Q&A

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Climate, crypto, convergence, conflict

What are the main challenges with achieving a single global definition of ESG for financial products? Is this feasible, and if so, how?

A common global definition of ESG for financial products is neither feasible nor desirable. Key challenges are the breadth of the potential topics covered by the term, the subjective and fickle nature of ESG assessments, and the troubling implications of a single standard. "Environmental," "social," and "governance" are three unrelated topics, each of which includes a potentially unending—and potentially contradictory—set of issues. What qualifies as E today may not next year. An investment that scores well on environmental metrics might be negative from a social perspective and vice versa. Even within the environmental category, efforts to reduce greenhouse gas emissions may directly conflict with biodiversity, water use, and other issues.

How particular activities rank on an ESG scale changes with personal and societal realities, sensibilities, challenges, and opportunities. In a coal-reliant jurisdiction, natural gas might be a significant improvement and thus be deemed green, whereas a country with a vibrant nuclear industry might deem natural gas brown. Matters of great importance to a developed country might be less important to a developing country in which people struggle daily to feed, house, clothe, and educate their families. For the developed country, clean energy might be more important than continued wealth creation, whereas the developing country might prioritize low-cost energy production to alleviate poverty. Legal and technical obstacles stand in the way of universal ESG standards, but there is a more fundamental challenge: does any one source of authority have the right to set the priority scale for everyone everywhere? No one authority can know the facts on the ground in each jurisdiction the standard covers.

Forcing universal definitions on ESG financial products also could have other undesirable consequences. A concentration of capital in ESG assets—particularly if an ESG label comes with favorable capital treatment or other regulatory benefits—might cause systemic instability. And because resources will be diverted from other sectors, society inevitably will miss out on products and services, including perhaps solutions to the environmental and social problems that now seem (to a regulator's mind at least) insurmountable.

What is the US situation regarding ESG corporate transparency and the ESG agenda of the Securities and Exchange Commission ("SEC")?

Legal differences across jurisdictions frustrate attempts to establish global standards. In the United States, for example, the objective of the SEC's disclosure requirements for public companies is to inform investors, not to alter companies' behavior. Similarly, our review of disclosure documents for investment products is not merit- based; we seek only to ensure that investors are getting an accurate picture of their investment. Shifting resources away from or to particular industries is investors' responsibility. Any government intervention in this process is political and thus belongs to Congress.

Questions about whether we have strayed into the political realm have arisen in connection with ESG rulemaking. For example, we proposed last year to require public companies to make an extensive set of climate- related disclosures. Our staff is working through the many difficult issues commenters raised. Whether to include Scope 3 emissions is one such issue, but other challenges include the peculiarity of the financial statement disclosures, the length of the time horizons covered, the uncertainty that characterizes many disclosure items, and the indirect regulation of customers and suppliers. If the rule is adopted, the implementation process will likely require substantial effort, attention, and resources. The SEC's agenda also includes a plan to propose that public companies disclose matters related to human

capital. In accordance with our limited mandate, the SEC should focus both rules on information that is financially material to public company shareholders. It should not seek to meet non- investors' information demands or to change corporate behavior through disclosure.

What are the key challenges to converging SEC climate disclosure standards and those proposed by ISSB and EFRAG?

Many globally active investors and companies hope that the SEC's climate disclosure rule will draw heavily from international standards, such as those proposed by the International Sustainability Standards Board or EFRAG. While regulatory convergence would be convenient for global entities pulled in many different regulatory directions, several obstacles stand in the way. Convergence even in accounting standard-setting, where the objective is clear and universally consistent, has proven to be difficult. Convergence in sustainability standard-setting, which is less precise, more subjective, and often more politically charged, is likely to be even more difficult. Moreover, each time a global standard is adopted or amended, the SEC would have to run it through our notice-and-comment rulemaking process, which would inevitably create departures from the international standard. Also complicating convergence are the different objectives that different standards seek to achieve. SEC standards are rooted in financial materiality to the disclosing entity, whereas international standards increasingly look at both financial materiality and "impact materiality." US law has not adopted this double materiality, and the SEC generally does not have the authority to adopt standards that turn on the materiality of the effects that a company's (and its suppliers' and customers') activities have on the environment or society.

Has the failure of certain cryptoasset service providers and stablecoins and the recent market downturn revealed specific crypto ecosystem fragilities? How are these issues addressed in the US?

2022, with its many notorious failures of well-known people and entities, was a difficult year for crypto. The industry learned some painful lessons, including that centralized crypto entities evince the same problems as centralized entities in other industries. Counterparty risk, poor collateral practices, undisclosed conflicts, unsegregated customer money, and fraud are not new problems and not unique to crypto. True decentralization, and the radical transparency that accompanies it, can solve some of those problems. Government regulation is another possible solution. Europe and other jurisdictions have moved quickly and productively on regulation. The United States, by contrast, has relied more on enforcement actions under existing rules than tailored rules or regulatory guidance. This approach perversely makes it more difficult for regulators, investors, and consumers to distinguish good actors from bad ones. Decentralized projects are likely to face particular challenges as current rules rely heavily on the existence of centralized companies.

To avoid a repeat of 2022, US regulators should engage with the public to design a regulatory framework that facilitates innovation, frustrates bad actors, allows decentralized, open-source technology to do some of the regulatory work, and respects fundamental American principles of free enterprise and efficient markets balanced with investor protection. That framework could include token disclosure requirements, trading platform registration, a path for regulated entities to assist customers in obtaining and managing crypto assets, and encouraging experimental application of the underlying technologies to the traditional securities markets.