Procedure Act.[330] The SEC is also likely to face significant opposition from the investors and managers of the companies that are disadvantaged.

Investor-optional rules would allow heterogeneous treatment while avoiding these problems. The SEC could apply an investor-optional rule to a subset of companies. Allowing companies to opt out would provide the SEC with information about investors' views about the rule.[331] In addition, so long as some companies did not opt out, the SEC would have a means of comparing a "treated" group with a "control" group. Of course, the opting out will not be random, and therefore it will be impossible to separate the effects of opting out from the factors that underlie the opt out decision.[332] This is a valid concern for academics looking to understand the effect of the

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[326] *Id.* at 272.

[327] *Id.*

[328] *See, e.g.*, Michael Abramowicz, Ian Ayres & Yair Listokin, *Randomizing Law*, 159 U. PA. L. REV. 929 (2011); Charles K. Whitehead, *The Goldilocks Approach: Financial Risk and Staged Regulation Symposium: Financial Regulatory Reform in the Wake of the Dodd-Frank Act*, 97 CORNELL L. REV. 1267 (2012); Lee, *supra* note 68; Zachary J. Gubler, *Experimental Rules*, 55 B.C. L. REV. 129 (2014). For an earlier discussion of experimentation and investor-optional rulemaking, see Hirst, *supra* note 34, at 277–29.

[329] *See* Hirst, *supra* note 34, at 277–29.

[330] *See infra* Section III.E.

[331] Allowing an opt-out for a selected subset of companies might provide a means to run a pilot study of a rule, in order to measure its likely effects or likely responses, before expanding the application of the rule to all companies.

[332] *See supra* Section IV.D. *See also* Hirst, *supra* note 34, at 278.

rule in isolation.[333] But it is not particularly relevant information for the SEC in assessing the costs of the rule: as the same types of companies that opt out during the pilot can be expected to opt out when the rule is implemented, it is unnecessary for the SEC to isolate the treatment effect from the selection effect.

CONCLUSION

As this Article has explained, to save climate disclosure from claims of invalidity, and to better protect investors, the SEC should let investors decide. Specifically, the SEC should allow an issuer to opt out of all or part of the obligation to make the disclosures required by the Proposed Rule, if its investors authorize the issuer to do so, in a manner which would provide appropriate guardrails to protect investors. This Article has described three critical advantages of investor-optional disclosure over a mandatory disclosure rule: First, it would actually be consistent with the SEC's investor demand rationale for the Proposed Rule, and would be the only practical way to resolve the uncertainty regarding the level of investor demand. Second, it would circumvent the major arguments against the validity of the Proposed Rule, which apply (if at all) only to mandatory rules. And third, allowing companies to opt out of climate change disclosure if their investors approve would be better for investors in those companies, and given the limited likelihood of substantial externality benefits to investors outside those companies, is also likely to be better for investors overall.

Although the focus of this Article has been the SEC's climate disclosure rule, investor optionality has much broader implications. Most obviously, the SEC should consider alternative rule designs as part of its future rulemaking. The reasoning in this Article why investor optionality is likely to be better for investors than a mandatory rule would also clearly apply to other ESG disclosure rules that the SEC may be considering, but would also apply to other SEC rules applicable to companies where there is substantial uncertainty regarding the benefits to investors from the rule, or substantial heterogeneity in its effects. By making these rules investor-optional, the SEC would improve its own regulatory program, as well as better protecting investors.

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[333] *Id.*

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