BIDEN ADMINISTRATION ESG ACTIVITY ACCELERATES

Date: 7 June 2021

Policy and Regulatory Alert

By: Daniel F. C. Crowley, Karishma Shah Page, Bruce J. Heiman, William A. Kirk, Lauren M. Flynn, Daniel S. Nuñez Cohen, Michael G. Lee

On 20 May 2021, President Biden announced an Executive Order to help "tackle the climate emergency," a top priority for his Administration.[1] The Executive Order builds upon the Securities and Exchange Commission's (SEC or Commission) on-going efforts to develop a disclosure framework for environmental, social, and governance (ESG) risks, particularly climate change-related financial risk. SEC Commissioner Allison Herren Lee delivered a speech defending the SEC's work shortly after the Executive Order was published. We expect the Commission to issue a proposed rulemaking on climate change-related risk disclosures later this year, as discussed in our previous alert, which is accessible here.

EXECUTIVE ORDER ON CLIMATE-RELATED FINANCIAL RISK

President Biden issued the Executive Order on Climate-related Financial Risk (Order) declaring that the policy of the United States is, among others, to "advance consistent, clear, intelligible, comparable, and accurate disclosure of climate-related financial risk" and "to mitigate that risk and its drivers, while accounting for and addressing disparate impacts on disadvantaged communities and communities of color." Accordingly, the Order directs the National Economic Council and the President's National Climate Adviser to develop a strategy within 120 days to identify, measure, assess, and disclose climate-related financial risks to government programs, assets, and liabilities; identify financing that would help achieve net zero greenhouse gas emissions by 2050; and analyze areas where public/private investments can support such financing while empowering communities of color. The Order further directs the Office of Management and Budget to develop recommendations for integrating climate-related financial risk into federal financial management and reporting, "especially as that risk relates to federal lending programs" and for "enhance[ing] accounting standards for federal financial reporting."

The Order directs the Treasury Secretary, in her role as the Chair of the Financial Stability Oversight Council (FSOC), to work with the other FSOC members to assess climate-related financial risk to the U.S. financial system, share climate-related financial risk data, and issue a report within 180 days addressing the efforts each FSOC member is undertaking to "integrate consideration of climate-related financial risk in their policies and programs." The report will discuss the "necessity of any actions to enhance climate-related disclosures" by regulated entities, updates to supervisory and regulatory policies to incorporate such risks, and recommendations to mitigate such risks. In response, Treasury Secretary Janet Yellen pledged that "FSOC will work with Council members to improve climate-related financial disclosures and other sources of data to better measure potential exposures."

Additionally, the Order directs the Federal Insurance Office and the Office of Financial Research to assess climate-related financial risks. It also requires the Department of Labor to suspend, revise or rescind any rules that would prohibit ERISA plans from considering ESG factors and to issue a report on (1) measures that can be taken to protect pension plans from climate risk and (2) how the Federal Retirement Investment Board is considering ESG factors in its investment decisions. The Department of Labor has previously stated that it will not enforce the “Financial Factors in Selecting Plan Investments” or the “Fiduciary Duties Regarding Proxy Voting and Shareholder Rights” rules. The Order also addresses federal procurement, flood risk management, and underwriting standards by the Departments of Housing and Veterans' Affairs, among other topics.

POTENTIAL DEVELOPMENT OF NEW DISCLOSURE RULES

SEC Chairman Gary Gensler indicated recently that the SEC will “soon” release a notice of proposed rulemaking on climate risk-related disclosures, after the Commission has had time to consider the responses to the currently open public comment period on climate risk disclosures (Climate Change Disclosures RFI). He declined to provide a more specific timeline, but he said the SEC will move “expeditiously” on the proposed rulemaking and will also start to work on human capital disclosures. The SEC staff is currently developing recommendations on human capital disclosures as well as cybersecurity disclosures.

For an indication of how the SEC might approach the proposed rulemaking, it is worth considering SEC Commissioner Allison Herren Lee's speech discussing the “4 myths” of ESG disclosures during the 2021 ESG Disclosure Priorities Event:

- Myth 1: ESG matters material to investors are already required to be disclosed.

She noted that there is “no general requirement under the securities laws to reveal all material information.” Rather, ESG disclosure is “only required when a specific duty to disclose exists.” Since the SEC and federal laws have implemented few explicit climate or other ESG disclosure requirements, ESG disclosure may be “required only when a particular discussion of climate is collateral to something else disclosed by the company.”

- Myth 2: Material ESG disclosures are already being made.

Commissioner Lee argued that a “principles-based standard that broadly requires disclosure of 'material' information presupposes that managers, including their lawyers, accountants, and auditors, will get the materiality determination right. In fact, they often do not,” as evidenced by SEC enforcement cases. In short, she contended that “a disclosure system that lacks sufficient specificity and relies too heavily on a broad-based concept of materiality will fall short of eliciting information material to reasonable investors.”

- Myth 3: SEC disclosure requirements must be strictly limited to material information.

According to Commissioner Lee, the SEC's “statutory rulemaking authority under Section 7 of the Securities Act of 1933 gives the SEC full rulemaking authority to require disclosures in the public interest and for the protection of investors because the authority is not qualified by 'materiality.' Similarly, the provisions for periodic reporting in Sections 12, 13 and 15 of the Securities Exchange Act of 1934 are not qualified by 'materiality.'” She concluded that materiality is relevant to anti-fraud rules, such as Rules 10b-5 and 14a-9, but is not the fundamental prerequisite of any required disclosure. She noted further that Regulation S-K requires some disclosures that may or may not be material to every single issuer.

- Myth 4: Climate and ESG are matters of social and political concern, and are not material to investment or voting.

Commissioner Lee argued that investors are “the arbiters of materiality” and “have been overwhelmingly clear” that climate risk and ESG matters are material. Moreover, she noted that investor interest in science and data is not political and, even if ESG issues have political or social significance, they can still be material to investors.

NEXT STEPS

For more information on the SEC's Climate Change Disclosures RFI, see our previous alert entitled SEC to Move Quickly on Proposed ESG Disclosures. **Comments are due on 15 June 2021.**

To assist our clients in staying abreast of important ESG developments, K&L Gates has established a dedicated ESG webpage to synergize robust ESG services in an integrated, multidisciplinary structure.

FOOTNOTES

[1] https://www.whitehouse.gov/priorities/.

KEY CONTACTS

DANIEL F. C. CROWLEY
PARTNER

WASHINGTON DC
+1.202.778.9447
DAN.CROWLEY@KLGATES.COM

KARISHMA SHAH PAGE
PARTNER

WASHINGTON DC
+1.202.778.9128
KARISHMA.PAGE@KLGATES.COM

BRUCE J. HEIMAN
PARTNER

WASHINGTON DC
+1.202.661.3935
BRUCE.HEIMAN@KLGATES.COM

WILLIAM A. KIRK
PARTNER

WASHINGTON DC
+1.202.661.3814
WILLIAM.KIRK@KLGATES.COM

LAUREN M. FLYNN
GOVERNMENT AFFAIRS ANALYST

WASHINGTON DC
+1.202.778.9051
LAUREN.FLYNN@KLGATES.COM