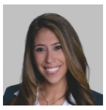
CADWALADER

Cabinet News and Views

Informed analysis for the financial services industry

In Depth: Dissecting the Real Estate, Structured Finance and Financial Services Industries' Comment Letters on the SEC's Climate Disclosure Proposal

By **Michael J. Ruder**
Special Counsel | Capital Markets



By **Melissa Farber**
Associate | Capital Markets

By **Daniel Meade**
Partner | Financial Regulation

By the time the comment period closed on June 17, 2022, the SEC had received thousands of comment letters from the public in response to the SEC's proposed climate disclosure rules (the "Proposal"), which is perhaps the most ambitious proposed rulemaking by the agency in at least two decades. Nestled among countless comment letters written by individual members of the public were comments submitted by trade associations representing the commercial real estate, structured finance and banking industries. This article summarizes notable highlights from letters put forward by some of the trade associations representing parts of the financial services industry, namely the Commercial Real Estate Finance Council ("CREFC"), the Bank Policy Institute ("BPI"), the Structured Finance Association ("SFA"), the American Bankers Association ("ABA") and a letter put forward jointly by a group of trade organizations representing real estate interests.

Commercial Real Estate Finance Council

CREFC generally agreed that climate disclosure rules could be beneficial, noting that "combatting climate change and laying the groundwork for a transition to net-zero emissions in a meaningful way requires a cooperative partnership between government and the private sector." CREFC advocated that the commercial real estate finance industry should be allowed to develop its own best practices that are tailored to its market participants, as existing industry efforts are "continuing with positive effect." CREFC described work it has already undertaken toward this goal, noting that it has already "analyzed what climate-related information is obtainable, relevant, and meaningful for borrowers, lenders, servicers, issuers, and investors and has developed preliminary climate-related data fields that can be incorporated into the existing Investor Reporting Package," which is "specifically tailored to the needs of CMBS investors."

CREFC expressed concerns with the Proposal's Scope 3 greenhouse gas emissions ("GHG") disclosure requirements and requested that the SEC provide more clarity and guidance regarding the extent the Proposal would apply to CREFC members, because of uncertainty regarding the extent to which Scope 3 disclosures apply to a lender's financed commercial real estate. The letter discussed foreseeable challenges to the potential disclosure requirements, warning that "obtaining the data necessary to calculate directly any of the categories of Scope 3 GHG emissions for the commercial real estate finance industry is at best difficult and at worst impossible." Moreover, agreements regularly used in the commercial real estate finance industry, such as tenant leases, mortgage loan documents and servicing agreements, do not currently provide for a right to obtain the necessary GHG emissions data, and such rights would take substantial time to become accepted in the market.

Finally, CREFC drew the SEC's attention to the fact that many commercial real estate finance participants do not directly own real estate but rather own loans, bonds or debt instruments secured by real estate, including preferred equity. Under such commercial real estate transactions, participants are able to exercise remedies that result in ownership or control over the underlying real estate. CREFC warned that the ability to timely exercise remedies against the underlying real estate may be delayed by concerns and risks resulting from immediate reporting obligations imposed under the Proposal. As CREFC described, "timely exercise of remedies can be critical in preserving the value of commercial real estate." Thus, CREFC asked that the SEC adopt a two-year grace period for Scope 1 and 2 GHG emissions reporting in connection with any commercial real estate property acquired through a foreclosure or other comparable remedy.

Joint Real Estate Trade Organizations

A letter was proffered jointly by a group of trade associations on behalf of real estate owners, banks, operators, investors, lenders, builders, developers, hospitality/resorts, agents and service providers (specifically, CRE Finance Council, Housing Policy Council, Institute for Portfolio Alternatives, Mortgage Bankers Association, NAIOP, the Commercial Real Estate Development Association, Nareit, National Apartment Association, National Association of Home Builders of the United States, National Association of REALTORS, NMHC, The Real Estate Roundtable). Despite the organizations' general endorsement of the SEC's efforts to provide investors with climate-related disclosures, the organizations expressed genuine concern with certain aspects of the Proposal, which the letter described "would be difficult or impossible for many registrants to currently implement." The letter opined that the December 2022 adoption date hinted at in the Proposal is too aggressive and could ultimately "short circuit" the progress being made to develop climate-related disclosures that are specific to the real estate sector.

The joint letter also expressed concerns with the Proposal's Scope 3 emission disclosures, "some of which are difficult to clearly link to certain real estate activities" and suggested that such disclosures "should not be mandatory unless part of a clearly articulated emissions reduction plan." The letter recommends that the Proposal's current safe harbor for Scope 3 emissions should be strengthened, as it is "confusingly worded." The letter recommended that the "safe harbor should apply unless the registrant has actual knowledge that the third-party information it is using in connection with its Scope 3 disclosures is erroneous."

Bank Policy Institute

BPI's letter acknowledged BPI's support of consistent and reliable climate-related disclosure. However, BPI warned against overly detailed disclosure requirements. Specifically, BPI argued that the Regulation S-X financial reporting requirements "are largely inoperable, will not result in useful disclosure for investors, and should be removed or, at a minimum, significantly narrowed." In BPI's view, compliance with the Proposal which would require separate accounting for climate-related factors would be "very difficult to impossible." BPI suggested that material climate-related financial impact disclosures would be more effective through qualitative nonfinancial disclosures and provided in the Management Discussion and Analysis section of 10-K filings. BPI noted that "banks are not able to look backwards to disaggregate the financial impact of any specific risk factor, and disaggregating climate-related risk would be even more challenging given the nascent and evolving state of climate risk management capabilities and the challenges around modeling a type of risk that is inherently uncertain."

The BPI letter also indicated that the Proposal's Scope 3 emissions disclosure requirements are overly broad and should be narrowed. Specifically, BPI cited significant problems with Scope 3 emissions information, including data quality, availability, organizational barriers and the evolving nature of calculation methodologies. In other words, current Scope 3 emissions disclosures would be largely subjective and would not provide data on which an investor could reasonably rely. BPI suggested that the SEC should promote Scope 3 emissions disclosures outside of SEC reporting documents or, alternatively, significantly narrow the Proposal's drafted requirements.

Structured Finance Association

The SFA, which has been proactively developing an ESG disclosure and reporting framework for the securitization market, also sent in a letter in response to the Proposal. Although the Proposal carved out asset-backed securities ("ABS"), it put forth several questions aimed at gauging how best to draft a regulation similar to the Proposal to cover asset-backed securities. The SFA's response indicated that any new regulation intended to cover ABS would be somewhat premature, and cautioned that the overly prescriptive reporting requirements of the Proposal, if applied to ABS, could impede public issuance of ABS and, in turn, disrupt a vital source of funding in ABS markets. Rather, the SFA favored a "smooth implementation" that allows ample time for the industry to digest and adopt proposed changes. Specifically, the SFA advised that "a principles-based approach to climate-related disclosures, combined with targeted asset-class specific metrics, might be an appropriate approach to ABS climate-related disclosure."

The SFA suggested that any future climate disclosure regulation covering ABS include safe harbors, which would add a level of protection and incentivize issuers to provide investors with material information relating to climate change. Specifically, the SFA recommended that any GHG emission disclosure requirement "contain a safe harbor that provides that underwriters and other persons who are not experts be subject to the same standard of liability for GHG emissions data as they would for expertised data under Section 11(b)(3)(C) of the Securities Act, and that such persons be deemed not to have 'scienter' under Section 10(b) of the Exchange Act if they had no reasonable ground to believe and did not believe that the relevant statement was untrue or misleading."

American Bankers Association

The ABA argued that the Proposal goes "far beyond the SEC's mandate to protect investors." The ABA highlighted certain concerns, including the broad nature of the Proposal, reasoning that "climate-related disclosure requirements should be limited to companies where there is a substantial likelihood that a reasonable investor would consider climate-related factors important when determining whether to buy or sell the company's securities, or how to vote on company proposals." As such, the ABA recommended that the Supreme Court's "reasonable investor" standard should be applied to the Proposal.

The ABA discussed the "high costs of compliance and uncertain usefulness of GHG emissions estimates." The ABA suggested that Scope 3 financed emissions disclosure should be limited to publicly announced climate-related targets, as such emissions "are often poor and confusing indicators of transition risk due to unavoidable variances in data availability and methodology, as well as inherent differences in risk profiles to other Scope 3 emissions and between financial products." The letter also noted that the SEC should better coordinate with the banking regulators and other federal financial regulators. The ABA also observed that the Proposal "suggests that the SEC's goal is to use the reporting of emissions to discourage lending as a way to allocate capital away from certain industries," which is "wholly inappropriate" and "not within the SEC's authority."

Conclusion

A few overarching themes appear throughout the aforementioned letters sent in response to the Proposal. First, the Proposal's current "one size fits all" approach ignores industry-specific considerations. Next, the practical application of the Proposal would lead to ambiguous and subjective reporting metrics. Finally, the Proposal's year-end implementation timeframe is overly ambitious and does not allow industry participants ample opportunity to develop and adopt effective disclosure protocols.

Based on the general market response, we believe that it may take the SEC some time before either issuing a revised proposal or a final rule. On the other hand, the SEC may be eager to finalize the rule before the midterm elections or before the calendar year ends. In addition to the industry comments noted above, over 100 Republican Members of the House of Representatives signed on to a letter criticizing the Proposal and calling for it to be rescinded. In any case, we expect the final rule to face court challenges over whether the SEC has the authority to issue the regulation or whether it properly considered the Proposal's economic costs to registrants and benefits to investors. In sum, despite the general support in favor of consistent and reliable climate-related disclosures, industry comment letters in response to the Proposal expressed concerns that were shared across the real estate finance and banking industries regarding the breadth of the Proposal.