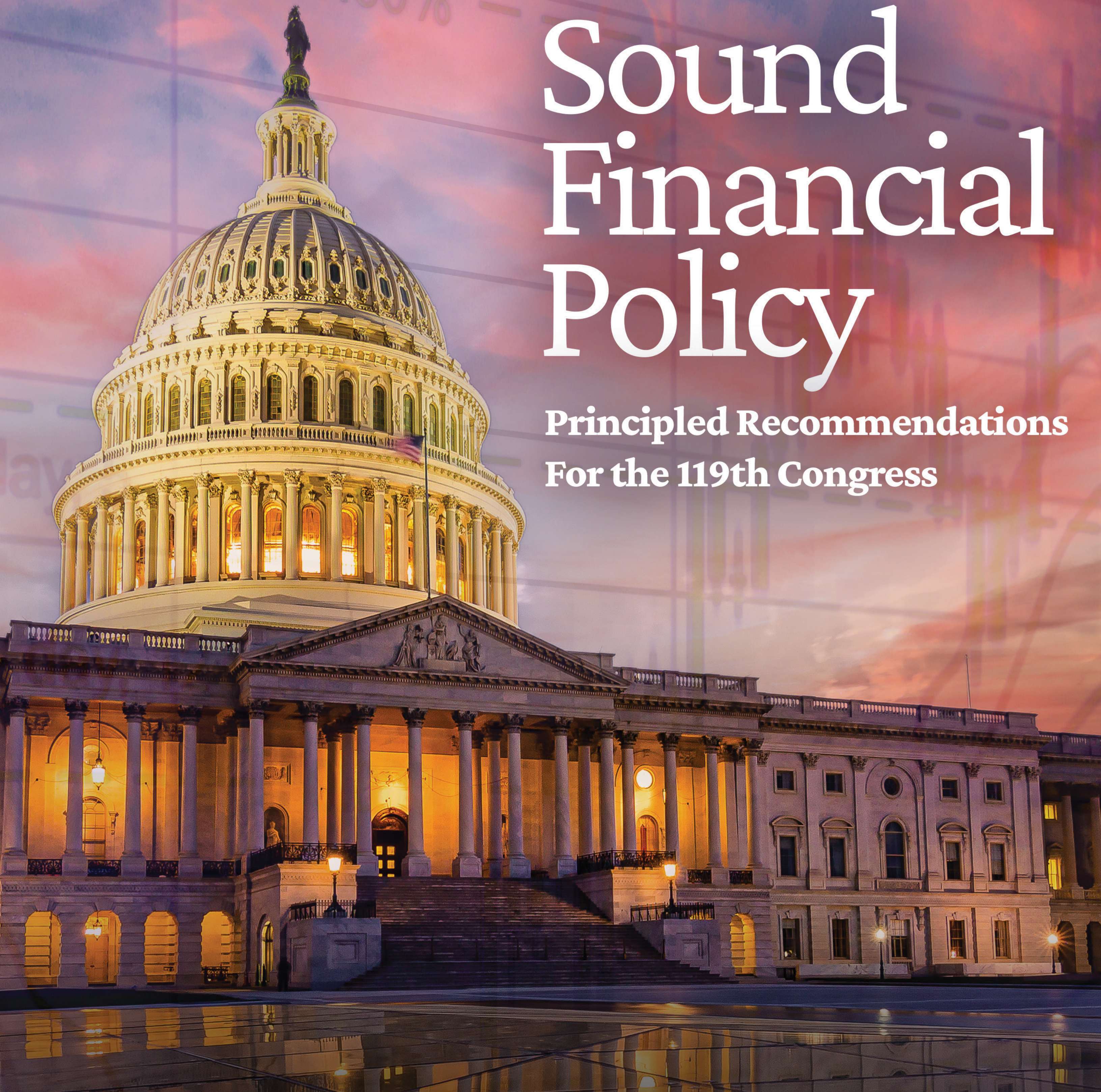
Sound Financial Policy

Principled Recommendations For the 119th Congress



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Section 4: Policymakers' Environmental, Social, and Governance Concerns Should Not Override the Market's Allocation of Resources

The US financial system is the means by which capital resources are allocated. At its most basic, borrowers, lenders, and investors exchange funds to finance projects and pursue a return on their financial assets. The market allocates funds based largely on the returns that the parties to the transactions expect to earn on their investments. In this way, "good" projects—those that provide goods or services that are desirable—get funded, and "bad" projects generally do not. While this process is not perfect, over time the incentives and signals provided by the market generally allocate scarce capital resources efficiently.

The market's allocation of capital resources, however, is threatened by the encroachment of regulations and policies that seek to enshrine environmental or social policy into the financial system's framework. This encroachment not only undermines the efficient allocation of capital and risks undermining growth and innovation, but also represents an abuse by financial regulators who are not tasked by Congress (or voters) to implement environmental or social policy and who lack the necessary expertise to create such policy.

Congress can take action to ensure that financial regulators do not function as central planners, deciding which enterprises are worthy of capital, by clarifying the scope of mandatory securities disclosures. Congress should also consider paring back federal regulators' discretion to deal with issues such as reputational risk and even safety and soundness.

THE PROBLEM

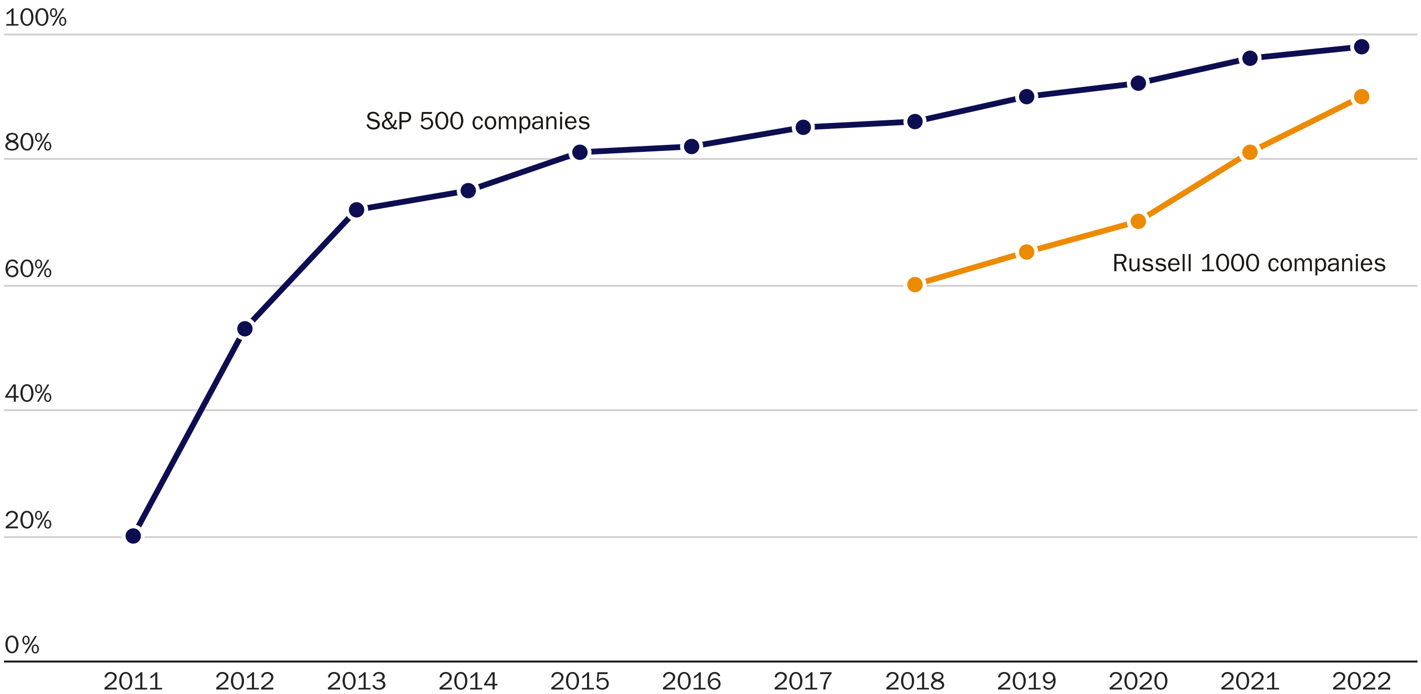
From public company disclosures to the regulation of bank capital, financial regulators have increasingly sought to implement environmental or social policy through the financial system's allocation of capital. Climate change policy was a priority for the Biden administration, which called climate change a "systemic risk to our economy and our financial system," saying that "we must take decisive action to mitigate its impacts."[1] Those actions included Treasury Secretary Janet Yellen's announcement that she would start a climate hub within the Department of the Treasury to coordinate "wide-ranging efforts to fight climate change through economic and tax policies" and "focus on financing for investments needed to reduce carbon emissions."[2] The Securities and Exchange Commission finalized wide-ranging climate-related disclosures for public companies (which have been challenged in federal court) and indicated its intent to prepare proposals on corporate board diversity and human capital management, which may include disclosures related to worker demographics and benefits. These types of regulation can place a drag on the economy by imposing high costs while inappropriately turning financial regulators into universal policymakers.

"Public companies' mandatory disclosures have expanded in recent years, at times serving as vehicles to promote extraneous policy goals."

Take, for instance, public company disclosures, which are meant to provide investors with information about a company's financial prospects. Public companies' mandatory disclosures have expanded in recent years, at times serving as vehicles to promote extraneous policy goals. The Dodd-Frank Act requires companies to report on the origin of certain "conflict minerals" used in their products and to disclose the ratio of the CEO's pay to the company's median

Figure 6

More than 90 percent of S&P 500 and Russell 1000 companies already publish sustainability reports or disclosures



Source: "2023 Sustainability Reporting in Focus," Governance and Accountability Institute Inc., December 2023.

employee. The SEC has already continued this expansion by finalizing climate-related disclosures and, at least under the Biden administration, was poised to continue by considering new mandatory public disclosures for a wide variety of information related to what is called "ESG" investing [environmental, social, and governance], meaning strategies or theories that take into account a company's environmental, social, and governance factors when making an investment decision. Notably, 98 percent of the largest US public companies and 90 percent of companies on the Russell 1000 Index already publish sustainability disclosures without an SEC mandate (see Figure 6).

Disclosures relating to climate change, board and workforce diversity, and corporate political contributions, among other things, stray far from the existing securities regulation framework of providing information relevant to price discovery by market participants. This expansion is problematic. If the SEC's disclosure regime becomes untethered from its price-discovery function, it can be bent to any purpose. Americans should feel secure that any disclosures the government requires are carefully cabined to encompass only information that is directly related to the legislation's initial intent. These disclosures also often have unintended consequences, particularly when the purpose of the disclosure is to drive non-securities-related policy change.

The banking sector similarly suffers when inappropriate policy aims drive the regulation of banks. Precedent already exists for federal officials using bank regulations to allocate credit to further political goals, including to discourage payday lending and to hinder financing for gun dealers. In January 2023, federal banking regulators even warned banks that certain types of crypto-related activities were "highly likely to be inconsistent with safe and sound banking practices," thus making banks less likely to open accounts for digital asset firms.[3] It is entirely plausible that federal officials could soon expand such actions, disadvantaging those firms in industries that disturb certain political sensibilities (such as fossil fuels and nonorganic agriculture).

Many federal agencies can influence bank activities through the federal regulatory framework, potentially imposing climate change–related regulations through the examination process (among other ways), whether citing concerns over capital adequacy, reputational risks, or even systemic risks. Regulators have a great deal of discretion in these cases, and banks have very little recourse. For example, the Federal Deposit Insurance Corporation can terminate a bank's status as an insured depository institution if it finds that the bank has engaged in "unsafe or unsound practices," and the agency alone is responsible for determining what constitutes unsafe or unsound practices. Moreover, when regulators determine that an insured depository institution has engaged in an unsafe or unsound practice, they have the explicit legal authority "to place limitations on the activities or functions of an insured depository institution or any institution-affiliated party."[4] Overall, bank regulators have enormous flexibility to develop regulations for anything that they deem a risk factor, including climate change, and banks have been (and will be) very hesitant to push back against these requirements.[5]

SOLUTIONS

Congress should undertake several reforms to protect the market's allocation of capital from distortion introduced by financial regulation of environmental and social causes.

- **Clarify scope of mandatory securities disclosures.** Although the scope of disclosures under the Securities Act of 1933 and the Securities Exchange Act of 1934 has long been understood to encompass information necessary for investors to value securities—primarily a company's financial performance and information about its business—the heated debate about the SEC's authority to promulgate climate risk disclosures indicates that a clear definition of this scope is necessary. Congress should plainly state that disclosures are limited to the type of information relevant to a company's prospects for financial success, as originally contemplated by the 1933 and 1934 acts, and repeal the sections of the Dodd-Frank Act that direct the SEC to promulgate the conflict minerals and pay-ratio disclosure rules.
- **Exercise strong congressional oversight of the SEC.** Even where the agency may have authority to promulgate rules that touch on environmental and social matters, Congress should exercise active oversight to ensure that the SEC is focusing its limited resources on advancing regulation related to its core mission.
- **Shrink and clarify bank regulators' responsibilities.** Congress should require banking regulators to consider solely economic and financial factors when promulgating regulations, rather than factors that might affect the public's view of a bank, including the bank's so-called reputational risks. More broadly, Congress should reassert its control over financial policy and reduce the regulatory authority and discretion of financial regulators. Repealing Title 1 of the Dodd-Frank Act, thus eliminating the Financial Stability Oversight Council, would be one step in a positive direction. Congress should explicitly prohibit banking regulators from considering social or political objectives, including climate change, in the supervision and examination of banks or credit unions regarding asset ratings, capital adequacy, reputational risk, lending limits, "prudential" standards, and financial stability.

SUGGESTED READINGS

The Eighth Circuit Should Block SEC's Illegal Climate Rule by Thomas A. Berry and Jennifer J. Schulp, *Cato at Liberty* (blog), Cato Institute (June 25, 2024)

SEC Overreach: Examining the Need for Reform, Before the US House of Representatives Committee on Financial Services Subcommittee on Capital Markets, 118th Cong., 2nd Sess. (March 20, 2024) (testimony of Jennifer J. Schulp).

Anti-ESG Legislation Is Demonstrating the Peril of Meddling in Markets by Jennifer J. Schulp, *Pro Market* (June 14, 2023)

"Securities Regulation" in *Cato Handbook for Policymakers*, 9th ed., by Jennifer J. Schulp, Cato Institute (2022)

Using Financial Regulation to Fight Climate Change: A Losing Battle by Norbert J. Michel, David R. Burton, and Nicolas D. Loris, Heritage Foundation Backgrounder no. 3634 (June 24, 2021)