BETTER MARKETS

SEC FACT SHEET

The SEC Must Finalize Its Climate Disclosure Rule, Its ESG Disclosure Rule, and Its Market Structure Reforms

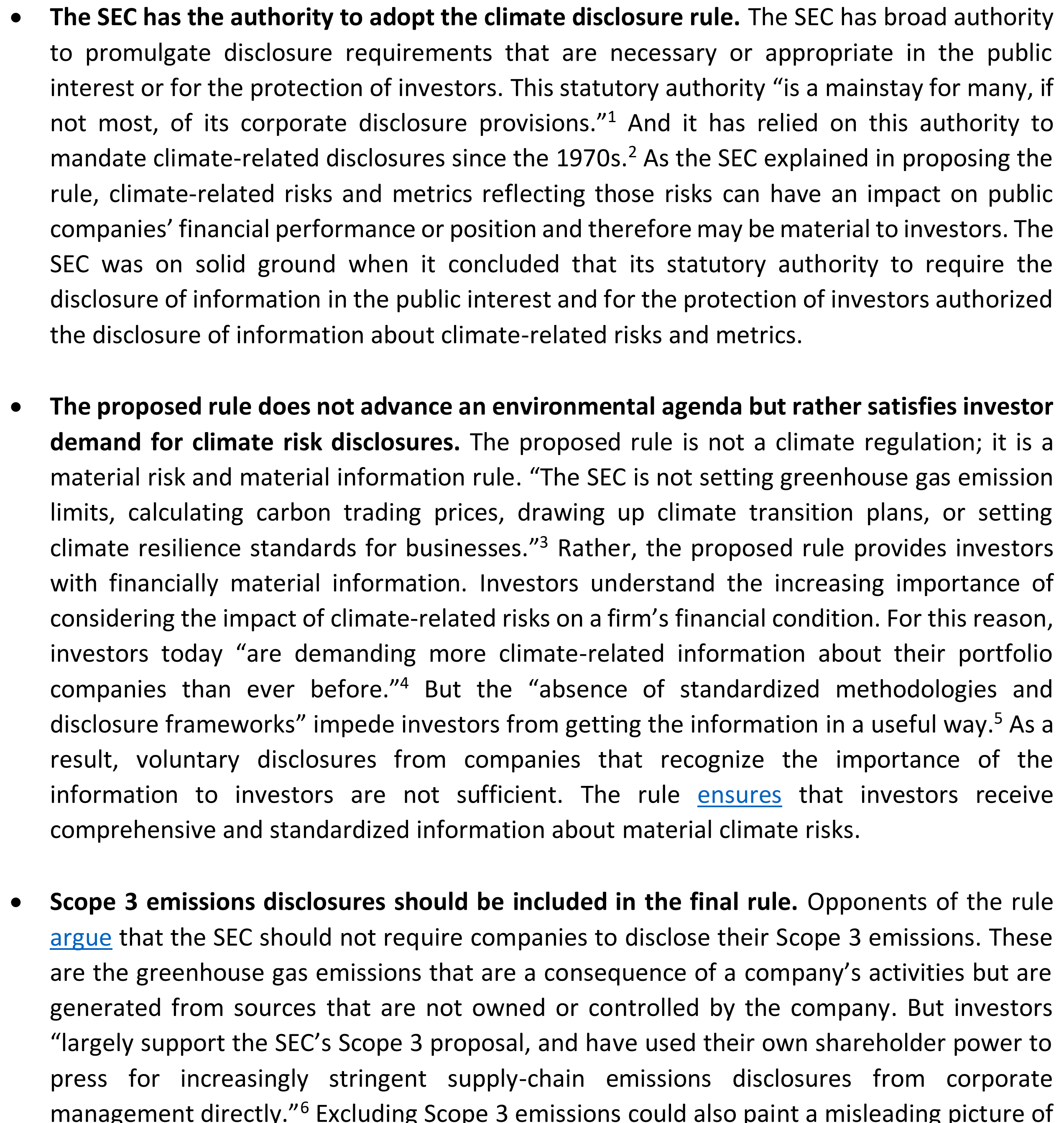
February 21, 2024

Since Chair Gensler was sworn in on April 17, 2021, the SEC has finalized over 30 rules and proposed but not yet finalized more than 25 additional rules. There are also more than 10 rules in the preproposal state on its regulatory agenda. Like many of the rules already finalized, many of the rules that have been proposed but not yet finalized have the potential to significantly benefit investors and the markets as well as facilitate capital formation and fuel the economy. As required by its statutory duties, the SEC has started the year strong with its recent adoption of its Special Purpose Acquisition Vehicles rule, its amendments to the Definition of a Dealer, and its amendments to Form PF. Now it is time for the SEC to focus on finalizing some of its most important pending rules: the Climate Disclosure Rule, its ESG Disclosures for Investment Advisers and Investment Companies rule, and its market structure reform rules.

Why is it so important? While many of the rules that have been proposed but not yet finalized have great potential and importance, these particular reforms are necessary to better protect investors and make the markets fairer and more transparent. They will help ensure that investors receive key information about the climate risks facing the companies they own, that investment funds can't mislead investors with unwarranted hype about their ESG offerings, and that everyday Americans really do get the best prices when brokers execute their securities trades. While we recognize that the SEC must take the time warranted to ensure that the rules fully comply with the law, achieve their intended results, are permissible under the limited economic analysis required, and minimize the risk of unintended consequences, investors and markets are entitled to the many benefits of these rules. Indeed, these rules are why the SEC exists, are core to its mission and mandate, and should be finalized as quickly as possible.

The SEC's Climate Disclosure Rule

In March 2022, the SEC proposed a rule to require that public companies disclose information about the climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition. The required information includes disclosures about a company's greenhouse gas emissions, which are a commonly used metric to assess a company's exposure to climate risks. The SEC should finalize the rule and reject arguments against it: Contrary to those claims, the SEC has ample authority to adopt the rule; the rule is focused on providing investors with material information relevant to their financial decisions, not promoting an environmental agenda; and the information that it would require about a company's greenhouse gas emissions is critically important to investor decision-making.



- **The SEC has the authority to adopt the climate disclosure rule.** The SEC has broad authority to promulgate disclosure requirements that are necessary or appropriate in the public interest or for the protection of investors. This statutory authority "is a mainstay for many, if not most, of its corporate disclosure provisions."[1] And it has relied on this authority to mandate climate-related disclosures since the 1970s.[2] As the SEC explained in proposing the rule, climate-related risks and metrics reflecting those risks can have an impact on public companies' financial performance or position and therefore may be material to investors. The SEC was on solid ground when it concluded that its statutory authority to require the disclosure of information in the public interest and for the protection of investors authorized the disclosure of information about climate-related risks and metrics.

- **The proposed rule does not advance an environmental agenda but rather satisfies investor demand for climate risk disclosures.** The proposed rule is not a climate regulation; it is a material risk and material information rule. "The SEC is not setting greenhouse gas emission limits, calculating carbon trading prices, drawing up climate transition plans, or setting climate resilience standards for businesses."[3] Rather, the proposed rule provides investors with financially material information. Investors understand the increasing importance of considering the impact of climate-related risks on a firm's financial condition. For this reason, investors today "are demanding more climate-related information about their portfolio companies than ever before."[4] But the "absence of standardized methodologies and disclosure frameworks" impede investors from getting the information in a useful way.[5] As a result, voluntary disclosures from companies that recognize the importance of the information to investors are not sufficient. The rule ensures that investors receive comprehensive and standardized information about material climate risks.

- **Scope 3 emissions disclosures should be included in the final rule.** Opponents of the rule argue that the SEC should not require companies to disclose their Scope 3 emissions. These are the greenhouse gas emissions that are a consequence of a company's activities but are generated from sources that are not owned or controlled by the company. But investors "largely support the SEC's Scope 3 proposal, and have used their own shareholder power to press for increasingly stringent supply-chain emissions disclosures from corporate management directly."[6] Excluding Scope 3 emissions could also paint a misleading picture of

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[1] Robert A. Robertson and Kimberley Church, *SEC "Authority" and the "Major Questions" Doctrine*, 17 Va. L. & Bus. Rev. 335, 384 (2023).
[2] *Id.*
[3] George S. Georgiev, *The Market-Essential Role of Corporate Climate Disclosure*, 56 U.C. Davis L. Rev. 2105, 2134 (2023).
[4] Jill E. Fisch, George S. Georgiev, Donna M. Nagy, and Cynthia A. Williams, *Climate Change, West Virginia v. EPA, and the SEC's Distinctive Statutory Mandate*, 47-SUM Admin. & Reg. L. News 9, 10 (2022).
[5] *Id.*
[6] Madison Condon, *What's Scope 3 Good For?*, 56 U.C. Davis L. Rev. 1921, 1924 (2023); *see also id.* at 1941.

the greenhouse gas footprint of a company relative to other companies.[7] So "the SEC should not back down on requiring the disclosure of relevant Scope 3 emissions."[8]

The SEC's ESG Disclosure Rule

In May 2022, the SEC proposed a rule to require investment advisers and investment companies to provide enhanced disclosures about their environmental, social, and governance (ESG) investment practices. The rule would establish a standardized ESG disclosure framework that would create more reliable, consistent, and comparable disclosures for ESG funds based on the extent to which a fund considers ESG factors in its investment selection and issuer engagement processes. Here too, the SEC should finalize the rule and reject arguments in opposition. In reality, the rule will provide material information to investors, is a necessary tool in the fight against "greenwashing," and is designed to benefit all investors, not cater to particular investors.

- **The ESG disclosure rule will provide investors with material information.** Investors need a way to compare the claims that funds make about the role of ESG in their investment strategies because "the claims that funds or firms make about their ESG characteristics have significant financial implications for investors."[9] And the SEC's attempt to provide investors with information about the role of ESG in funds' investment strategies is especially important because it comes "at a time when investor demand for ESG investment products is rising exponentially."[10] In light of the increasing demand for ESG investments, investors need a clear and comparable understanding of the role that the ESG factors play in fund investment strategies so they can make optimal financial judgments and assess the veracity of the claims made by ESG funds.

- **A rule requiring ESG disclosures specifically is necessary to combat greenwashing.** The strong demand for ESG investing "provides a powerful incentive for greenwashing."[11] Greenwashing occurs when investment firms attract investors by misleading them with hype about the environmental or social benefits of their products.[12] The SEC cannot use its existing authorities to adequately prevent greenwashing because currently "there are no SEC disclosure regulations that directly address ESG in a holistic fashion."[13] The SEC needs to mandate that funds disclose the role of ESG in their investment strategies. That will better enable the SEC to act if funds mislead investors.

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[7] *Id.* at 1940.
[8] *Id.* at 1926.
[9] Caleb N. Griffin, *Extrinsic Value*, 75 ALA. L. REV. 423, 467 (2023).
[10] Virgina Harper Ho, *Climate Disclosure Line-Drawing & Securities Regulation*, 56 U.C. DAVIS L. REV. 1875, 1878 (2023).
[11] Jonathan R. Macey, *Fraud in a Land of Plenty*, 118 NW. U. L. REV. 227, 255 (2023).
[12] Dana Brakman Reiser and Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, 41 CARDOZO L. REV. 1921, 1997 n.244 (2020).
[13] Scott Shackelford, Angie Raymond, Martin A. McCrory, and Andrea Bonime-Blanc, *Cyber Silent Spring: Leveraging ESG+T Frameworks and Trustmarks to Better Inform Investors and Consumers About the Sustainability, Cybersecurity, and Privacy of Internet-Connected Devices*, 25 U. PA. J. BUS. L. 505, 529 (2023).

- **The rule benefits all investors.** ESG disclosures are necessary so that investors are able to identify the funds that align with their perspective on the ESG factors.[14] And although "only a subset of investors may seek out ESG funds, a broad group of investors stands to be harmed when funds or firms make misleading or inaccurate disclosures."[15] As a result, even if it were true that institutional investors and international organizations are responsible for the increasing awareness of the importance of the ESG factors, that "does not mean that individual investors do not support mandatory ESG reporting, would not benefit from it, and/or would not be better protected as investors in knowing the information such reporting would make available and possibly accountable to them."[16]

The Market Structure Proposals

In December 2022, the SEC proposed four rules to improve the way securities trades are routed and executed. These proposals include: Regulation Best Execution; Disclosure of Order Execution Information; Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders; and the Order Competition Rule. Taken together, these proposed reforms have the potential to vastly improve the fairness and transparency of the securities markets and ensure that retail investors are not exploited by their brokers and other financial intermediaries. The comment period for these rules ended almost a year ago on March 31, 2023. The SEC should finalize these rules so that retail investors receive the significant benefits that they would confer.

- **Regulation Best Execution.** The SEC should quickly adopt Regulation Best Execution. Broker-dealers should be required to exercise reasonable diligence to obtain the most favorable prices for their customers under prevailing market conditions.

  - The SEC must reject industry arguments that Regulation Best Execution is unnecessary because the broker-run organization known as FINRA already purportedly imposes a duty of best execution on its members. The existence of a FINRA rule provides no basis for the Commission to withdraw or dilute its proposed rule. For example, the FINRA rule is rarely enforced, so the Commission itself needs the full arsenal of enforcement tools at its disposal to ensure that broker-dealers really do provide best execution to their customers and follow their own policies and procedures for doing so.

  - The SEC should also ensure that its Regulation Best Execution is stronger than FINRA's rule. FINRA essentially only requires that broker-dealers periodically assess which order routing practices offer the most favorable terms of execution in the aggregate. A duty of best execution that applies whenever broker-dealers handle customer orders and that requires that they document their compliance on an order-by-order basis is necessary and easily doable in today's marketplace. It would counteract the current practice of

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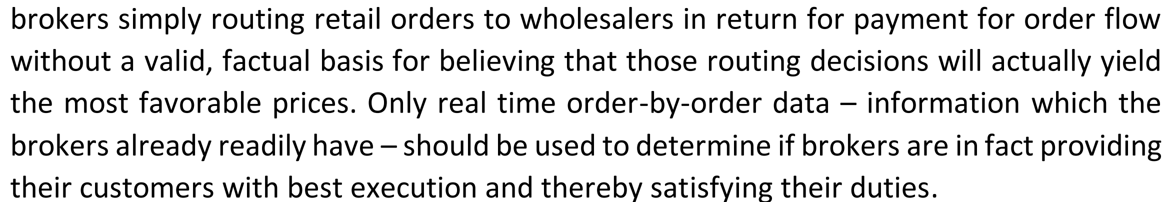
[14] Cathy Hwang and Emily Winston, *The Limits of Corporate Governance*, 47 SEATTLE U. L. REV. 677, 687 (2024).
[15] Griffin, 75 ALA. L. REV. at 468.
[16] Thomas M. Madden and Gerlinde Berger-Walliser, *Making Sense of ESG with the SEC*, 25 U. PA. J. BUS. L. 927, 944 (2023).



brokers simply routing retail orders to wholesalers in return for payment for order flow without a valid, factual basis for believing that those routing decisions will actually yield the most favorable prices. Only real time order-by-order data – information which the brokers already readily have – should be used to determine if brokers are in fact providing their customers with best execution and thereby satisfying their duties.

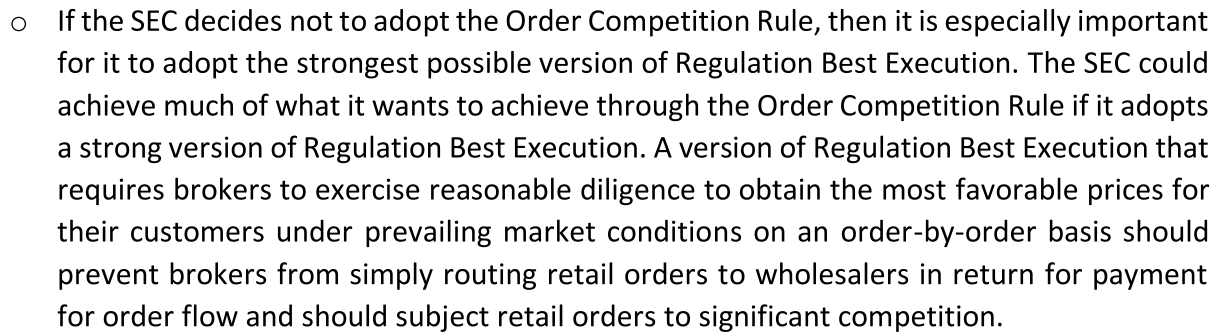
- **Disclosure of Order Execution Information.** This rule would increase transparency by ensuring that additional information is disclosed about how investor orders are executed, thus enabling a better comparison and evaluation of execution quality. Although this rule is relatively uncontroversial, the SEC should reject the argument that it should adopt this rule first and postpone adopting the other market structure rules. The SEC does not need more information about execution quality to know that its other rules will also benefit investors.

- **Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders.** The proposal to lower the minimum pricing increments, or "tick sizes," at which a stock's price can be quoted and traded would benefit investors. The current $0.01 minimum tick size for most stocks prevents traders from quoting the prices that reflect true supply and demand. Lowering the minimum tick size would allow investors to determine the prices at which they would bid or offer without being impeded by a fixed minimum tick size that is too large and that prevents stocks from reaching a natural price that would be within a penny spread.

    - Lowering the minimum tick size by an appropriate amount mitigates the diversion of order flow to over-the-counter market makers who can trade in sub-penny increments. But a minimum tick size of $0.001, as proposed, raises the risk that at each price point there will be less liquidity and less stability in the quotes. Tick sizes should be lowered, but the appropriate amount would be to reduce the minimum tick size to $0.005.

- **Order Competition Rule.** The Order Competition Rule would largely eliminate the harmful effects of payment for order flow by requiring that retail orders be routed first to open auctions. Currently, retail orders are often routed not to exchanges but to "wholesalers" who execute the orders internally at prices that are profitable for those firms but are not optimal for retail investors. The rule would remedy this situation by ensuring that other traders interact with retail orders before they can be executed internally by a wholesaler.

    - The SEC should reject industry arguments that it should withdraw the rule because the rule would represent a drastic overhaul of the way trading with respect to retail orders works. The rule would force retail brokers to provide their customers with more competitive routing and execution by giving all market participants more equal access to retail order flow through auctions. So the rule would reduce or remove the market power, size, and dominance that wholesalers currently exert by routing a large percentage of retail order flow to auctions where they are subject to true order-by-order competition.



- If the SEC decides not to adopt the Order Competition Rule, then it is especially important for it to adopt the strongest possible version of Regulation Best Execution. The SEC could achieve much of what it wants to achieve through the Order Competition Rule if it adopts a strong version of Regulation Best Execution. A version of Regulation Best Execution that requires brokers to exercise reasonable diligence to obtain the most favorable prices for their customers under prevailing market conditions on an order-by-order basis should prevent brokers from simply routing retail orders to wholesalers in return for payment for order flow and should subject retail orders to significant competition.

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