SECURITIES & EXCHANGE

‘ESG’ Disclosure and Securities Regulation

An SEC push for environmental, social, and governance disclosure would cater to Wall Street instead of Main Street.

BY PAUL G. MAHONEY AND JULIA D. MAHONEY

Politicians, policy experts, and academics have long debated the merits of socially motivated investing and corporate management. In recent months, these debates have intensified as leading institutional investors have joined environmental and social activists to urge the Securities and Exchange Commission to require public companies to disclose additional "Environmental, Social, and Governance" (ESG) factors. There are signs that the SEC will soon heed these calls and impose new ESG disclosure requirements. The most obvious candidate in the near term is disclosure on the potential effects on firm finances of climate change and governmental efforts to mitigate it.

If put in force, ESG disclosure mandates would represent a substantial change in the SEC's approach to its stated mission of protecting "Main Street investors" and "maintaining fair, orderly, and efficient markets," in the words of its website. Since its founding in 1934, the SEC has maintained a regulatory framework centered on the disclosure of material risks to the businesses of companies with publicly traded securities. Information is considered material if a reasonable investor would consider it important in deciding whether to invest. The disclosure system attempts to put large and small investors on a more nearly equal informational footing and thereby promotes public trust that the financial markets are fair rather than rigged in favor of market professionals. As we discuss below, ESG mandates risk eroding that trust for the simple reason that they prioritize the social and political views of the largest Wall Street asset management firms over the financial well-being of the households whose savings they manage.

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A shift in the criteria for disclosure from materiality to the pursuit of amorphous social goals could therefore have detrimental consequences for both the smooth functioning of the capital markets and the SEC's reputation as an effective and respected nonpartisan regulator. The shift could fuel the impression that regulators are open to playing favorites by raising the costs of capital for companies not in step with the current priorities of the governing political party—a danger with which the Federal Reserve is also flirting. The costs of capital for any given company could then fluctuate with each change in administration. Investors in the U.S. markets would have to become expert in assessing political risks, just like investors in emerging markets.

SECURITIES LAW, DISCLOSURE, AND ESG INVESTMENT

At the core of securities law lies mandatory disclosure of material information. Under current law and practice, companies must disclose specific risks that are material to their businesses, which may include potential losses from extreme weather events, foreseeable future regulatory changes, and so forth. Some companies also choose voluntarily to follow disclosure principles promulgated by nonprofit organizations such as the Sustainability Accounting Standards Board.

The supporters of ESG disclosure mandates argue that this is not enough. All companies should be required to disclose more ESG information on an SEC-specified template. Such a mandate, they contend, fits squarely within the SEC's traditional mission because it would better inform investors about material risks. In support, they cite two types of evidence: studies showing a relation between ESG factors and corporate performance, and the support of many large asset managers—including Blackrock, State Street, and Vanguard—for mandatory ESG disclosures.

While there is an established link between certain measures of good corporate governance (the "G" in ESG) and performance, the

evidence for a link between "E" (environmental) and "S" (social) factors and performance is more tenuous. Put most charitably to ESG supporters, financial economists are far from reaching consensus that there is such a link. And even if there is a link, there must be some reason to believe that the current materiality-based disclosure system is not eliciting sufficient value-relevant ESG-related information.

In arguing that the current system provides insufficient ESG disclosures, supporters note the divergence in disclosure practices among companies. But this is to be expected of disclosures about future events whose magnitudes are uncertain and whose financial consequences will vary substantially from one company to another. ESG advocates want what is essentially a stress test: a statement of the effects on the company of hypothetical physical and political conditions 10, 20, or 30 years from now. This would be a substantial departure from the materiality framework, which focuses on known risks that are likely to affect a given company's business.

Why, then, are we witnessing such widespread and vigorous support for additional ESG disclosure requirements? For social and environmental activists, the answer is straightforward: they wish to use the information generated through ESG disclosures to pressure firms to change the way they operate and to organize traditional and social media campaigns to shame companies whose ESG "scores" lag behind their peers. For institutional money managers, the answer is more complicated and is rooted in the misalignment of incentives between the institutions and their beneficiaries.

GETTY IMAGES

MONEY MANAGERS VS. BENEFICIARIES: THE "NEW" SEPARATION OF OWNERSHIP AND CONTROL

In their 1932 book *The Modern Corporation and Private Property*, Adolph Berle and Gardiner Means characterized the separation of ownership and control between corporate shareholders and managers as the fundamental problem of corporate law. Writing at a time when individual investors directly owned the majority of outstanding corporate shares, Berle and Means explained how corporate fiduciaries often failed to serve as the faithful agents of the shareholders. Today, the landscape of corporate ownership is radically different. While most American households hold stakes in public companies, their ownership is largely indirect, held in the form of mutual funds, employer-sponsored pension plans, and bank trust accounts. Institutional investors function as intermediaries, charged with administering investments on behalf of households for whom they act as fiduciaries.

From one perspective, this shift from direct to indirect corporate ownership makes eminent sense. Institutional investors have the capacity to monitor and discipline corporate managers, thus addressing the agency problems that so troubled Berle and Means. But this intermediation creates its own agency problems. Households with only small or moderate holdings cannot monitor the institutions that administer their mutual funds or pension plans any better than they can monitor corporate managers. As a result, household investors are now vulnerable to the danger that the very institutions they trust to safeguard their interests against corporate misconduct will instead use their discretion to buy, sell, and vote shares to pursue their own agendas.

Institutional investors that have come out in support of ESG-related disclosures deny that their purpose is to further social goals at the possible expense of those whose money they manage. It is important to recognize, however, that fiduciary principles constrain professional asset managers from admitting non-financial motivations. While individual investors may opt to sacrifice financial returns to invest in companies that share their values, and asset managers may assist them in doing so by offering tailored investment portfolios, fiduciaries may not compel beneficiaries to forgo returns to pursue social goals, however worthy.

Notwithstanding their fiduciary obligations, there are good reasons to believe that these institutional asset managers are putting their executives' and employees' social objectives ahead of the financial interests of their beneficiaries. For

one thing, the herding behavior of large fund managers toward ESG activism is puzzling if they are interested only in discerning and profiting from risks that the financial markets do not yet price accurately. After all, money managers who believe they have identified an over- or under-valued asset do not generally broadcast that fact to the world and invite others to share in the investment opportunity. Their public demands for portfolio companies to meet ESG metrics are more consistent with the pursuit of social than financial goals. Creating a "bandwagon effect" is a common and often highly effective strategy for bringing about social change.

There are two obvious forces pushing asset managers toward ESG activism. One is the personal beliefs of their top executives that climate change is a massive threat requiring a massive societal response. These executives, of course, have every right to use their personal time and resources to advocate for just such a response, but not to enlist other people's money in the effort. In a democracy, climate policy should be determined at the ballot box, not on the corporate proxy card.

The second force is the desire to avoid confrontation. Asset managers face pressure from politicians, activists, social peers, and increasingly their own employees to show that they are on the "right side" of social issues. We suspect that some asset managers have joined the ESG bandwagon while privately harboring substantial doubts that it is either good policy or good investment strategy.

If we are right that institutional investors' enthusiasm for ESG investing is not simply a matter of risk and return, then mandatory ESG disclosures are likely to undermine the SEC's core regulatory objectives. One of the agency's primary functions is to protect Main Street investors from conflicts of interest affecting those responsible for managing their money. Mandated ESG disclosures promise to exacerbate rather than alleviate these conflicts.

Mandated ESG disclosures may also subvert the SEC's mission of protecting retail investors in another, more subtle way. Disclosure requirements that come bundled with substantial political and litigation risk can discourage companies from going (or remaining) public. The result will be to reduce the investible assets available to Main Street investors—although not to high net-worth investors who are eligible under SEC rules to participate in private investment vehicles.

POLICY RECOMMENDATIONS

How, then, should the SEC respond to calls for ESG disclosure mandates? In the short term, the SEC should analyze these proposals using the following metric: what is the financial benefit to households whose retirement, college, and other savings are invested through pension plans, mutual funds, and other investment vehicles? Such analyses will require the SEC to take careful account of the conflicts of interest between money managers and their beneficiaries. That will ensure that the needs of beneficiaries to build wealth and achieve financial security are not compromised.

The SEC should also consider stating explicitly that its mission is investor protection, efficiency, competition, and capital formation, not social welfare writ large. Finally, the SEC might reiterate that its rules require companies to disclose known trends and uncertainties.

In the longer term, the SEC should take seriously the danger that some institutional investors are willing to prioritize their own policy preferences over the interests of their beneficiaries. To address this danger, the SEC might consider requiring mutual funds to pass through voting rights to their shareholders. It might also consider repealing Regulation 14A and replacing it with simple anti-fraud and disclosure rules, thus returning the substantive regulation of proxy voting to the individual states. A state that wished to encourage companies to make their annual meeting a forum to vote on shareholder proposals designed to advance public policy goals could do so, while other states might choose to be more restrictive.

The most intractable policy issue involves public pension funds, the largest of which are among the country's most important asset managers and the most likely to prioritize politics over returns. Typically, at least some of their trustees are politically appointed. They mostly oversee defined-benefit plans in which the beneficiaries' entitlements are not tied to investment returns. Those beneficiaries are largely a captive audience that cannot easily move their retirement savings elsewhere. In short, the trustees face weak market discipline but are subject to strong political forces. As Yale Law School professor Roberta Romano has observed, the misalignment of interests between public pension fund trustees and their beneficiaries is likely insoluble absent a move away from defined-benefit to (portable) defined-contribution plans—a move that states may consider as pension costs rise.

CONCLUSION

The SEC faces a stark choice. On the one hand, the agency may continue to follow its longstanding practice of focusing on material risks when crafting disclosure requirements, with special attention on protecting "Main Street" investors from agency costs. That approach has served investors and the economy well for almost a century. It has also been essential to achieving the SEC's enviable reputation as an even-handed and highly competent regulator of the capital markets.

Alternatively, the SEC may opt to modify its disclosure emphasis from materiality to a set of ever-shifting criteria designed to further emotionally appealing nonfinancial objectives. This approach would take the SEC into potentially treacherous territory. It carries the risk that the agency will be seen as doing the bidding of asset management executives and political activists who aim to promote their partisan preferences while sidestepping the transparency and compromises inherent in normal substantive policymaking processes. Fairly or not, if the SEC opts to change course, it may lead both ordinary investors and the broader public to conclude that the SEC caters to Wall Street rather than Main Street. *R*