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July 21, 2021

SEC Commissioner Hester Peirce Speech on Potential ESG Rulemaking

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TO: ICI Members
ESG Advisory Group
ESG Task Force
SEC Rules Committee SUBJECTS: Disclosure
ESG RE: SEC Commissioner Hester Peirce Speech on Potential ESG Rulemaking

In remarks at a July 20, 2021, Brookings event, SEC Commissioner Hester Peirce set forth ten theses for consideration relating to the complexities and consequences of potential ESG rulemaking, which are summarized below.[1]

1. **ESG as a category of topics is ill-suited, and perhaps inherently antithetical, to the establishment of clear boundaries and internal cohesion.** Commissioner Peirce stated that ESG readily expands to include whatever the speaker or the news media are focused on and that figuring out how to deal with ESG from a disclosure standpoint is complicated by the great and growing number of unrelated (and incommensurable) items it encompasses.
2. **Many ESG issues lack a clear tie to financial materiality and therefore do not warrant inclusion in SEC-mandated disclosure.** Noting that many proponents of an ESG disclosure framework insist that materiality is an appropriate restraint, she stated that this position begs the question of where the SEC's current materiality standard and enforcement regime are missing the mark. Companies should be disclosing material risks under the SEC's current rules, she said. If specific ESG metrics are material to every company in every sector across time, she said, the SEC can identify them one-by-one for incorporation in its rules, but throwing out materiality or stretching it to encompass everything and anything would harm investors.
3. **The biggest ESG advocates are not investors, but stakeholders.** Commissioner Peirce observed that many non-investors have tried to repurpose the SEC's investor-oriented disclosure tool to get information of interest to them and asserted that expanding the SEC's disclosure framework to facilitate the imposition of non-investor demands would take the agency into uncharted territory. She stated that some of the "loudest voices in favor of ESG disclosures for issuers are asset managers who advise

pension funds or fund complexes." As fiduciaries, she said, asset managers are obligated to put their clients' interests first and doing so may allow them to take ESG factors into account, but only if certain circumstances are met, including that the ESG factors have a clear link to risk-adjusted returns or to objectives that the client has chosen to override financial returns. She observed that portfolio managers within a fund complex may have a diversity of views on ESG matters but that many fund complexes make voting decisions centrally and speak with a single voice on ESG issues. Citing an academic paper, she said that fund managers—who are humans susceptible to pressure from peers, personally held values, employees, and others—may be making voting and investment decisions based on their own self-interest rather than in the interest of the funds they manage.[2]

4. **ESG rulemaking is high-stakes because so many people stand to gain from it.** Commissioner Peirce observed that ESG consultants, standard-setters and raters who are now making a lot of money in producing, seeking to standardize, and assessing voluntary disclosure "have an incentive to ensure that whatever rule gets written keeps that money flowing." More generally, the more metrics any ESG rule mandates, she said, the greater degree of assurance it will require, and the higher level of liability risk it will present to issuers, the more demand it will create for consultants, auditors, lawyers, sustainability professionals, and other rent seekers. She said that asset managers stand to benefit financially from rules imposed on public companies, which diminishes the amount of legwork they have to do to get the information they want for their ESG funds. She asked: "When the rule goes into effect, will the asset managers respond by lowering the fees they charge for ESG funds?"
5. **"Good" in ESG is subjective, so writing a rule to highlight the good, the bad, and the ugly will be hard.** She said that, even though a rule that mandates the disclosure of ESG metrics by issuers need not explicitly embody ESG value judgments, the choices about which metrics to require can indirectly reflect such judgments. Noting that the SEC's rules for funds and advisers are value-neutral, she asserted that if the SEC in the name of standardizing terminology were to start evaluating whether an adviser's or fund's interpretation of ESG matched the SEC's conception of ESG, it would raise questions it has no business asking or answering, such as "Are funds that avoid fossil fuels ESG, while those that include companies working to replace wood and coal fuel in developing nations with natural gas not ESG?"
6. **An ESG rulemaking cannot resolve the many debates around ESG models, methodologies, and metrics.** Commissioner Peirce noted that ESG models, methodologies, and metrics involve a lot of assumptions and uncertainties, and that climate modeling is challenging. She stated that the SEC is not well-suited to make judgments about which climate metrics should be reported by whom and that other agencies, like the Environmental Protection Agency, are better at making these judgments.
7. **Emotions around ESG issues may push us to write rules outside our area of authority.** She expressed concern that emotions tied to ESG matters (e.g., fear, guilt, and despair born of real concern for the planet, animals, plants, and people) can tempt the SEC to wander outside its limited regulatory mission to address any number of issues. Hastily conceived ESG disclosure rules can impede preventative, remedial, and adaptive efforts by cutting off capital to places where it can be most effective at solving the world's most intractable problems, she said.
8. **ESG issues are inherently political, which means that an ESG rulemaking could drag the SEC and issuers into territory that is best left to political and civil society institutions.** Commissioner Peirce stated that Congress and state legislatures, with their direct accountability to the American people, and civil society

institutions are the proper venues for deciding political and social issues, and that Congress has not granted authority to the SEC to address ESG issues for the purpose of promoting goals unrelated to the federal securities laws.

9. **ESG disclosure requirements may direct capital flows to favored industries in a way that runs counter to our historically agnostic approach.** Commissioner Peirce asserted that following the approach of other jurisdictions in directing capital flows to green uses—as some commenters have supported—would be a new role for the SEC, which, historically, has focused not on deciding where capital should go, but on making disclosure available and allowing investors to decide where capital should go.
10. **An ESG rulemaking could play a role in undermining financial and economic stability.** The growing global concentration of capital in certain sectors or issuers deemed to be green could destabilize the financial system, she asserted. She also expressed concern that many of the potentially large unintended consequences of the greening of capital flows that ESG disclosures will help to drive are likely to be borne by people who can least afford it.

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endnotes

[1] See SEC Commissioner Peirce, Chocolate Covered Cicadas (Jul. 20, 2021), available at https://www.sec.gov/news/speech/peirce-chocolate-covered-cicadas-072021. A recording of the Brookings event, "What role should the SEC play in ESG investing?", is available at https://www.brookings.edu/events/what-role-should-the-sec-play-in-esg-investing/.

[2] See Paul G. Mahoney and Julia D. Mahoney, The New Separation of Ownership and Control: Institutional Investors and ESG, Colum. Bus. L. Rev. (forthcoming), https://www.sec.gov/comments/climate-disclosure/cll12-8855236-238441.pdf.
