Tow Truck Taxonomies: Remarks before Eurofi

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Thank you for the chance to address you this morning. I particularly appreciate your welcoming me to address environmental, social, andgovernance ("ESG") issues despite my heterodox – some might say heretical – views. You will be happy to know, therefore, that I speak only for myself, and not necessarily for the US Securities and Exchange Commission ("SEC") or my fellow commissioners.

Let me state those views briefly. First, I am concerned that ESG standards, intentionally or not, drive private capital to uses that check the right officially sanctioned ESG box, not where it will best meet human needs and solve societal problems. Second, ESG rulemaking, by concentrating capital in favored assets, could become a source of systemic instability. The third concern, which exacerbates the first two, is the considerable international pressure to converge on a single set of ESG standards. If every jurisdiction directs capital using a single set of standards, poor choices will reverberate through the global economy.

ESG is an ambiguous term, the depths of which I do not have time to plumb.[1] Companies, asset managers, and investors always have considered a wide range of factors in deciding how to spend or invest their money. Some of those factors might today get an ESG label, but we do not need ESG-specific standards to serve investors' needs; materiality-based disclosure standards already do this.

Today's ESG-specific standards too often have a different purpose. These standards cannot help but direct the allocation of private capital, especially when they are combined with sustainable finance initiatives designed to encourage financing of favored activities and the defunding of disfavored activities.[2] Indeed, they appear intended to do exactly this: to direct private capital flows. As such, they are meant not primarily to serve investors' needs but rather to direct the allocation of private capital to further government ends. This objective, and not concerns about consistency or comparability, is what distinguishes voluntary ESG standards, which have been around for many years, from the mandatory standards that we are increasingly rushing to adopt. The parallel, though not identical, standards the United States,[3] the European Union,[4] and the International Sustainability Standards Board ("ISSB")[5] are developing are more ambitious, complicated, and costly than anything we have seen before in the corporate reporting realm.

This commandeering of private capital in the name of ESG causes me grave concerns. To illustrate why I think this sustainability-themed centralized allocation of capital is a bad development, let me tell you a story.

Several months ago, I found myself waiting for a long time by the side of the road for a tow truck. A first tow truck arrived relatively early in the evening, but the driver, mumbling that "This job is impossible!" drove off after looking at the car's severely damaged wheel. Many hours later, after a dark chill had set in, a second truck arrived. This driver pulled up, got out, and quickly and without saying much, assessed the situation. He then calmly set to work by the light of his cellphone. With remarkable skill, alacrity, and precision, he removed the wheel of the car, inspected the considerable extent of the damage, provided an estimate for its repair, lifted the car, and gradually and methodically worked it onto the back of his truck. He was an expert doing a difficult job in uncomfortable circumstances with confidence, meticulousness, and ease. After about fifteen minutes, he was on his way with the car in tow. The driver's skill, deep knowledge of his craft – a knowledge that involved so many disciplines such as math, physics, mechanical skill, technical ability, a bit of psychology, and spatial relations – is a miracle that repeats itself billions of times each day; each person possesses a unique set of talents, interests, skills, and experiences.[6]

Why am I going on about tow-truck drivers? That incident helped me to put my finger on my concerns around current ESG standard-setting efforts. First, that encounter renewed my appreciation for the depth and diversity of human activity and correspondingly underscored the futility of the technocratic effort to use elaborate ESG disclosure standards and taxonomies to classify the full range of human economic activity in an effort to reroute capital to human activities that we regulators favor.

It may sound like I am exaggerating the scope required to make these disclosure standards work, but let us be clear about this: This effort – if undertaken to starve unsustainable activities of capital and flood sustainable activities with capital – necessarily entails understanding and classifying all of economic activity in terms of its effect on an increasing number of complex, sometimes mutually contradictory, metrics. This task is impossible. Even brilliant people in tidy conference rooms far removed from the nitty-gritty complexity of the world (or these days behind screens in their cozy living rooms) cannot accurately label swathes of human activity as categorically positive or negative. Collecting bushels of data to measure the unmeasurable and quantify the unquantifiable is an unreliable basis for deciding where to send capital, even if all these data create the illusion that we understand the world and how humans live and work in it.

As little as standard setters can hope to know about the world as it currently exists, the future remains an even greater enigma. Yes, scientists can help regulators estimate how the climate is changing, technologists can help regulators predict which solutions for mitigating and adapting to these changes look most promising, and economists can advise about the viability of those solutions. But nobody – not even the most capable regulators advised by the most qualified experts – can prophesy where, when, and how the most important innovations will arise. A regulator trying today to drive capital flows toward green technologies might be doing the opposite inadvertently.[7] Solutions to our greatest problems will come – in ways we could never have imagined – from people, many of whom are just now being born and educated. In a fully taxonomized world would these people with truly original ideas be able to access capital? Inflexible taxonomies, updated through the slow political process, are static solutions to dynamic problems like food insecurity, water shortages, educational needs, air pollution, access to medical care, climate change, and many other problems we have not yet seen. A principles-based regulatory framework designed to elicit financially material information about companies will not guarantee that these innovators are funded, but it will not foreclose their access to capital by prejudging the who, what, where, and when of innovation.

Second, ESG taxonomies, built on misplaced confidence in how accurately they capture reality, and the sustainable finance behemoth resting on top of these taxonomies will concentrate capital in ways that could create systemic instability. Past financial crises have taught us that regulatory inducements to invest in particular sectors or in particular ways can harm investors, financial institutions, the financial system, and the broader economy. Leading up to the great financial crisis, for example, policies designed to favor certain asset classes injected dangerous instability into the financial system.[8] As unique as each person is, humans nevertheless sometimes behave like sheep[9] and follow others uncritically into investing fads. Government regulation can exacerbate these trends by distorting incentives.

Moving capital to government-designated sustainable activities could create a green bubble within the financial system as investors pour money uncritically into green assets, as defined in the relevant taxonomy. We already see tell-tale signs of a problem: investors are complaining about the lack of investable assets, and, as we have seen many times before, the search for investable assets may cause them to forgo standard risk management precautions. Asset bubbles always pop, no matter how noble the intentions of those who established the incentives that helped create them. We have no reason to expect that the distorted incentives created by ESG disclosure standards and related policies will produce a different result. And because the herding that created the bubble also likely will lead to the underfunding of activities that could produce real change but that do not fit within our taxonomies, the messy economic aftermath may not even be softened by the consolation that these standards brought us closer to solutions to any of the problems these taxonomies were designed to address.

We could mitigate the risk created by fallible regulators and herd-prone investors by allowing for diversity across jurisdictions. But increasing calls for regulatory convergence threaten diversity in ESG standards, which brings me to my third concern. While I appreciate the difficulty companies and investors face with multiple competing standards, we need to be more specific about what we mean by convergence. If convergence allows for mutual recognition of different approaches – including a US approach to ESG disclosures truly rooted in financial materiality – then it would be a positive development. For example, the world has managed to operate with multiple sets of accounting standards.

If, by contrast, convergence means that every jurisdiction has to implement substantially identical standards, then convergence raises several serious concerns. First, if all jurisdictions use the same standard, the distortion of private capital flows will be more pronounced. Any problems in the taxonomy – favoring harmful activities or disfavoring socially useful activities – will reverberate through the whole world, rather than being confined to a particular jurisdiction. Second, and related, if my systemic concerns are well-founded, a consistent set of ESG standards could exacerbate them by creating a global asset bubble. Third, as the tow-truck driver reminds us, regulators will have a difficult time writing standards that apply equally well everywhere. Global standards could miss important nuances about the physical, legal, social, and cultural environment in which an activity occurs. Finally, achieving convergence by applying standards extraterritorially, would undermine national sovereignty and the rule of law. A jurisdiction that has a set of procedures for adopting new disclosure standards cannot simply delegate the task to a supra-national body, such as the ISSB,[10] or another jurisdiction, such as the EU.[11]

I shared with you the wonder that I have when I see human talent in action. I also am awed by the talent of the people in this room who are devising and implementing complex sustainability regulatory frameworks – the sheer ambition of the projects you are undertaking, your passionate devotion, and your deep knowledge are impressive. But I fear the impossible scale and scope of your undertaking. I do not believe even the most talented taxonomist could capture the full range of skills a tow-truck driver might bring to bear on any particular accident he might encounter where I live in the Washington, DC area. But even if you could, imagine the sheer complexity of attempting to generate a taxonomy of skills that would be accurate for every tow truck driver operating across the globe, from the icy roads of northern Canada to the deserts of North Africa to the rain forests of Southeast Asia. Even an accomplished taxonomist would be humbled by this task and would have to confront the reality that producing a taxonomy for this one profession that was actually useful – and not so general as to be utterly useless – would require years of fieldwork and analysis. Now imagine the same undertaking for every economic activity in every jurisdiction and in every form that it takes place. We do not – and cannot no matter how hard we try – know it all. Thank you for your time this morning.

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[1] For an interesting and nuanced discussion of ESG,*see*Alex Edmans, *Applying Economics – Not Gut Feel – To ESG* (Mar. 16, 2023), https://ssrn.com/abstract=4346646.

[2] *See, e.g.*,*See Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088* at para. 16, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852 (hereinafter, "Regulation (EU) 2020/852") ("A classification of environmentally sustainable economic activities at Union level should enable the development of future Union policies in support of sustainable finance, including Union-wide standards for environmentally sustainable financial products and the eventual establishment of labels that formally recognise compliance with those standards across the Union."). The EU's taxonomy feeds into the design of green bonds and similar products, the classification of investment funds, and the calculation of financial firms' Green Asset Ratios. *See, e.g.*,Sanne Wass, *Bank disclosures reveal limitations of green asset ratio as a comparable metric*, S&P Global Market Intelligence (Jun. 8, 2022), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/bank-disclosures-reveal-limitations-of-green-asset-ratio-as-a-comparable-metric-70544636("The European Banking Authority will require around 150 lenders to publish a so-called green asset ratio, or GAR, from 2024. The ratio is slated as a comparable and harmonized metric showing environmentally sustainable assets as a percentage of lenders' banking books. Banks will follow a common classification system, the EU's taxonomy, to define a 'green' asset."). The EU explained that a "common language and a clear definition of what is 'sustainable' is needed . . . to meet the EU's climate and energy targets for 2030 and reach the objectives of the European green deal, [for which] it is vital that we direct investments towards sustainable projects and activities."European Commission, *EU taxonomy for sustainable activities*, https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en (last visited, Apr. 27, 2023). Sustainable finance lowers the capital costs for activities favored by the government and likely raises capital costs for disfavored activities.*See, e.g.*,Council of the EU, *Sustainable finance: Provisional agreement reached on European green bonds* (Feb. 23, 2023), https://www.consilium.europa.eu/en/press/press-releases/2023/02/28/sustainable-finance-provisional-agreement-reached-on-european-green-bonds/ ("Under the provisional agreement, all proceeds of [EU green bonds] will need to be invested in economic activities that are aligned with the EU taxonomy, provided the sectors concerned are already covered by it. For those sectors not yet covered by the EU taxonomy and for certain very specific activities there will be a flexibility pocket of 15%. This is to ensure the usability of the European green bond standard from the start of its existence. The use and the need for this flexibility pocket will be re-evaluated as Europe's transition towards climate neutrality progresses and with the ever increasing number of attractive and green investment opportunities that are expected to become available in the coming years."). Whether sustainable finance will change behavior as hoped is unclear.*See, e.g.*,Jitendra Aswani and Shivaram Rajgopal, *Rethinking the Value and Emission Implications of Green Bonds* at 6 (Sept. 11, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4215882 (finding that although emissions fall in the first year after issuance of green bonds, "when that time window is expanded, emissions of green bond issuers do not fall after four years following the issuance.").

[3] In the United States, a little over a year ago, the SEC proposed to require public companies to disclose, among other things, their climate-related risks, the governance of those risks, granular greenhouse gas emissions, a number of climate-related financial statement metrics, any climate-related targets and goals, and any transition plan.*See The Enhancement and Standardization of Climate-Related Disclosures for Investors*87 FR 21334 (Apr. 11, 2022),https://www.federalregister.gov/documents/2022/04/11/2022-06342/the-enhancement-and-standardization-of-climate-related-disclosures-for-investors. Congress did not authorize the SEC to direct capital flows, but the SEC's climate proposal would likely have that effect. It departs repeatedly

from a common understanding of financial materiality, and its unusual granularity will serve as a checklist for companies, which will dull their creativity as they respond to regulatory cues, rather than market cues.

[4] For a description of the European "action plan on financing sustainable growth," *see* European Commission, *Renewed sustainable finance strategy and implementation of the action plan on financing sustainable growth*, https://finance.ec.europa.eu/publications/renewed-sustainable-finance-strategy-and-implementation-action-plan-financing-sustainable-growth_en (last visited Apr. 27, 2023). The Europe Union ("EU"), as part of the European Green Deal to reach carbon neutrality by 2050, has taken a number of steps. Pursuant to its Corporate Sustainability Reporting Directive, the European Financial Standards Advisory Group developed twelve European Sustainability Reporting Standards ("ESRS") for adoption by the European Commission. *See* European Commission, *Corporate sustainability reporting*, https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en (last visited, Apr. 27, 2023) ("On 5 January 2023, the Corporate Sustainability Reporting Directive (CSRD) entered into force. This new directive modernises and strengthens the rules concerning the social and environmental information that companies have to report. A broader set of large companies, as well as listed SMEs, will now be required to report on sustainability – approximately 50 000 companies in total."); European Financial Reporting Advisory Group, *Draft European Sustainability Reporting Standards: Cover Letter* (Nov. 22, 2022), https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2F01%2520EFRAG%2527s%2520Cover%2520Letter%2520to%2520the%2520first%2520set%2520of%2520ESRS%252022%252
These standards, which cover a range of topics from climate to biodiversity to workforce, are more expansive and apply more broadly than the Non-Financial Reporting Directive they replace.

In addition, the EU is developing a taxonomy to classify environmentally sustainable economic activities.*See* Regulation (EU) 2020/852 at para. 6 ("In its communication of 8 March 2018, the Commission published its action plan on financing sustainable growth, launching an ambitious and comprehensive strategy on sustainable finance. One of the objectives set out in that action plan is to reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth. The establishment of a unified classification system for sustainable activities is the most important and urgent action envisaged by the action plan. The action plan recognises that the shift of capital flows towards more sustainable activities has to be underpinned by a shared, holistic understanding of the environmental sustainability of activities and investments. As a first step, clear guidance on activities that qualify as contributing to environmental objectives would help inform investors about the investments that fund environmentally sustainable economic activities. Further guidance on activities that contribute to other sustainability objectives, including social objectives, might be developed at a later stage."). For an overview of the taxonomy,*see Frequently Asked Questions about the work of the European Commission and the Technical Expert Group on Sustainable Finance on EU Taxonomy & EU Green Bond Standard*, https://finance.ec.europa.eu/system/files/2021-01/200610-sustainable-finance-teg-taxonomy-green-bond-standard-faq_en.pdf (last visited, Apr. 27, 2023); *see also* Nigel Howorth, et al., *EU Finalises Sustainable Finance Taxonomy: New Obligations for Financial Market Participants and Large Public-Interest Entities*, Clifford Chance (Jan. 2020), https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2020/01/eu-finalises-sustainable-finance-taxonomy.pdf; Vanessa Havard-Williams, *EU Taxonomy Regulation: what does it do and what happens next?* Linklaters (Sept. 22, 2020), https://sustainablefutures.linklaters.com/post/102h1rz/eu-taxonomy-regulation-what-does-it-do-and-what-happens-next. Environmentally sustainable economic activities are activities that "make a substantial contribution to at least one of the EU's climate and environmental objectives, while at the same time not significantly harming any of these objectives and meeting minimum safeguards." European Commission, *EU Taxonomy Navigator*, https://ec.europa.eu/sustainable-finance-taxonomy/ (last visited Apr. 27, 2023). The double materiality approach that is embedded within the EU standards is intended "to provide a long-term incentive to direct financial flows towards environmentally sustainable activities."Frédéric Louis et al., *One More Step Towards Sustainable Finance in the European Union*, WilmerHale (Dec. 17, 2021), https://www.wilmerhale.com/insights/client-alerts/20211217-one-more-step-towards-sustainable-finance-in-the-european-union. *See also* European Commission, *Sustainable finance: Political agreement on Corporate Sustainability Reporting Directive will improve the way firms report sustainability information (Jul. 26, 2022),* https://ec.europa.eu/newsroom/fisma/items/754701/en ("The CSRD incorporates the concept of 'double materiality'. This means that companies have to report not only on how sustainability issues might create financial risks for the company (financial materiality), but also on the company's own impacts on people and the environment (impact materiality).").

[5] The International Sustainability Standards Board ("ISSB") has prepared two sustainability standards which will soon be ready for adoption by jurisdictions across the world, including a standard focused on climate. *See* IFRS, *Climate-related disclosures*, https://www.ifrs.org/projects/work-plan/climate-related-disclosures/ (last visited, Apr. 27, 2023) and IFRS, *General Sustainability-related Disclosures*, https://www.ifrs.org/projects/work-plan/general-sustainability-related-disclosures/ (last visited, Apr. 27, 2023). The ISSB has taken a granular approach that wanders from traditional conceptions of materiality.

[6] For additional examples of skill, talent, and expertise, *see* Mike Rowe, *Dirty Jobs*, https://mikerowe.com/videos/dirty-jobs/ (last visited Apr. 27, 2023); *see also* Greg Morabito, *'Chef's Table' Recap: Magnus Nilsson Created a New Cuisine by Embracing His Homeland* (Sept. 28, 2018), https://www.eater.com/2018/9/28/17267784/chefs-table-magnus-nilsson-recap-season-1-episode-6.

[7] Innovation, for example, coming out of industries that do not qualify as green may be key in carbon reduction. *See, e.g.*, S&P Global, *ESG Insider Podcast* (Mar. 17, 2023), https://www.spglobal.com/esg/podcasts/on-the-ground-at-ceraweek-where-the-energy-world-stands-on-the-low-carbon-transition (David Victor, professor of innovation and public policy at the School of Global Policy and Strategy at UC San Diego in California explained that the oil-and-gas companies "that went off and did the obvious things . . . solar and wind, they're frankly scaling back those plans because those plans don't generate the kinds of returns and don't rely on the kinds of risk management, chemical engineering skills that these firms are really good at doing and petroleum engineering skills. And so what we're seeing is more companies trying to figure out what are we going to do on hydrogen. It's potentially an area where they have a lot of skills. What are we going to do with the carbon capture and storage, downhole activities? It's another area where they have potentially large skills.").

[8] *See, e.g.*, Stephen Matteo Miller, *The Recourse Rule: How Regulatory Capture Gave Rise to the Financial Crisis*, Mercatus Center (Jan. 15, 2019), https://www.mercatus.org/research/policy-briefs/recourse-rule-how-regulatory-capture-gave-rise-financial-crisis ("Well-intentioned regulations can have harmful unintended consequences. The 2007–2009 financial crisis revealed such a possibility for a particular regulation: the so-called Recourse Rule. After that rule reduced bank capital requirements for a narrow class of financial products, including those at the heart of the crisis, some bank holding companies (BHCs)—the legal structure within which many banks operate—increased their holdings of those financial products. The result was damaging to the BHCs that exposed themselves.").

[9] No offense to Shaun the Sustainable Sheep intended.*See* European Commission, *Sustainable Shaun online game* https://ec.europa.eu/environment/sustainableshaun/game_en.htm (last visited, Apr. 27, 2023).

[10] The ISSB, with the assistance of IOSCO and other allies, is conducting a campaign for widespread adoption of its standards.

[11] The EU has adopted a framework that would apply to many companies and company activities outside of the EU. Even companies that do not directly serve European customers may be part of a European company's value chain or a European asset manager's portfolio, which would require them to collect the data required by European standards. The EU could exercise mutual recognition based on financially material standards in other jurisdictions to address this concern.The EU's Sustainability Reporting Standards, which will apply to European subsidiaries and, after several years, to their parent companies outside the EU. Europe has taken an aggressively extraterritorial approach in applying its European Sustainability Reporting Standards,

which will apply to European subsidiaries and, after several years, to their parent companies outside the EU. *See, e.g*, EY*, Think ESG: a view of the EU Taxonomy – The Better Finance Podcast*, (Feb. 20, 2023), https://podcasts.apple.com/us/podcast/think-esg-a-view-of-the-eu-taxonomy/id1251517753?i=1000600690038 (discussing magnitude of the effects on US companies); Paul Kiernan, *SEC Climate Rules Could Decide Whether U.S. Firms Face Tough EU Law*, Wall Street Journal (Apr. 26, 2023), https://www.wsj.com/articles/sec-climate-rules-could-decide-whether-u-s-companies-face-tough-eu-law-6ccd4c83 ("More than 3,000 U.S. companies are expected to have to gather and disclose data on their greenhouse-gas emissions and those of their suppliers and customers under a European Union law passed in 2022."); Sarah Katz and Torben Kulasingam, *Here's how the EU Taxonomy could influence US businesses*, Ramboll (May 11, 2022), https://ramboll.com/ingenuity/heres-how-the-eu-taxonomy-could-influence-us-businesses ("A new research partnership . . . recently evaluated the extent to which large US financial institutions and real estate firms are prepared to comply with [the EU's] ambitious sustainable reporting requirements. The main takeaway . . . is that these firms need more and better data to assess whether their assets meet the definition of sustainability, as outlined by the EU Taxonomy."); Andy Marks, *New EU Sustainability Reporting Rules: How Impacted US Companies Can Prepare,* WSJ Pro (Feb. 1, 2023), https://deloitte.wsj.com/articles/new-eu-sustainability-reporting-rules-how-impacted-us-companies-can-prepare-01675110236?st=mlnfb14is7jr83b&reflink=desktopwebshare_permalink ("The new sustainability reporting requirements will affect not only EU-based companies, but all companies with significant operations in EU jurisdictions, including U.S.-based companies with as little as one subsidiary or branch in the European Union."); Emma Bichet, Jack Eastwood, and Michael Mencher, *EU's New ESG Reporting Rules Will Apply to Many US Issuers*, Harvard Law Forum on Corporate Governance, https://corpgov.law.harvard.edu/2022/11/23/eus-new-esg-reporting-rules-will-apply-to-many-us-issuers/ ("New environmental, social and governance (ESG) reporting requirements in the European Union and the US are set to fundamentally change the nonfinancial reporting landscape. The new EU rules will require ESG reporting on a level never seen before, and will capture a whole host of companies that previously were not subject to mandatory nonfinancial reporting requirements, including public and private non-EU companies that meet certain EU-presence thresholds. For US issuers, the new EU rules will result in mandatory reporting on a broader set of ESG topics than those required under current and proposed Securities and Exchange Commission (SEC) rules.").