



The SEC Should Write Its Own Environmental, Social, and Governance Rules

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Introduction and Summary

Investors, other market participants, and the public are increasingly pressing companies for information on a broad range of environmental, social, and governance (ESG) issues. Even before the COVID-19 pandemic and the 2020 calls for racial justice and equity, investors in the United States and abroad were pushing companies to disclose how they handle climate change risks, whether they treat their workers fairly, how they promote diversity in hiring and leadership, and much more.¹

In response to these demands, the U.S. Securities and Exchange Commission (SEC) has announced that it will propose rules on climate change disclosure, workforce disclosures, and corporate board diversity, among others.² It will likely propose more ESG rules in the future.

This recent movement on ESG rulemaking comes after more than a decade in which various private sector initiatives have sought to develop frameworks for disclosure on climate risk and other ESG matters. These voluntary frameworks and related initiatives, which are described in earlier Center for American Progress reports,³ provide a wealth of different ideas for how to structure disclosure standards.

However, these frameworks also raise significant challenges for those who may seek to benefit from disclosures. As an initial matter, these standards are currently voluntary, which has led to varying degrees of compliance by corporate issuers. Second, both issuers and investors have been frustrated by the proliferation of voluntary disclosure standards, which differ in significant ways. Third, many of the standards still do not call for the information investors and other market participants seek.⁴

This report discusses the uncertainties inherent in delegating ESG standard-setting authority to third parties and recommends that the SEC craft and propose ESG-related rules on its own, rather than relying on a third-party standard-setter, even one ostensibly modeled after the existing third-party financial accounting standard-setter in the United States, the Financial Accounting Standards Board (FASB). SEC-required disclosures can and should be complemented by third-party frameworks for additional information that the SEC does not yet require. There are many advantages to this approach, which would not only reduce legal uncertainties but also likely be at least as efficient as using an existing outside framework, as well as enable adequate comment from investors, other market participants, and the public. Moreover, it would allow the SEC to proceed carefully on the most important rules, adding others only when and to the extent necessary based on the needs of investors and other market participants.

The most efficient and effective way to ensure that investors have the ESG information they seek is for the SEC to write its own ESG disclosure rules. Doing so would allow the SEC to avoid the potential legal, policy, and administrative risks of delegating that authority to a third party.

Background on ESG disclosures

In recent years, a group of the world's largest companies under the umbrella of the World Economic Forum developed a core set of metrics and disclosures drawing from some of the leading frameworks, including the Sustainability Accounting Standards Board—now part of the Value Reporting Foundation—and the Global Reporting Initiative.⁵ Meanwhile, the International Financial Reporting Standards Foundation, which oversees international financial accounting standards, is setting up a Sustainability Standards Board next to its more traditional financial rulemaking body, the International Accounting Standards Board (IASB).⁶ The IASB administers the International Financial

Reporting Standards (IFRS) followed by most of the world.⁷ The United States follows its own accounting standards, known as generally accepted accounting principles (GAAP), which the FASB administers.⁸

Unfortunately, despite years of negotiations and efforts by investors with tens of trillions of dollars in assets,⁹ companies do not generally disclose all the ESG information investors and other market participants seek, much less in reliable, consistent, and comparable formats.

The SEC is poised to step in and require companies to disclose reliable, consistent, comparable, and decision-useful ESG information. On March 15, 2021, SEC Commissioner Allison Herren Lee, then acting chair of the commission, requested information from the public on how the SEC should best go about adopting new ESG disclosure requirements.¹⁰ Among many other matters, she specifically sought information on whether and how the SEC might best use third-party standard-setters.¹¹

The SEC received hundreds of comment letters, some of which expressed a desire to have it use an existing third-party standard-setter. Among the latter, three general approaches emerge. They range from full delegation of standard-setting responsibility to incorporating third-party rules by reference. All three approaches pose significant legal, policy, or administrative risks.

Many companies and their allies—some of whom acknowledge problems with the current state of ESG disclosure—have expressed the desire to have the SEC use an existing third-party standard-setter specifically on the grounds that the extreme urgency of the issues means “[t]here isn’t time available to reinvent these wheels, nor the necessity to do so.”¹² However, the perceived benefits of using a third-party entity should be analyzed and balanced against the potential risks. Before doing this, it helps to consider how delegation to a third-party entity might be structured.

Approaches to delegating ESG matters to a third party

In comments to the SEC, many interested parties have expressed the view that the SEC should look to outside entities for its ESG standards. The variations on using third-party standard-setters can be categorized into three basic approaches.

Full delegation

The first would involve a full delegation of standard-setting authority to an outside standard-setter.¹³ Those who support this approach point to the existing structure of the FASB, which oversees financial accounting standards, as a model. Proponents see this as a mirror of the IFRS' International Sustainability Standards Board, which is expected to operate next to the IASB, its financial accounting standard-setter.

Hybrid approach

The second general approach for creating ESG standards would be for the SEC to designate compliance with one or more third-party standards as sufficient to meet its obligations. Under this approach, the SEC would develop “core” standards and “general principles” for all issuers,¹⁴ while simultaneously empowering one or more third-party standard-setters to provide more detailed, industry-specific guidance.¹⁵ Compliance with any such standards would then be accepted as adequate unless and until the SEC were to withdraw its recognition. Although this option would provide the SEC some control over the direction and details of ESG standards, it includes a more formal role for private sector standards than the third option below, albeit well short of full delegation to an independent standard-setter.

This hybrid approach is sometimes referred to as the “COSO model,” as it follows the approach that the SEC used when it adopted rules for internal controls over financial reporting. The SEC required corporate managers to use a “suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment” as a way to “evaluate the company’s internal control over financial reporting.”¹⁶ In releasing its rules, the SEC explicitly recognized the control framework of the Committee of Sponsoring Organizations of the Treadway Commission (COSO)¹⁷ as one that satisfied the regulatory criteria, but it left the door open that others may qualify as well.¹⁸

Because this hybrid approach retains SEC responsibility for setting disclosure requirements and determining which standards to recognize as satisfying those requirements, it avoids some of the most significant objections to outright delegation of standard-setting authority. First, the SEC would have to adopt any disclosure requirements through a notice-and-comment rulemaking, which would require robust legal and economic analysis and an opportunity for all interested parties to weigh in. In theory, the hybrid approach poses fewer legal and operational challenges than delegating authority to a standard-setter outright, while still enabling the SEC to rely on a standard-setter’s work.¹⁹

Incorporation by reference (IBR)

The third option for developing ESG standards is for the SEC to undertake incorporation by reference (IBR) of one or more specific third-party standards into its own regulations. The IBR model is commonly used across the federal government to formally incorporate third-party standards into federal rules.²⁰ It is a well-known policymaking method that “allows agencies to comply with the requirement of publishing rules in the Federal Register . . . by referring to material published elsewhere,”²¹ and it would allow the SEC to adopt through the notice-and-comment process the standards promulgated by a third party as its own regulations.²² Essentially, it would be a workaround to some of the legal issues raised in the prior two options, while still permitting a third party to set the standards.

Understanding these three basic ways that some commenters have proposed for the SEC to delegate its ESG disclosure authority helps clarify the potential risks of delegation and underscores why the commission should write its own rules.

Legal pitfalls of agency delegation

A key concern for any agency in establishing new rules is that those rules may be subject to legal challenge, which could delay implementation of the rules or even overturn them. Although the above approaches for delegating all or part of the U.S. Securities and Exchange Commission’s authority to promulgate rules establishing standards of corporate disclosure on environmental, social, and governance matters could potentially be accomplished legally, all three also could be subject to legal challenge.

The SEC should retain decision-making authority

While the Constitution gives Congress the authority to regulate commerce,²³ Congress may delegate some of its authority to an administrative agency within limitations. In the 1930s, Congress created the SEC and gave it the authority to oversee the capital markets in order to protect investors and the public—a key concern of Congress in the wake of the stock market crash and the economic devastation that followed.²⁴ The new agency was given broad powers to ensure that investors and the public have a full and fair understanding of securities sold to the public.²⁵

The SEC’s administrative authority, as delegated to it by Congress, includes the ability to require companies to disclose information in furtherance of the agency’s mission of protecting investors and the public. The SEC is not legally

precluded from seeking help from a private third-party entity in establishing standards regarding what and how items should be disclosed,²⁶ but there are potential legal risks in how it does so. In *United States Telecom Association v. Federal Communications Commission*, the leading case on this topic, the U.S. Court of Appeals for the D.C. Circuit established a useful framework for assessing whether agency reliance on an outside party is appropriate.²⁷ As one commentator observed, the decision “imposed order and coherence on what had seemed like doctrinal chaos,” and did so by “articulating a framework that allows the sorting of cases into different categories.”²⁸

The court’s decision in *United States Telecom* invalidated the Federal Communications Commission’s (FCC) practice of delegating “impairment determinations”²⁹ to state communications commissions, which the agency deemed better positioned, as local regulators, to make more nuanced and granular assessments and decisions.³⁰ In striking down this delegation, the court distinguished between delegating decision-making authority to subordinate agencies and delegating decision-making authority to outside parties.³¹

The court observed that there is a presumption of validity that applies to delegation of authority to a subordinate official or agency, but that presumption does not extend to delegation to outside parties.³² As such, “while federal agency officials may []delegate their decision-making authority to subordinates absent evidence of contrary congressional intent, *they may not subdelegate to outside entities—private or sovereign—absent affirmative evidence of authority to do so.*”³³ (emphasis added)

The reasoning the court provided helps explain this distinction between delegating to subordinates and delegating to outside entities: “When an agency delegates authority to its subordinate, responsibility—and thus accountability—clearly remain with the federal agency. But when an agency delegates power to outside parties, lines of accountability may blur, undermining an important democratic check on government decision-making.”³⁴ Furthermore, outside entities that do not report to agency decision-makers may “not share the agency’s ‘national vision and perspective,’ and thus may pursue goals inconsistent with those of the agency and underlying statutory scheme.”³⁵

The *United States Telecom* decision does, however, leave room for agencies to utilize outside entities in their regulatory schemes. Agencies may, for example, delegate responsibility to outside entities for collecting and providing the agencies “with factual information” for use in decision-making,³⁶ and they may also

allow compliance with an outside entity’s rules to be a “short-cut” for complying with their own—as long as they provide other, agency-created rules sufficient for compliance.³⁷ A federal agency may also “condition its grant of permission on the decision of another entity . . . so long as there is a reasonable connection between the outside entity’s decision and the federal agency’s determination.”³⁸

The court’s holding raises two relevant questions in the context of SEC delegation of ESG standard-setting to third parties. First, does the practice and process of ESG standard-setting constitute agency decision-making? Second, is there affirmative expression in statute of congressional permission to subdelegate the agency’s authority to an outside party? The answers to these questions are not certain and could form the basis for a challenge to third-party ESG standard-setting.

The *United States Telecom* court found that the facts before it amounted to decision-making. As the court observed, the FCC’s order “lets the states make crucial decisions regarding market definition and application of the FCC’s general impairment standard to the specific circumstances of those markets.”³⁹ Thus, in *United States Telecom*, the determinations made by the subordinate agencies that were deemed unlawful clearly demonstrated regulatory decision-making with respect to regulated entities; they were fact-specific adjudications.

It is possible that a future court looking at a third-party ESG standard-setter could determine that certain aspects of its work involved decision-making as to subgroups of regulated entities. In this regard, the industry-specific climate standards that some current outside ESG frameworks establish come to mind.⁴⁰ Indeed, one such standard-setter asserts that it helps businesses “report on the sustainability topics that matter most to their investors,” a determination (what matters most to a business’ investors) that seems core to the commission’s decision-making authority, conflates individual companies’ investors with investors in general, and leaves out the other part of the SEC’s mission—to protect the public.⁴¹

On the other hand, a future court could decide that there is no correlation at all between the facts of *United States Telecom* and those surrounding a third-party ESG standard-setter. Of course, that does not necessarily mean that the latter would not be considered decision-making, as presumably there are other fact patterns that a court would consider to be decision-making. Because there is no bright-line guidance on this fact-based determination, the uncertainty about whether a third-party standard-setter’s activities constitute decision-making may be a legal pitfall.

An ESG standard-setter arrangement could require affirmative evidence of SEC authority to subdelegate

The makeup of the courts today and the general politicization of agency regulation of companies increase the risk that a future court could find that the SEC's subdelegation of ESG standard-setting to an outside entity is delegation of decision-making. If so, the court could further find that the delegation is not affirmatively authorized by Congress.

Thus, in the event that a future court did determine that an ESG standard-setter's work was decision-making, the SEC may be required to establish affirmative evidence of its authority to make such a subdelegation of its duties.

Although parallels have been drawn between potential delegation of ESG standard-setting to a third party and delegation of financial accounting standards to the Financial Accounting Standards Board, the Sarbanes-Oxley Act provided explicit statutory authority for the SEC to delegate financial accounting standards to an outside entity such as the FASB.⁴² A future court could find that the FASB structure is only permissible because Sarbanes-Oxley expressly allowed the SEC to subdelegate financial accounting standards to a third-party standard-setter.

The SEC should retain final reviewing authority

Recent judicial trends, particularly in the context of a now solidly conservative Supreme Court, may present growing risks to public-private structures such as the FASB, which have been instrumental to securities market regulation. The SEC currently relies upon dozens of private entities that it has empowered with some governmental functions. These are commonly referred to as self-regulatory organizations (SROs).⁴³ According to law professor Benjamin Edwards, "Even though SROs have operated with federal statutory authority since 1934, they remain vulnerable to constitutional challenges. Now, converging lines of judicial decisions have created uncertainty about whether the Supreme Court will declare existing SRO structures unconstitutional."⁴⁴

In addition to these potential challenges to a broad delegation of agency duties, there are also a handful of cases that have closely examined more narrow administrative delegation, with varying results and caveats. For example, a 2017 decision of the U.S. Court of Appeals for the D.C. Circuit, *Louisiana Public Service Commission v. Federal Energy Regulatory Commission*, found no unlawful delegation where the agency in question retained final "review authority" over the delegated activity, which involved subdelegation of wholesale ratemaking to a state regulator.⁴⁵ In that case, the subdelegated activity,

while considered decision-making, was only one part of the decision-making process, with the ultimate authority to accept or deny the subdelegated decision remaining with the agency. A future court reviewing a third-party ESG standard-setting arrangement might question the sufficiency of any final reviewing authority, presenting yet another legal pitfall.

Policy and administrative issues of agency delegation

Supporters of having third parties, rather than the SEC, develop ESG standards argue that the SEC's broad mandate and limited resources would inhibit its ability to write standards quickly and that better-funded, nongovernmental entities would be able to utilize specialized and expensive expertise and could move quickly.⁴⁶ However, these purported benefits are actually detrimental to the development of ESG standards. Relying on a third-party standard-setter can lead to policy concerns, such as the potential for bias due to the manner in which the entity is funded; or to administrative concerns, such as whether there is sufficient opportunity for comment on proposed rules or whether the third-party structure is actually more flexible, faster, or more efficient than the alternative of the SEC writing its own standards.

Having the SEC delegate to a third-party standard-setter could give rise to the significant risk that the third party would not develop appropriate policy. On the one hand, some worry that third-party standard-setters could essentially ask for “too much,” burdening issuers with making costly disclosures of potentially limited utility. Corporate issuers and their advocates have expressed concerns that third-party standard-setters may be unduly “swayed by various environmental, social, and political agendas”⁴⁷ or “not insulated enough from stakeholder and other policy agendas and may not satisfactorily incorporate practitioner input into new standards.”⁴⁸ Conversely, investors and other stakeholders have expressed concerns that third-party standard-setters may not develop, implement, and ensure compliance with standards that provide them with the reliable, consistent, comparable, decision-useful information that they seek.⁴⁹

There are several reasons to be wary of getting the appropriate policy from a third-party standard-setter. First and foremost, the governance and funding structure of the third party may result in a structural bias that risks insufficient action or results in action contrary to the interests of investors and the public. If the standard-setter is controlled by a board that is not broadly representative of the various stakeholder groups and is biased in favor of, say, issuers over investors,

or if board members are not free from conflicts of interest, they are likely to draft disclosure standards that are insufficient for investors or lack objectivity and a purported public-interest focus. Furthermore, having a standard-setter be funded in a manner that biases it would similarly result in insufficient ESG standards.⁵⁰

Compounding the problem, this funding concern cannot be addressed in the absence of legislation to establish a support fee to fund the standard-setter.⁵¹ That poses a potential challenge for the SEC, as it makes it more difficult to ensure the independence that many consider essential to the credibility and reliability of the standard-setting process. That, in turn, calls into question one of the advantages sometimes attributed to a third-party standard-setter: that it would be better funded than the SEC to fulfill this responsibility.⁵²

Even with governance rules and appropriate funding in place, a recent review of the SEC's reliance on third parties found that "third parties imbued with governmental functions have historically ended up exercising their powers in ways that either directly benefit themselves, or benefit those whom they are intended to most directly regulate."⁵³ These substantive concerns may be particularly heightened with respect to the existing ESG standard-setters, in part because these historically voluntary standard-setters have had to win support for their standards from companies, and "the existing voluntary frameworks have historically tended to be either issuer dominated or, alternatively, enjoyed only modest levels of compliance."⁵⁴ For example, the Consumer Federation of America has noted that although "steps were taken as part of the Sarbanes-Oxley Act to strengthen FASB's funding and governance, the same longstanding complaints about the accounting standard-setting process remain today ... investors continue to voice concerns that the board is both slow and dominated by auditors and corporate finance executives, who hold a majority of seats on the board."⁵⁵

An additional concern is that the third-party standard-setter may not appropriately allow for notice and comment on proposed standards. The notice-and-comment process allows members of the public to engage the policymaking body and express their preferences and concerns. Were the SEC to draft standards, it would have to go through this process, but it is possible that a third-party standard-setter would not.

The FASB model has many weaknesses

Full delegation of ESG standard-setting by the SEC to an outside entity similar to the Financial Accounting Standards Board would be the most far-reaching delegation among the three approaches discussed in this report. As such, it would potentially face the greatest risk under the case law as it has developed to this point.

As currently structured, the FASB meets a higher standard of independent governance, funding, and transparency than many if not most private sector ESG standard-setters. Still, the FASB structure has flaws and offers a precautionary view of following that route, particularly as it relates to expectations of speed, freedom from political interference, and independent governance.

Delay

A key selling point touted by advocates of delegating authority to a private sector standard-setter is that a private body is likely to be quicker than the SEC in developing standards. But a look at the 85-year history of independent financial accounting standard-setting illustrates that is not reliably the case. Throughout that history, a constant refrain has been that the process is glacially slow, to the point that important issues are not addressed in a timely fashion, putting investors and capital markets at risk.

As just one example, at the time Enron imploded in 2001, after having used thousands of special purpose entities (SPEs) to hide the extent of its indebtedness, the FASB had been working for 15 years on accounting standards for consolidation of SPEs without producing a final rule.⁵⁶ It was similarly slow to complete a standard on revenue recognition, even though that was a major factor in financial restatements and enforcement actions. None of the reforms to the standard-setting process adopted along the way—neither creating a full-time board with an expert staff to develop the standards nor securing an independent and reliable funding mechanism—solved that problem. Investors today continue to complain that the FASB is both slow to address important issues and unresponsive to their needs.⁵⁷

Political interference

Because the issue of mandatory ESG disclosures has taken on partisan overtones, there is a legitimate concern among supporters of ESG rulemaking that the rules could be quickly withdrawn or effectively gutted if the political winds change. Many assume that a private sector standard-setter would be less prone than the SEC to political interference. But the history of financial accounting makes clear that this is not necessarily the case. As Sen. Paul Sarbanes (D-MD) so succinctly

put it, “Private interests go hard at FASB and if they do not seem to be getting anywhere, then they go hard at the Congress to get the Congress to go hard at FASB.”⁵⁸ There is no reason to believe an ESG standard-setter would be immune to this sort of pressure. On the contrary, if a new presidential administration or new members of Congress wanted to undo any ESG rules adopted by this administration, they would have plenty of tools for making their influence felt regardless of whether the standards are set in-house at the SEC or through a third-party standard-setter. Perceived political independence is therefore not a sufficient reason for the SEC to delegate standard-setting authority to a third party.

Corporate capture

Advocates of delegating authority to an independent ESG standard-setter suggest that independent governance and funding, robust due process, and appropriate government oversight can help ensure that the standard-setter produces standards that meet investors’ need for accurate, comparable, and decision-useful information.⁵⁹ It is true that robust provisions to ensure the independent governance and funding, as well as SEC oversight, of any such standard-setting body, along with a transparent process that allows an opportunity for all interested parties to weigh in, are absolutely essential to win public trust.

But this independence is likely to be insufficient, especially when a standard-setter has been in the past controlled or captured by industry, as the history of the FASB suggests. The FASB was created by the private sector in the early 1970s and was funded and operated by the Financial Accounting Foundation. Only with the enactment of the Sarbanes-Oxley Act in 2002 did the FASB begin being funded by user fees approved by the SEC. Yet the FASB has struggled to escape its prior biases in its approach, even though its governance and funding are more independent than they were previously. There is no reason to believe that experience with the private sector ESG standard-setters would be any better.

Ultimately, a board that fails to include robust representation for knowledgeable investors is unlikely to produce standards that meet their needs. Meanwhile, none of the existing ESG standard-setters appear to fully meet those criteria of independence and investor participation.⁶⁰ Given apparent limits on the SEC’s authority to create an independent funding mechanism for such a body, it is not clear that a newly created ESG standard-setter would meet them either. The SEC should approach with healthy skepticism suggestions that it should delegate or defer to such an independent ESG standard-setter in developing its ESG rules. The purported benefits are too uncertain, and the potential downsides are too real, to be dismissed lightly.

Other limited-delegation options raise similar concerns

Other limited delegation approaches—such as the hybrid and IBR approaches described above—may seem appealing in light of the challenges of standing up a new standard-setting body, but a closer look reveals many of the same problems. In addition, these approaches might not lead to disclosures that are useful to investors.

Hybrid approach

The second approach, in which the SEC establishes high-level standards and principles and identifies third-party standard-setters it approves for meeting those standards, provides the SEC with a ready mechanism, at least in theory, for ensuring that any standards relied on to comply with its rules are developed subject to robust criteria for independence, due process, and transparency, while simultaneously addressing the concern that the SEC lacks the resources and in-house expertise necessary for that task, particularly when it comes to developing industry-specific standards and updating those standards over time.⁶¹

Theoretically, this model would also enable the SEC to piece together the best features of the various voluntary standards. As the International Organization for Standardization stated in a comment letter, “The challenge here is that none of the suggested frameworks address all the elements, and appear to focus mostly on climate, not on the broader environmental concerns that one would address from a systems perspective.”⁶²

But many of the policy concerns expressed under the full-delegation option exist under this option as well. Third-party standard-setters’ governance and funding structures may be inappropriately aligned such that the standards they enact are not appropriate and in the public interest and end up overly benefiting the entities that fund the standard-setter or the entities that draft its standards. Further, the notice-and-comment process may be unavailable.

Even worse, however, because the most likely scenario would be one in which the SEC recognizes or endorses multiple standards to satisfy a particular rule, companies would be able to decide between standards. If the SEC were to adopt this approach, it is far from clear that it would produce the comparable and decision-useful disclosures that investors are demanding. As the Healthy Markets Association has noted, “If multiple third parties develop acceptable standards, then the Commission has not necessarily materially advanced the objective of having reliable or comparable disclosures.”⁶³ The Consumer Federation of America has raised similar concerns, warning that if the SEC were to provide the

same kind of flexibility with regard to ESG disclosures that it does for internal control reporting, it “would not lead to the enhanced disclosure consistency investors are seeking. Instead, this approach could perpetuate investors’ main complaint about the existing voluntary disclosure environment—that it doesn’t result in disclosures that are consistent, comparable, and decision-useful.”⁶⁴

Incorporation by reference

As with the second option, the third approach raises many of the policy concerns expressed under the full-delegation method, including that the governance structure and funding for the third party developing the incorporated standards would bias its decision-making. In addition, practical problems exist that would make an IBR approach to ESG standard-setting even more fraught.

As an initial matter, the law governing IBR does not allow for dynamic updating of incorporated materials. As discussed above, climate and other ESG topics are dynamic issue areas, and disclosure standards are expected to require regular updating as understanding of the issues continues to evolve. Under the Office of the Federal Register’s (OFR) regulations, which govern the publication of all federal regulations, incorporation by reference of dynamic standards is prohibited.⁶⁵ As such, if a third party updated its standards, the SEC would need to go through a new notice-and-comment rulemaking each time changes are made in order to make those changes legally binding.

This process would significantly reduce the supposed resource-saving benefits of delegating standard-setting authority relative to in-house SEC rulemaking and runs directly counter to one of the key arguments offered in favor of delegating authority to a third-party standard-setter. Under IBR, a third-party standard-setter would go through its own process to develop ESG standards, including potentially obtaining input from the public by requesting comment on its proposal. Once the third party’s standard was finalized, the SEC would begin its own notice-and-comment process to draft a regulation directing issuers to comply with the third party’s standards. Because the SEC would be required to evaluate the effects of this new rulemaking by evaluating the appropriateness of all facets of a third party’s standards on issuers, the benefit over having the SEC write standards itself appears extremely limited.⁶⁶ Although a number of commenters have suggested that an SEC-created expert advisory committee could assist in evaluating which standards are in need of updating,⁶⁷ significant time and resources would be necessary to analyze frequent changes, comply with legal requirements, and evaluate the impacts of changes on markets and the public interest.⁶⁸

Finally, there are concerns as to the availability of standards that are incorporated by reference. Under procedures adopted by the OFR, agencies using IBR must secure formal approval from the OFR, and that approval is conditioned on the agency’s making the incorporated material reasonably available to interested parties.⁶⁹ However, reasonable availability does not necessarily mean, for example, free of charge or in the public domain in the way that SEC-issued standards are.

Any advantages of the various approaches to delegation are overcome by the array of legal, policy, and administrative risks and challenges. And those challenges could delay ESG standards or, even worse, lead to standards that fail to meet the needs of investors seeking comparable and consistent information on ESG matters affecting companies’ profitability and long-term resilience.

The best approach is for the SEC to draft ESG rules in-house

In a comment letter to the SEC, members of the Regenerative Crisis Response Committee, joined by banking and finance law professor Nakita Cuttino, stated that, “Regulation of public disclosures is an essential public function that is at the core of the SEC’s responsibilities and, therefore, should not be delegated to private parties whose interests and responsibilities may differ from that of government, particularly in advancing the public good.”⁷⁰ Research shows that private actors exercising government power “systematically evade” baseline values of accountability, transparency, legitimacy, and rational decision-making, in contrast to their federal counterparts.⁷¹ For these reasons, the SEC commissioners—who have been nominated by the president and confirmed by the Senate—should be the individuals making these policy decisions.⁷²

The continuing role of third parties

Although this report recommends that the SEC develop its own ESG standards rather than deferring to nongovernmental entities, there would still be a role for those third parties. They can, for example, develop standards above and beyond those articulated by the SEC that individual entities can adopt to differentiate themselves from their competitors, much as how private self-regulatory organizations have heightened

rules for their members.⁷³ Private standard-setters may also help advance the techniques and science behind standards and develop best practices. Perhaps most importantly, they can advance the ball as they have in the past, pinpointing gaps in existing SEC standards, identifying areas in need of SEC-issued standards, and actively participating in the SEC’s notice-and-comment rulemaking process.

Beyond the democratic accountability that comes from the SEC making standard-setting decisions itself, other benefits exist. An SEC rulemaking would require the agency to put out proposals for public comment and provide a clear presentation of the policy and legal bases for its actions. This would also guarantee all interested parties the opportunity to comment on the proposal. Supporters and opponents of ESG standards would be able to argue their perspectives, with the SEC making the final decisions. Furthermore, with a direct SEC rulemaking, rather than incorporation by reference, only one notice-and-comment process would occur—rather than perhaps two, with the third party asking for comment and then the SEC doing the same.

It is also conceivable that SEC-drafted standards would lead to more coherent regulatory policy beyond the SEC. ESG issues—from climate change and other environmental issues to worker-related matters to diversity and equity concerns—involve underlying policy considerations and taxonomies. The extensive expertise of other government agencies in these areas would be more readily available to the SEC staff than to an outside standard-setter. For example, with workforce disclosures and board diversity, the SEC could work with the Equal Employment Opportunity Commission to ensure consistency with and improvement upon the definitions firms already use for their confidential filings on Form EEO-1. As another example, the U.S. Environmental Protection Agency and the U.S. Department of Energy could offer readily available expertise and data needed for standardizing and updating climate and other environment-related rules. Presumably, if the SEC is in the driver’s seat, coordination of rules across financial regulators would be easier, which is especially important for all-of-government initiatives such as meeting the challenges that climate change poses to the financial system.

Conclusion

Investors, other market participants, and the public are best served by ESG standards that are developed by the SEC staff in consultation with experts in other agencies and with the public. This is what the SEC was intended to do. Even though the Congress of the 1930s would not have foreseen climate change and many other ESG issues, it clearly wanted to protect the public, as well as investors; prevent undue influence by corporations interested in the rules governing them; and encourage transparency so that investors would make sound decisions and the public would be protected from systemic risks to the capital markets.⁷⁴

The lesson gleaned over the decades since the SEC was created is that delegation of its duties to an outside entity is unlikely to help the commission meet its mission. Rather, the SEC should meet the growing investor demand for ESG information by writing its own ESG disclosure standards going forward.

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Endnotes

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- 11 *Ibid.*, question 6.
- 12 Timothy G. Coville, Letter to SEC Chair Gensler, St. John's University, June 15, 2021, available at <https://www.sec.gov/comments/climate-disclosure/ccl12-8918028-245087.pdf>. See also Jessica Ground and Clara Kang, "Comment on Climate Change Disclosures," Harvard Law School Forum on Corporate Governance, October 14, 2021, available at <https://corpgov.law.harvard.edu/2021/10/14/comment-on-climate-change-disclosures/>. For access to all responses to the SEC request, see U.S. Securities and Exchange Commission, "Comments on Climate Change Disclosures," available at <https://www.sec.gov/comments/climate-disclosure/ccl12.htm> (last accessed October 2021).
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- 25 *Ibid.*
- 26 See, for example, Jill Fisch and others, "Comment Letter Re: Public Input Welcomed on Climate Change Disclosures," University of Pennsylvania Law School, June 11, 2021, p. 15, available at <https://www.sec.gov/comments/climate-disclosure/ccl12-8911728-244385.pdf>. (explaining that "Section 19(b) [of the Securities Act] does not preclude the SEC from looking to a privately funded entity to assist with establishing the standards and principles that it seeks to incorporate into new disclosure rules and regulations")
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- 30 The specifics of these determinations are technical and unique to telecommunications infrastructure. For a useful and informative discussion of *United States Telecom v. FCC*, see Matthew C. Stephenson, "When and Why Agencies Must Decide for Themselves: Judge Williams's Restrictive Approach to Administrative Subdelegation," p. 753, et seq.
- 31 *United States Telecom v. FCC*, p. 565.
- 32 *Ibid.* ("... the case law strongly suggests that sub-delegations to outside parties are assumed to be improper absent an affirmative showing of congressional authorization.")
- 33 *Ibid.*, p. 566.
- 34 *Ibid.*, p. 565.
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- 51 Fisch and others, Comment Letter Re: Public Input Welcomed on Climate Change Disclosures, University of Pennsylvania Law School, June 11, 2021, p. 14, available at <https://www.sec.gov/comments/climate-disclosure/cil12-8911728-244385.pdf>.
- 52 See *ibid.*, noting that "a single private sector standard setter operating under SEC oversight with essential due process safeguards for public participation is costly," and the prospect of relying on private funding sources to maintain such a structure is, as illustrated by the FASB's history, less than ideal.
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- 58 Sen. Paul Sarbanes, Hearing before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, February 14, 2002, at p. 117, available at https://books.google.com/books?id=7MMn1VTnx7QC&pg=PA117&pg=PA117&dq=sarbanes+private+go+hard+at+getting+anywhere+hard+at+congress&source=bl&ots=xBPSWAZDPI&sig=ACfU3U0bE91un2Zn4fJ9cncANHNYb8uJkQ&hl=en&sa=X&ved=2ahUKEWUxfCwfw_zAhXumHIEHv4BVMQ6AF6BAGXEA M#v=onepage&q=sarbanes%20private%20go%20hard%20at%20getting%20anywhere%20hard%20at%20congress&f=false. See also Shana Clor-Proell and Brian White, "Congress should leave accounting standards to FASB," *Accounting Today*, May 18, 2020, available at <https://www.accountingtoday.com/opinion/congress-should-leave-accounting-standards-to-fasb>. ("The nature of our political system all but guarantees that Congress's interference in accounting standards will become an unwelcome focus of special interests and lobbyists. Members of Congress will inevitably see accounting standards through the biased lens of partisanship and electoral consequences. The result will be financial reports that no longer reflect economic reality in a neutral manner, leading to deteriorating investor confidence and adverse effects on capital markets.")
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- 65 *Ibid.*, p. 25, citing 1 C.F.R. § 51.5(b); 1 C.F.R. § 51.1(f). ("Incorporation by reference of a publication is limited to the edition of the publication that is approved. Future amendments or revisions of the publication are not included.")
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