ISSUE BRIEF

ESG-related Regulatory Requirements

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It's no secret that ESG has experienced tremendous growth over the past decade. Many companies, consumer products, and investment strategies are now labeled "ESG", "sustainable", or "environmentally friendly". In fact, one in eight dollars of U.S. assets under professional management in 2022 incorporated ESG criteria into investment decision-making.

However, the scrutiny on the "ESG" label began to intensify in 2022. Multiple ESG regulations were proposed or modified around the world to help define ESG criteria and standardize corporate ESG disclosures. While regulators in the United States are working on improved ESG disclosures as well, they are doing so in a much more politicized environment as some Republican policymakers have launched an "anti-ESG" campaign. Though progress is being made on the regulatory front, finalized ESG-related laws in the United States now face a more uphill battle, and as a result, the U.S. markets may have to wait for more standardized definitions, disclosures, and reporting on ESG.

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The ESG Regulatory Landscape in the United States

Biden Administration's Climate Priority, SEC's Proposed Climate Rule; Supreme Court's and Congress' Rules, Actions

In the United States, the Biden administration has made climate transparency and accountability a priority, which has resulted in the proposal of new laws by various financial system regulators in recent years. In March 2022, the SEC proposed rules that would require registered companies to disclose climate-related risks in annual filings. Proposed disclosures include risk management processes of climate risks, how climate-related risks materially impact business, strategy, outlook and financial statements, and how climate-related events and transition activities impact financial statements. The rules would also require registered companies to disclose Scope 1 and Scope 2 greenhouse gas (GHG) emissions, as well as select larger companies to disclose Scope 3 emissions. The proposed rules would be the most comprehensive climate disclosure requirements in the U.S. thus far and, naturally, there has been much pushback.

Two headwinds have delayed the finalized ruling, which is expected in April 2023. In June 2022, the Supreme Court ruled in *West Virginia v. Environmental Protection Agency* that the Environmental Protection Agency is not authorized to regulate power plant emissions. The ruling is significant, as it prevents agencies from bypassing Congress by issuing regulations in order to further an agenda that has major economic or political effects—whether considered good or bad. The second headwind is a result of Congressman Patrick McHenry becoming Chairman of the House Financial Services Committee in late 2022. McHenry has shared plans to probe the SEC's Chair Gary Gensler on the SEC's proposed climate-related disclosure rule; the hearings will not make it easy to finalize the rule by April.

Proposed ESG Disclosures for Investment Advisers & Companies

In 2022, the SEC also proposed an ESG disclosure rule applicable to investment advisers and investment companies. The proposal would require additional disclosures in the prospectus of funds that integrate ESG factors into the investment process. The level of disclosures would be reflective of the level ESG factors that are utilized in the strategy. Investment advisers would be required to provide similar disclosures in their brochures. The proposal includes disclosures addressing proxy voting, corporate engagement, and GHG emissions for environment-focused funds. The proposed rule aims to curb misleading claims relating to ESG investment approaches and to help investors more easily compare ESG processes across strategies.

The DOL Rule: Climate Change May Be Relevant

In a similar climate-as-a-risk vein, the Department of Labor's Employee Retirement Income Security Act ("ERISA") ruling in 2020 stated that plan fiduciaries must make investment decisions based on pecuniary factors

only. This language left investors confused on whether incorporating ESG factors into the investment decision-making process would be in opposition to their fiduciary duty. In an effort to provide greater clarity, the Department of Labor (DOL)issued a rule that more explicitly addressed ESG in November of 2022. The final rule recognizes that climate change and other ESG factors may be relevant to the risk and return analysis and, therefore, may be incorporated into investment decisions as deemed appropriate by the plan fiduciary. Further, under the new rule, plan fiduciaries may consider participants' policy, social, or value preferences.

Federal Reserve Board Draft Principles for Climate-related Risk Management

Another new development on the U.S. ESG regulatory front is the draft *Principles for Climate-Related Financial Risk Management for Large Financial Institutions* proposed by the Federal Reserve Board. Applicable to financial institutions with over $100 billion in assets, the draft principles would require these banks to consider and maintain oversight of climate-related financial risks in their audits and risk management. The principles would also propose the inclusion of climate-related scenario analysis to determine more forward-looking risks. The proposed guidance was drafted in consultation with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), which have similar draft principles in the works. The guidance of all three is expected to be coordinated. The Federal Reserve Board is currently seeking public comments.

Anti-and Pro-ESG Bills at the State Level, Rooted in Political Partisanship

At the state level, there has also been recent ESG-related policy making, largely seeking to further the anti-ESG agenda. In 2022, Florida passed a rule preventing the state's pension fund from considering ESG factors. According to Ceres, nine states saw anti-ESG bills proposed during the first week of this year's legislative session. There are two main types of the anti-ESG bills. One format disallows the consideration of ESG factors in investment decisions. The other is 'boycotting' or 'discrimination against' laws, which mainly target entities refusing to invest in or do business with products or industries such as fossil-fuel, gun, or tobacco companies. Other states, however, have passed 'pro-ESG' legislation, explicitly allowing considering of ESG factors into investment decision-making. Some states such as Maine even promote divestment from fossil fuels. The fact that states with anti-ESG policies tend to be Republican-led, and those with pro-ESG policies tend to be Democrat-led, demonstrates how politicized ESG has become.

Status of ESG Laws in the European Union

Historically, the EU has been a leader in both ESG adoption and ESG regulation. Several initiatives have been implemented in recent years seeking to standardize ESG disclosures. The Sustainable Finance Disclosure Regulation aims to improve transparency and prevent greenwashing by mandating specific disclosures from financial market participants (i.e., asset managers, financial advisers, and so forth) with sustainable investment products and strategies.

In January 2023, the Corporate Sustainability Reporting Directive (CSRD) went into effect and will require roughly 50,000 companies to report on sustainability in alignment with European Sustainability Reporting Standards and the EU Taxonomy. The CSRD builds on previous legislation, and drastically expands the reporting requirements. Under the CSRD, significantly more entities will be required to report on ESG topics, and with greater depth of detail. Possibly the most comprehensive and intricate ESG regulation to date, the CSRD's mandated disclosures include targets and transition plans, sustainability factors across the value chain, and impacts of sustainability factors on the business model and strategy.

Progress Towards Global Sustainability Standards

As countries struggle to reach agreement on sustainability disclosure requirements within their own countries, proposed requirements across the globe also differ. It's difficult to imagine an accepted global framework, but the IFRS Foundation is working on the development of one. The IFRS Foundation, which is the governing body of the International Accounting Standards Board, determines

the accounting rules for financial statements of public companies used by most developed countries. The Foundation established the International Sustainability Standards Board (ISSB) at COP26 with the goal of creating a global baseline of sustainability-related disclosure standards. In 2022, ISSB conducted a consultation period and drafted proposals informed by several existing frameworks, such as Task Force on Climate-Related Financial Disclosures (TCFD). ISSB is currently working towards finalizing two proposed standards: one on climate and another on general sustainability-related disclosures. It remains to be seen the extent to which countries will adopt these standards.

Screenshot source : Auditboard

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