

## Financial Economists Roundtable

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### Statement on SEC Regulation of ESG Issues

#### “SEC Should Mandate ESG Disclosure Limited to Matters that Directly Affect the Firm’s Cash Flows”

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The Financial Economist Roundtable (FER) is a group of senior financial economists who have made significant contributions to the finance literature and seek to apply their knowledge to current policy debates. The Roundtable focuses on microeconomic issues in investments, corporate finance, as well as financial institutions and markets, both in the U.S. and internationally. It aims to create a forum for intellectual interaction that promotes in-depth analyses of current policy issues to raise the level of public and private policy debate and improve the quality of policy decisions.

FER was founded in 1993 and meets annually. Members attending an FER meeting discuss specific policy issues on which the FER may adopt statements. When the FER issues a statement, it reflects a consensus among at least two-thirds of the attending members, and all the members who sign it support it. The statements are intended to increase the awareness and understanding of public policy makers, the financial economics profession, the communications media, and the public. FER distributes its statements to relevant policy makers and the media. This statement is the outcome of the FER’s discussion at its annual meeting, which took place on July 17-19, 2021, in Shepherdstown, West Virginia.

We signatories to this statement believe that any ESG disclosures that financial regulators mandate should be limited to matters that directly affect the firm’s cash flows. Further, when issuer filings include ESG ratings, those filings should include information about the raters, the factors used, and the weights on the factors.

We recommend that the SEC should not mandate disclosure of the firm’s impacts on environmental and social (E&S) outcomes. Such disclosures lie outside the SEC’s statutory mandate and outside the SEC’s expertise.

Our recommendations balance the benefits of disclosure under the SEC mandate against the costs that arise from measurement, regulatory overreach, and forestalling private efforts ongoing in this area.

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## SEC should mandate ESG disclosure limited to matters that directly affect the firm's cash flows

### *Statement of the Financial Economics Roundtable*

**Background:** The Financial Economist Roundtable (“FER”) met on July 17-19, 2021, to discuss current efforts to measure and require disclosure of firms’ activities related to the environment, social issues, and governance (ESG). While the views of individual FER members about specific issues raised by our discussion often differ, the consensus was that financial regulators should be cautious in mandating disclosures. We propose guidelines for disclosures about firm cash-flow impacts from environmental and social issues. We also propose that, when filings include ESG ratings, those filings include information about the raters, the factors used, and the weights on the factors. We recommend that the SEC should *not* mandate disclosure of the firm’s impacts on environmental and social (E&S) outcomes. Such disclosures lie outside the SEC’s statutory mandate and outside the SEC’s expertise.<sup>1</sup> Our recommendations balance the benefits of disclosure under the SEC mandate against the costs that arise from measurement, regulatory overreach, and forestalling private efforts ongoing in this area.

### **Introduction**

The explosion of interest in policy proposals about ESG disclosure, as well as the substantial growth in funds invested in assets with ESG ratings, require a pause and consideration of what research suggests government and private sector institutions can accomplish through disclosure. Existing calls for ESG reporting often fail to distinguish between two goals: (1) understanding the impact of E&S activities on the firm’s cash flows; and (2) understanding how the firm’s activities affect society, including E&S-related outcomes. Distinguishing between the two is essential because the SEC’s mandate covers only the first. The SEC’s mission of investor protection indicates that it should consider disclosure mandates that will help investors understand E&S-related impacts on the firm’s cash flows. As outlined below, the FER believes that certain disclosures would advance this objective.

The second goal, which seeks disclosures to help readers understand how firms’ activities affect society, results, at least in part, from many citizens’ frustration with the lack of legislative and regulatory action on environmental and social issues.<sup>2</sup> For example, although the most equitable and effective tool for controlling greenhouse gas emissions by firms is a greenhouse gas tax or cap-and-trade mechanism, no political consensus has developed to legislate such tools at the federal level in the U.S. Nor has the U.S. Congress developed legislation requiring firms to disclose workplace-related social issues.

In the absence of legislative action, proponents of SEC disclosure mandates want the SEC to enter the E&S arena. They assume, without widely-accepted evidence, that the registrants’ disclosures would empower consumers, workers, and investors to pressure firms and lead to positive changes in firms’ E&S-related activities.

The SEC should not yield to pressure from proponents of mandated disclosures about firms’ E&S-related societal impacts, and the U.S. Congress should not require the SEC to mandate such disclosures. The SEC’s expertise lies in *financial* disclosures; the SEC does not have the authorization from Congress, nor the expertise, to design disclosures that seek to influence societal outcomes, nor the resources to review

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<sup>1</sup> Our recommendations stem from the SEC’s mission within the U.S. regulatory landscape. Agencies such as the European Commission and Financial Stability Board, which are currently engaged in rulemaking regarding climate change related disclosures, have different mandates.

<sup>2</sup> Some ESG ratings agencies and funds that cater to ESG-minded investors also support ESG disclosures to decrease costs and boost demand for their products and services.

such disclosures. Just because some investors and asset managers are among the groups demanding the information does not mean that the SEC mandates are appropriate to supply it.

Using the SEC as a tool to promote environmental and social change creates significant potential costs, with questionable benefit. First, any product and capital market pressures for firms to change their behaviors that arise from *mandated* disclosures imposes a cost on firms. The burden of this cost would likely fall unequally on firms and among the different stakeholders of most firms. Second, what gets measured gets managed. By setting requirements for firms to disclose specific environmental and social outcomes, the SEC would involve itself in setting U.S. environmental and social priorities. Mandates of this type allow the SEC to become a political tool. Third, burdensome disclosure requirements will drive some public companies to become private and limit other firms' willingness to go public. This incentive for firms to be private could inhibit capital formation and decrease at least some disclosures, contrary to the SEC's mandates to facilitate capital formation and efficient markets.<sup>3</sup>

In summary, we see no clear benefits resulting from the SEC's becoming involved with societal impact disclosures (except perhaps to ease the workload of ESG funds who want to identify portfolio constituents), yet such disclosures create significant costs. Agencies such as the EPA, Labor Department, and EEOC, are better equipped to set reporting requirements for carbon emissions or workforce diversity. Furthermore, requirements by such agencies will apply to all firms, public and private, whereas the SEC oversees disclosures of public issuers only.

So much for what the SEC should *not* require. The SEC *should* require a registrant to disclose its E&S-related cash-flow impacts in its 10-K (or 10-KSB). As detailed below, this mandate would include E&S-related risk factors and current cash outflows (e.g., investments made) that affect the firm's E&S outcomes. The SEC should encourage the use of quantitative disclosures. We recommend also that the SEC require well-defined language, either by creating its own glossary of terms or requiring that firms define terms. We recommend further that the SEC require that any reference to "ESG" ratings, including for purposes of marketing an "ESG" fund or financial product, discloses the rater, the factors in the rating, and the weights given to the factors in the rating.

Taken together, these recommendations will result in disclosures that are more verifiable, comparable, and informative. The recommendations will lead to a principles-based mandate with voluntary content. We expect this framework will induce firms that develop best practices in the environmental and social space to disclose their activities in a clear and quantitative way, which will create pressure on other firms to do the same, reducing the tendency for other firms to use boilerplate language.

In summary, the FER makes four recommendations.

- The SEC should *not* mandate disclosure of a firm's E&S-related societal outcomes.
- The SEC should mandate disclosure of E&S-related cash flow effects, including investments that alter E&S outcomes.
- The SEC should require reference to ESG (or E, or S, or G) ratings to be accompanied by a description of the rating method, including factors and weights.
- The SEC should oversee development of a glossary of terms related to ESG.

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<sup>3</sup> Neither the Congress nor the SEC has defined "capital formation," but we use it to mean raising of funds for productive investment. See "Speech by SEC Commissioner: Facilitating Real Capital Formation," by Commissioner Luis A. Aguilar, April 4, 2011. [Sec.gov/news/speech/2011/spch0404111aa.htm](http://Sec.gov/news/speech/2011/spch0404111aa.htm)

These recommendations for SEC mandates conform to the SEC's three-part mission: "...protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."

## **Analytical Framework**

Four tenets--observations and principles--underlie our analysis and motivate our proposals:

**(i) Two aims of ESG disclosure.** Existing calls for ESG reporting often fail to distinguish between two goals:

1. Understanding the impact of E&S activities on the firm's value through their effects on a firm's cash flows (firm cash-flow impacts);
2. Understanding the consequences of the firm's activities on ESG outcomes external to the firm (societal impacts).

The two categories overlap. Societal impacts can create indirect cash-flow impacts. Firms face the risk that legislation, regulation, changes in consumer preferences, and litigation growing out of firms' E&S effects on society will feed back into cash flows. In addition, firms make cash-flow decisions, such as investments in greener technology, that affect its societal impact.

The SEC's statutory mandate and its expertise relate to impacts on a firm's cash flows, but not to its societal impacts.

**(ii) Aggregation issues.** ESG aggregates three constructs, each with its own definitional and measurement problems. Most demands for environmental performance (E) disclosures focus on the firm's external societal impacts, especially carbon, methane and other greenhouse gasses. (For shorthand, we refer to these as *carbon*.) Social issues (S) include workplace diversity, employee safety, corporate giving, and a company's statements on political issues. Governance (G) refers to the rules and procedures firms adopt to control agency problems and promote operational efficiency. Measures that seek to aggregate a firm's performance across all three hopelessly add incommensurate apples and oranges. And, each of the components is itself multidimensional.

That the audience for disclosures about the societal impacts of E&S activities includes heterogeneous customers, employees, suppliers, and communities complicates the aggregation issue. Financial economics research has shown that managers' duty to pursue shareholders' interests, while relatively tractable, is complicated enough when shareholders have different consumption preferences, information, tax bases, or investment horizons.<sup>4</sup> A disclosure mandate will require managers to discern the various interests of heterogeneous stakeholder groups, which will increase the likelihood of conflict, waste, and

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<sup>4</sup> For examples, see Hodrick (1991), Lucas and McDonald (1998), Hart and Zingales (2017), and Partnoy (2021). DeAngelo (1981) discusses conditions under which shareholders agree on corporate policies.

managerial self-dealing.<sup>5</sup> Recent research provides examples of how managers' attempts to cater to one group of stakeholders imposes costs on other stakeholders.<sup>6</sup>

**(iii) Measuring societal impacts is difficult.** There are hundreds of possible metrics to choose from, and the relevant metrics can vary by industry, region, and firm size. Proprietors of E measures disagree on how best to rate different aspects of firm activities. Should a public utility that generates electricity by hydraulic power generators earn a high score on an E measure because it has low carbon emissions? Or should it earn a low score because its dams destroy the populations of endangered wild salmon?

Inconsistent or poorly defined terms exacerbate the measurement problem. For example, CO<sub>2</sub> emissions differ from other greenhouse gas emissions. Commonly used terms such as carbon footprint, climate change, governance, workforce diversity, physical risk, and transition risk have come to mean different things to different users of these terms. Without definitions, one cannot easily compare and verify across firms.

**(iv) Side effects.** Regulation almost always leads to at least some undesirable consequences. Possible side effects specific to ESG include:

- The more disclosure the agency requires, the more costs it imposes on public firms. Additional mandated disclosures would give public firms incentives to go private and private firms to stay private, in the process offsetting some of the total information made available about firms' societal impacts. Increasing the burden on public companies directly conflicts with the goal of the 2012 JOBS Act and other legislation that seeks to increase the number of publicly traded companies.
- The SEC has limited resources. Its efforts to police additional ESG-related disclosures will affect, and could detract from, the Commission's other activities.
- The SEC helped to create legalized quasi-monopolies in the bond-rating industry (which the FER and others believe contributed to the financial crisis of 2008-09). The SEC would create an analogous problem if, as part of its E&S-related regulations, it gives formal or informal approval to specific ESG ratings or ratings organizations.
- Both the private and government sectors recognize that, "What gets measured, gets managed." To the extent the SEC requires disclosure of any specific measures, its rules or guidance will have ripple effects on firm investments, operations, and performance, both intended and unintended.

## Recommendations

Based on the observations above, the FER makes three recommendations for actions the SEC should take and one recommendation for not taking action. Our recommendations pertain primarily to the E&S components of ESG. Governance differs from E&S in that it generates no direct societal impacts,

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<sup>5</sup> For example, see Denis (2016, 2019), Bebchuk and Tallarita (2020), Bhagat and Hubbard (2020), and Karpoff (2021). Edmans (2020) and Starks (2021) discuss the history of debate over stockholder vs. stakeholder objectives.

<sup>6</sup> For example, Painter (2020) shows how Walmart's attempt to cater to more liberal consumers by eliminating retail gun sales had the effect of alienating more pro-gun rights customers. Gurun, Nickerson, and Solomon (2021) show that Starbucks' attempt to provide bathroom services to local communities ended up alienating paying customers.

although it can do so indirectly by affecting specific firm decisions that have E&S societal impacts. In addition, disclosures of G activities are already regulated. Accordingly, the analysis of the costs and benefits of SEC-mandated disclosures related to G should differ from those for E&S and deserve a separate discussion.

***1) Require precise, well-defined language.***

Before any regulatory body (public or private) can set sensible rules for disclosure of E&S matters, much less measurements of them, it should define terms. A clear set of definitions increases comparability across firms, which in turn allows capital markets to pressure firms into better voluntary disclosure. Voluntary disclosure models predict that capital market pressures can induce disclosure, but they require that market participants know that the firm has information it could disclose.<sup>7</sup> If firms disclose ill-defined metrics or describe activities with ill-defined language, investors cannot infer insufficient disclosure and therefore cannot pressure firms to make improved disclosures.

In addition, defined terms leave less room for managerial discretion in a disclosure and increase verifiability. Precise terms also reduce opportunities for boilerplate language or selective language choices that a firm can use to present itself favorably. For example, a firm cannot make a bogus claim to have decreased its impact on “climate change” if that term has a definition sufficiently clear that “increase” and “decrease” have operational meaning.

The SEC should oversee development of its own glossary of E&S related terms. This practice of definitions in SEC rules is common. For example, in the rules on mutual fund risk disclosures (Rule 22e-4), funds are required to disclose liquidity risk, which is defined as “the risk that a fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors’ interests in the fund.” In the context of environmental issues, two examples of terms requiring definitions are carbon neutral and carbon offsets.

We recommend the SEC collect or refer to language from the agencies that specialize and regulate these issues. The EPA has a “vocabulary catalog” and the EEOC has a glossary/definitions page for terms used on their sites and in their reporting requirements.<sup>8</sup> Case law is another source of meanings for E&S terms.

The ideal glossary with consistent language for all registrants would increase comparability, transparency, and mitigate the use of boilerplate language. The FER recognizes that creating such a glossary is difficult and we do not want the lack of a glossary to stand in the way of our other recommendations. At a minimum, the SEC could require firms to define any terms E&S-related terms that lack clear and widely understood meanings.

***2) Require disclosure in an issuer’s 10-K (or 10-KSB) that summarizes material E&S-related cash-flow impacts***

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<sup>7</sup> The idea that rational investors can infer hidden information -- the “unraveling result” -- is attributed to Milgrom (1981). See also Grossman (1981) and Grossman and Hart (1980).

<sup>8</sup>The EPA’s vocabulary catalog can be found at:

[https://sor.epa.gov/sor\\_internet/registry/termreg/searchandretrieve/glossariesandkeywordlists/search.do?details=&glossaryName=Glossary%20Climate%20Change%20Terms](https://sor.epa.gov/sor_internet/registry/termreg/searchandretrieve/glossariesandkeywordlists/search.do?details=&glossaryName=Glossary%20Climate%20Change%20Terms).

The EEOC’s glossary/definitions page can be found at: <https://www.eeoc.gov/federal-sector/reports/appendix-i-glossary-definitions-0>

A central objective of securities regulation is to ensure that investors have materially useful information about the current-period and expected cash flows of public firms. Accordingly, a disclosure mandate for E&S-related firm cash-flow impacts is consistent with the SEC’s statutory mission.

Before describing the specific content of the disclosures we recommend, we note several details.

- The disclosures ought to be in a filing. Disclosures that have the status of a filing tend to be more informative because that format subjects the issuer to private litigation, increasing incentives for truthful reporting.
- Most FER members believe the rule should require E&S-related disclosures in a separate section of the filing. Firms are currently required to make *some* E&S-related disclosures, when E&S events present a risk factor to the firm’s cash flows. Other recommended disclosures could be included in the MD&A. Our recommendation that the firm disclose the impacts of E&S-related activities on cash-flows in a separate section would give them increased prominence. Along with an ESG glossary of terms, including disclosures in a separate section should reduce opportunities for managerial obfuscation and boilerplate language.<sup>9</sup> FER members believe that, given investors’ significant interest in E&S-related activities, the incremental cost to firms will be small compared to the benefits to investors from highlighting the E&S information.<sup>10</sup>
- The disclosure mandate applies to issuers that file an annual 10-K. The mandate should not apply to investment vehicles like mutual funds, ETFs, and other multi-firm financial products. That is, these asset managers do not need to make disclosures about firms that comprise their investment portfolios.

We distinguish two sources of E&S-related cash-flow impacts that the SEC should require firms to disclose.

The first source is events or activities by parties or forces outside the firm. For example, the firm’s assets in place may be subject to increased frequency and severity of natural disasters due to climate change. Consumer preferences for “green” products may affect sales. Regulators may take actions that impose costs, such as extensive diversity reporting requirements. Current rules require disclosing these sorts of valuation-relevant risk factors. Thus, the incremental cost of separately disclosing the cash-flow impacts of material E&S risk factors is minimal, and most FER members believe the benefits for investors are large, through enhanced informativeness, verifiability, and comparability.

The second source of E&S-related cash-flow impacts comes from the firm’s internal decisions to decrease its adverse societal impacts or to enhance its positive impacts. As noted above, direct cash-flow impacts overlap societal impacts. For example, the firm can invest in greener technology or forgo investments in brown assets. The firm can maintain its equipment more frequently, reducing its impact on the

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<sup>9</sup> Risk factor disclosures, in particular, are criticized for being boilerplate. Dyer, Lang and Stice-Lorien (2017) document that risk factor disclosures (as well as fair value/impairment disclosures and internal control disclosures) have high levels of “redundancy, stickiness and boilerplate, and low levels of readability, specificity, and hard information.”

<sup>10</sup> The FER members who do not support mandating a separate E&S disclosure section note that firms can separately disclose E&S-related activities voluntarily, as many already do, and argue that E&S-related risks and cash flows are not more significant than many other specific sources of risk (e.g., cyber security risk, expropriation risk) for many firms. Regardless, the FER members agree on the content of the disclosures, as discussed in this recommendation.



environment. Such investments and expenditures decrease the firm's current cash flows and are therefore relevant to investors, but current SEC disclosure rules do not require their separate reporting.

The SEC's statutory mandate allows it to require firms to report on the investments they make (and the cash flows they use) related to E&S. E&S expenditures require special monitoring because the benefit does not accrue to the firm in terms of net cash inflows. Rather, the value of the investment benefits society. If the firm makes these sorts of investments, investors will find the information relevant whether they support such investments or want to avoid firms that make them.

Disclosures of cash flows used (or saved) related to E&S, including forgone opportunities, would be new. Firms report on investments, but the current disclosure requirements do not focus on the subcategory of investments and activities that have an impact on E or S. Such a requirement has precedents. Firms must also disclose annual expenditures on R&D and advertising, for example, because they "...provide useful information to investors about intangibles."<sup>11</sup> Along the same lines, providing disclosures about investments in (or expenditures on) E&S-related assets provides information useful to investors about the firm's E&S strategy.

The FER believes the design of the SEC mandate should provide only principles-based guidance on the contents of the E&S disclosures. That is, the firm must disclose, but it can choose what and how. We envision rules and guidance similar to those for the MD&A. The framework could require or suggest categories of disclosures such as: (1) Regulatory environment and anticipated intervention; (2) Supply chain activities/risks; (3) Distribution channel activity/risks; (4) Current investments/activities; and (5) Metrics tracked by management, if any. The SEC could also encourage issuers to make peer group comparisons. Firms would have discretion over which peer group(s) to use, but would have to explain their choices.

Issuers should be encouraged to make quantitative rather than qualitative disclosures. The recommended disclosures, after all, are *cash-flow* impacts, either anticipated future cash flows, which must be estimated, or current cash flows (investments or expenditures). Cash flows are inherently quantitative. For investments in assets or expenditures that the firm believes will change its societal impacts, firms should be able to report dollars spent. Examples of other quantitative and objective measures are the number or percent of suppliers (or dollars of supplies purchased from suppliers) with stated "S" characteristics.

To be clear, although we believe the SEC should encourage *quantification* of cash-flow impacts, our core suggestion remains that any disclosure mandate should provide only principles-based guidance. We recommend that the SEC do not require firms to produce any particular E&S metrics. Disclosure costs increase with each additional required metric, but selecting metrics leads to the what-gets-measured-gets-managed problem, and the SEC would end up prioritizing the E&S agenda. We do, however, encourage the SEC to define a variety of such metrics in the ESG glossary (recommendation #1) and to encourage firms to disclose quantitative metrics that the firm deems appropriate to assessing its own E&S-related cash-flow impacts. Giving the firm the discretion to choose metrics mitigates problems associated with variation in relevant metrics across industries and other firm attributes.

A principles-based framework also would allow firms to highlight possible benefits of climate change on the firms' business (such as manufacturers of wind turbines or solar panels that benefit from efforts to combat climate change) in a neutral way.

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<sup>11</sup> Division of Corporate Finance Current Accounting and Disclosure Issues. August 31, 2001. U.S. Securities and Exchange Commission. Washington D.C.

One can question whether some firms will exploit the principles-based approach to provide qualitative mush. Counteracting that tendency is the fact that investors will review these disclosures. The power of capital-market pressure to disclose more detailed information should not be underestimated.<sup>12</sup> If the best firms in an industry start disclosing their E&S activities and cash-flow impacts with quantitative metrics, investors will reasonably assume the worst about the firms that remain silent or provide boilerplate and meaningless disclosures. Without a framework, investors cannot easily make inferences about the silent firms. With a well-specified framework and clear use of ESG-related terms, capital markets will learn from silence as well.<sup>13</sup>

The FER believes our recommendation would survive an SEC cost/benefit analysis. The recommendation meets the mandate to protect investors by requiring disclosure of cash-flow impacts. Disclosures about factors that pose a risk to the firm's cash flows pose little incremental cost on firms that were complying with the risk factor rules. Tracking cash outlays for E&S-related investments should not pose a significant cost for firms, relative to the benefits. This information is relevant to capital formation. Whether investors believe their capital should or should not be used to improve societal outcomes, the FER believes that its recommended disclosure would facilitate investors' decisions about their own capital allocation. These disclosures represent an incremental cost to the firm, but they benefit investors by providing them with information about how management is deploying invested assets, a benefit that falls within the SEC's mandate.

In summary, requiring disclosures of E&S-related cash flows and risks, including voluntary investments, improves information for investors. Including them in a filing increases verifiability and credibility, due to the threat of private litigation. Including them in one place makes information acquisition and processing less costly for investors. The incremental disclosures should be principles-based, allowing for evolution as more quantifiable metrics are developed. Also, clear definitions of E&S-related terms, as in a glossary, as well as peer group comparisons, improve comparability of the information in E&S disclosures.

***3) Require that any registrant's reference to "ESG" ratings, including for purposes of marketing an "ESG" fund or financial product, discloses the rater as well as details about the factors in the rating and the weights given to the factors.***

Although E, S, and G represent a set of dissimilar constructs, as noted above, the term ESG has been applied to an investment category that is already substantial and growing and an industry has emerged to rate firms on their ESG performance (e.g., Matos 2020; Bloomberg Professional Services 2020). The SEC cannot prohibit the use of ratings nor the term *ESG*, but it can issue rules that promote clarity in the use of the terms and ratings. We recommend:

- Any entity that provides an ESG rating in a filing must simultaneously disclose information allowing investors to understand the rating's inputs and weights. If a rating is widely used, this disclosure requirement could be met by providing the name of the rating organization, and perhaps a link to their rating methods. If a rating service provides multiple ratings sub-categories, the firm would need to be specific about which of the sub-categories it means. If the methods are not easily accessible, the issuer would have to provide a more detailed discussion, including

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<sup>12</sup> See Easterbrook and Fischel (1984) for an excellent discussion of capital market pressure and disclosure.

<sup>13</sup> Again, see Milgrom (1981), Grossman (1981), and Grossman and Hart (1980).

factors and weights.<sup>14</sup> If firms use ESG ratings for which the method is not easily accessible, they should explain why they use the specific rating they choose.

- An entity that reports an average rating over multiple rating agencies should report which particular ratings it uses to compute the average, with reference to factors and weights as described above.
- If an entity reports a self-rating, it should also provide a comparison with an appropriate peer group, which it should identify and justify.
- If an entity uses a proprietary ESG rating system and objects to disclosing the inputs and weights for its ratings, it should disclose to investors that the system is proprietary. Investors can then decide whether to invest in a fund with hidden ESG rating attributes.

This mandate would cover the use of ratings in any SEC filing, including corporate issuers who highlight their own ratings, perhaps selectively, as well as asset managers, including ESG mutual funds and ETFs that market themselves based on their ESG status.

The FER believes full disclosure of rater, factors used in rating, and factor weights is superior to regulator certification of ESG rating agencies or methods. Such a certification process created an oligopolistic bond-rating industry whose inaccurate ratings contributed to the 2008-09 financial crisis.

#### ***4) Do not require discussion of the issuers' societal impacts on E and S.***

Society faces a broad set of social and economic challenges, including those relating to the environment, ensuring equal economic opportunity and inclusion, and combating racism. Mandating disclosure is not the appropriate tool to respond to these challenges.

Mandated disclosures for public firms have clear but limited objectives under the securities laws. These disclosures intend to protect investors and promote capital market efficiency. Disclosure that is used as a tool to encourage more socially desirable firm behavior will tend to have undesirable side effects while not aiming squarely at the intended social goals. The best way for society to achieve specific objectives is through the direct policy tools available to the legislative branch of government, including taxes, subsidies, and regulation.

There are other policy solutions that can more effectively meet regulatory goals with respect to E and S. For example, in the case of greenhouse gas emissions that contribute to climate change, experts broadly agree that the optimal policy response is to tax greenhouse gas (GHG) emissions – often expressed in shorthand as a “carbon tax” – equal to some measure of the costs imposed on the public by those emissions.<sup>15</sup> Imposing firm-specific caps on GHG emissions and allowing participants to trade emissions permits – “cap and trade” – can achieve similar objectives. Either mechanism ensures that the price charged for goods and services includes their social cost of carbon. Participants in the marketplace, in

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<sup>14</sup> This recommendation resembles the GAAP requirement for firms to provide “...a description of the valuation technique(s) and the inputs used in the fair value measurement” for valuations of assets or liabilities falling within Level 2 and Level 3 of the fair value hierarchy, such as financial instruments without quoted prices in active markets. (See ASC 820).

<sup>15</sup> For a summary of the broad support among economists for a carbon tax over command-and-control regulations, see [https://en.wikipedia.org/wiki/Carbon\\_tax#Economists\\_and\\_climate\\_scientists](https://en.wikipedia.org/wiki/Carbon_tax#Economists_and_climate_scientists).

reducing their own private costs, will then undertake to reduce carbon emissions and implement carbon capture (taking ambient GHG out of the air or water) in the least costly way to society.

Several jurisdictions have adopted or are considering carbon taxes or cap-and-trade mechanisms including parts of the United States (California and New England), the European Union, and China. So far, however, no political consensus has emerged for adopting either at the federal level in the U.S.<sup>16</sup>

Some parties have proposed greater ESG disclosure mandates as a tool to achieve the desired outcomes that policymakers have not addressed directly. Proponents of such mandates argue, so far without widely-accepted evidence, that the disclosures would empower consumers, workers, and investors to pressure firms and lead to meaningful changes in firm behavior.<sup>17</sup> Mandated disclosures have been proposed for other E&S elements, as well, such as workforce diversity and wage disparities.

We believe such disclosure mandates are inappropriate for several reasons.

- In setting E&S disclosure standards, the SEC would be using executive authority to influence U.S. environmental and social policy. As noted previously, what gets measured gets managed, which means that any disclosure mandates will force firms to focus on the required metrics, which cannot be the socially optimal choice for all firms. The SEC has a mandate to protect investors and facilitate firms' capital formation. SEC rule-making meant to influence societal outcomes amounts to an expansion of power by one independent agency, taking power that belongs to the legislative branch.

One might argue that if enough investors are interested in an issue, then requiring disclosure falls within the SEC's mandate to "facilitate capital formation." We caution the SEC to consider the negative implications of broadening its mandate in this way, for two reasons. First, firms already have incentives to provide such disclosures if enough investors demand them, because failure to do so would increase a firm's cost of capital.<sup>18</sup> Second, using the capital formation mandate to require disclosure of E&S outcomes would create a dangerous precedent. As new causes arise, or the political tide in the country turns, other groups could use the SEC to require disclosures that fit their political agendas. The SEC should not allow itself to be used as a political tool.

- Any product and capital market pressures for firms to change their behaviors that arise from *mandated* disclosures implicitly tax firms. The burden of this tax would surely fall unequally among firms and among the different stakeholders of most firms.
- The SEC does not have the expertise to design disclosures that seek to influence societal outcomes. Agencies such as the EPA, Labor Department, and EEOC, can set reporting requirements for carbon emissions and workforce diversity, respectively. These agencies already require firms, both public and private, to report some E&S related outcomes. For example, the

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<sup>16</sup> Bartram, Hou and Kim (2021) provide evidence that California's cap and trade program led constrained firms to move emissions to other states.

<sup>17</sup> For example, Heinkel et al. (2001) describe conditions in which socially responsible investing can change a firm's cost of capital and E&S-related activities, but Heath et al. (2021) do not find evidence that such effects are economically material.

<sup>18</sup> See Verrecchia (2001) for a review of the literature on the association between disclosure and the information asymmetry component of the cost of capital due to adverse selection.

EPA collects and publishes data on various greenhouse gas emissions by facilities throughout the U.S. as part of its greenhouse gas reporting program (GHGRP).<sup>19</sup> The Equal Employment Opportunity Commission (EEOC) collects data on discrimination complaints and workforce diversity, although it does not make the data public.

- The SEC does not have the resources to enforce new disclosures. Increasing the SEC's budget to provide such resources would duplicate the mandates and expertise of other executive department branches, including the EPA.
- Mandated disclosures would have negative side effects. In particular, burdensome disclosure requirements will drive public companies private and reduce private companies' willingness to go public, which could work contrary to the SEC's mandate to facilitate capital formation.

To be clear, we do not propose that the SEC forbid disclosures of societal impacts or even discourage them. But it should not *require* such disclosures. In contrast, the SEC should require that any disclosures that firms voluntarily make about their impact on E&S matters use clearly defined E- and S-related terms. The SEC should focus on disclosures that reflect firms' cash-flow related E&S activities and risks, and put faith in capital markets to regulate voluntary disclosure of firm's impacts on E&S outcomes. To the extent that investors need information on E&S outcomes to facilitate raising and allocating funds between competing demands, investors will punish firms that do not provide it.

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<sup>19</sup> <https://www.epa.gov/ghgreporting>

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