The Banking Law Journal

Established 1889

An A.S. Pratt™ PUBLICATION

NOVEMBER/DECEMBER 2021

LexisNexis

THE BANKING LAW JOURNAL

VOLUME 138 **NUMBER 10** **November/December 2021**

LexisNexis

QUESTIONS ABOUT THIS PUBLICATION?

For questions about the **Editorial Content** appearing in these volumes or reprint permission, please call:

Matthew T. Burke at .... (800) 252-9257
Email: .... matthew.t.burke@lexisnexis.com
Outside the United States and Canada, please call . . . . (973) 820-2000

For assistance with replacement pages, shipments, billing or other customer service matters, please call:

Customer Services Department at . . . . (800) 833-9844
Outside the United States and Canada, please call . . . . (518) 487-3385
Fax Number . . . . (800) 828-8341
Customer Service Website . . . . http://www.lexisnexis.com/custserv/

For information on other Matthew Bender publications, please call
Your account manager or . . . . (800) 223-1940
Outside the United States and Canada, please call . . . . (937) 247-0293

ISBN: 978-0-7698-7878-2 (print)
ISSN: 0005-5506 (Print)

Cite this publication as:

The Banking Law Journal (LexisNexis A.S. Pratt)

Because the section you are citing may be revised in a later release, you may wish to photocopy or print out the section for convenient future reference.

Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

MATTHEW BENDER

(2021–Pub.4815)

Editor-in-Chief, Editor & Board of Editors

THE BANKING LAW JOURNAL (ISBN 978-0-76987-878-2) (USPS 003-160) is published ten times a year by Matthew Bender & Company, Inc. Periodicals Postage Paid at Washington, D.C., and at additional mailing offices. For customer support, please contact LexisNexis Matthew Bender, 1275 Broadway, Albany, NY 12204 or e-mail Customer.Support@lexisnexis.com. Direct any editorial inquiries and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 26910 Grand Central Parkway, #18R, Floral Park, NY 11005, smeyerowitz@meyerowitzcommunications.com, 631.291.5541. Material for publication is welcomed—articles, decisions, or other items of interest to bankers, officers of financial institutions, and their attorneys.

POSTMASTER: Send address changes to THE BANKING LAW JOURNAL, LexisNexis Matthew Bender, 230 Park Ave, 7th Floor, New York, NY 10169.

POSTMASTER: Send address changes to THE BANKING LAW JOURNAL, A.S. Pratt & Sons, 805 Fifteenth Street, NW, Third Floor, Washington, DC 20005-2207.

ESG and Banking: The Disclosure Debate

Robert C. Azarow, Erik Walsh, Sarah Grey, and Paul Nabhan*

The Securities and Exchange Commission has made a series of public statements and has taken preliminary steps indicating that it likely soon will enhance its climate-related disclosure requirements for all public companies, including financial institutions. The authors of this article discuss the Commission's statements, legislative developments, and current expectations for environmental, social, and governance disclosures for financial institutions.

Over the last several years the market has seen the increase of environmental, social, and governance ("ESG") disclosures by public companies occur in fits and starts in reaction to pressures from a variety of constituents, including some of the largest institutional investors. Until this year, the U.S. Securities and Exchange Commission ("SEC") has taken a cautious approach to developing uniform ESG disclosure requirements.

During 2021, the SEC has made a series of public statements and has taken preliminary steps indicating that it likely soon will enhance its climate-related disclosure requirements for all public companies, including financial institutions, and not just those with the largest carbon footprints that attract the attention of large institutional investors and activist groups. While any new SEC rulemaking concerning climate-related disclosures likely would not take effect until 2022, below we provide recommendations that financial institutions should consider to prepare for a new ESG disclosure regime.

BACKGROUND

The drive for enhanced ESG disclosure has recently been led by some of the largest institutional investors. For example, BlackRock's revised ESG Integration Statement as of May 19, 2021, states: "Our investment conviction is that sustainability and climate-integrated portfolios can provide better risk-adjusted returns to investors over the long-term, and that sustainability-related data provides an increasingly important set of tools to identify unpriced risks and opportunities within portfolios." Fidelity and Vanguard also integrate ESG

* Robert C. Azarow (robert.azarow@arnoldporter.com) is a partner at Arnold & Porter Kaye Scholer LLP, where he heads the firm's Financial Services Transactions practice. Erik Walsh (erik.walsh@arnoldporter.com) is counsel at the firm representing financial institution clients in enforcement, compliance, and regulatory matters. Sarah Grey (sarah.grey@arnoldporter.com) is a senior associate at the firm focusing on environmental matters. Paul Nabhan (paul.nabhan@arnoldporter.com) is a corporate and finance associate at the firm.

factors into their investing and voting policies, which are premised on increased discourse and engagement with the management of the companies in which they invest.

Moreover, the Institutional Shareholder Services 2020 proxy voting guidelines devote a full section to ESG related proposals. With respect to climate change and human capital, Institutional Shareholder Services recommends supporting proposals seeking enhanced disclosure or greater transparency (unless sufficient information is already available) regarding financial, physical or regulatory risks to operations and investments and regarding how a company identifies, measures, and manages such risks.

The SEC's efforts to standardize ESG disclosures commenced in earnest last year. On August 26, 2020, as part of its goal to modernize the description of business, legal proceedings and risk factors sections[1] in registration statements and annual and quarterly reports, the SEC increased the quantitative disclosure threshold for environmental proceedings to which the government is a party. The SEC also required registrants to address the material effects of compliance with environmental laws and describe their human capital resources to the extent material to an understanding of the business. The purpose of framing these revised disclosure requirements in a general manner was to allow registrants to craft their own disclosures based on their determinations of what is material to their businesses, a tacit acknowledgement of the difficulty in creating a uniform standard that is also industry agnostic. It would appear, however, that the SEC is now moving in a different direction consistent with the stated priorities of the Biden Administration.

Before Gary Gensler was officially sworn in as SEC Chair, then-Acting Chair Allison Herren Lee, on March 15, 2021, solicited public input from investors, registrants, and other market participants on climate-related disclosures. Noting that the last time the SEC examined climate change disclosures was in 2010, then-Acting Chair Lee observed that since then investor demand for ESG disclosures had grown dramatically and that by 2020 both the SEC Investor Advisory Committee and the SEC Asset Management Committee recommended that the SEC start to update reporting requirements to include disclosures related to ESG risks. The comment period ended on June 13, 2021, and the SEC reported receiving over 500 letters in response.

On June 11, 2021, the SEC announced its Spring 2021 Unified Agenda of Regulatory and Deregulatory Actions. Among other proposals, the SEC included the following ESG-related topics as being in the Proposed Rule Stage:

[1] https://www.sec.gov/rules/final/2020/33-10825.pdf.

- Climate Change Disclosure (October 2021);[2]
- Corporate Board Diversity (October 2021);[3]
- Human Capital Management Disclosure (October 2021);[4] and
- Rules Related to Investment Companies and Investment Advisers to Address Matters Relating to Environmental, Social and Governance Factors (April 2022).[5]

Hence, registrants had been expecting the SEC to propose rules for ESG disclosures as soon as October 2021, while investment companies and investment advisers are expecting proposed rules relating to ESG factors as soon as April 2022. However, dates identified in regulators' agendas often slip for a variety of reasons, including competing regulatory priorities and lengthy pre-proposal development (which seems likely here, particularly on a climate change disclosure proposal).

WHERE THE SEC MAY BE HEADED

Recent speeches by SEC Commissioners Lee and Elad Roisman highlight some of the key elements of disclosure likely under consideration by the staff, as well as their personal priorities in this area. On May 24, 2021, Commissioner Lee outlined[6] what she deemed the "myths and misconceptions about 'materiality'" with respect to ESG disclosures. Her key takeaways were:

(1) "There is no general requirement under the securities laws to reveal all material information . . . disclosure is only required when a specific duty to disclose exists," meaning that, under the current disclosure regime, ESG information important to a reasonable investor may not necessarily be disclosed;

(2) Even when a duty to disclose exists, a standard that broadly requires the disclosure of "material" information assumes that management will assess materiality correctly, but they often do not, suggesting that a requirement lacking sufficient specificity will fall short of eliciting such material information;

(3) Under Section 7 of the Securities Act of 1933, the SEC has full

[2] https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202104&RIN=3235-AM87.

[3] https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202104&RIN=3235-AL91.

[4] https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202104&RIN=3235-AM88.

[5] https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202104&RIN=3235-AM96.

[6] https://www.sec.gov/news/speech/lee-living-material-world-052421.

rulemaking authority to require any disclosures in the public interest and for the protection of investors, not merely material disclosures; and

(4) The fact that an issue may be a social or political concern does not foreclose it from also being material.

On June 22, 2021, Commissioner Lee stated at a diversity forum[7] that the SEC should consider requiring registrants to disclose the gender and diversity data they already provide in EEO-1 reports to the Equal Employment Opportunity Commission.

Commissioner Lee's public comments have extended beyond disclosure to her views on boards' roles in "navigat[ing] challenges presented by climate change, racial injustice, economic inequality and numerous other issues that are fundamental to the success and sustainability of companies, financial markets, and [the] economy." In a speech delivered[8] on June 28 at the 2021 Society for Corporate Governance National Conference, she noted that directors are increasingly required to consider the impact of climate change and ESG matters with respect to a company's financial statements and other disclosures as matters like climate change may affect the valuation of assets, inventory, supply chain and future cash flows. Her remarks suggested that:

(1) Boards may need to refresh and diversify perspectives, which could facilitate more current and proactive approaches to climate and ESG governance (in addition to enhancing the diversity of boards);

(2) Companies should consider ways to enhance the ESG competence of their boards, including integrating ESG considerations into the nomination process, training and education for board members and board engagement with outside experts; and

(3) Boards should align executive compensation with ESG metrics and strategic goals.

Contrasting the disclosure approach advocated by Commissioner Lee, on June 3, 2021, Commissioner Roisman spoke[9] about his concerns and reservations around ESG disclosures. In particular, he noted that standardized ESG disclosures are very difficult to craft. Some of the data requested of registrants, according to Commissioner Roisman, is inherently imprecise, relies on con-

[7] https://news.bloomberglaw.com/securities-law/secs-lee-eyes-release-of-workforce-diversity-data-sent-to-eeoc.

[8] https://www.sec.gov/news/speech/lee-climate-esg-board-of-directors.

[9] https://www.sec.gov/news/speech/roisman-esg-2021-06-03.

tinually evolving assumptions and can be reasonably calculated in different ways. He advocated for the SEC to tailor disclosure requirements to balance the benefits it hopes to achieve with the inevitable costs, calling for:

(1) Scaling disclosure requirements to ease the burden on smaller companies;

(2) Tempering the expectations of what registrants can disclose and how registrants disclose it, including not expecting an unreasonable degree in precision in such disclosures (i.e., no strict liability) and possibly not subjecting ESG disclosures to heightened verification requirements via an attestation or audit;

(3) Providing a safe harbor to registrants to mitigate litigation risk and avoid a chilling effect;

(4) Permitting the furnishing of ESG disclosures to the SEC, rather than including the disclosures in their public filings in order to mitigate registrants' litigation risk; and

(5) Phasing in and extending the implementation period for ESG disclosures to allow for variation and investor feedback.

On June 23, 2021, Chair Gensler made it clear that a formal process was underway, announcing that he had asked the SEC staff to "to put together recommendations on mandatory company disclosures on climate risk and on human capital." Chair Gensler also noted[10] that the staff is looking into specific ESG metrics to determine which are most relevant to investors. He also announced that the staff is looking at potential requirements for registrants that have made forward-looking climate commitments and what factors should underlie the claims of those funds marketing themselves as "sustainable, green, or 'ESG.'"

Further, on July 7, 2021, Chair Gensler spoke[11] to the Asset Management Advisory Committee. There, he addressed fund disclosures and fund names with respect to the growing number of funds marketing themselves as "green," "sustainable," or other pro-ESG names. Noting that in light of the fact that there are not standardized meanings of sustainability-related terms, Chair Gensler stated that he asked the SEC staff to consider recommendations about whether fund managers should disclose the criteria and underlying data used as well as to take a "holistic look" at fund naming conventions. In addition, Chair

[10] https://www.sec.gov/news/speech/gensler-speech-london-city-week-062321.

[11] https://www.sec.gov/news/public-statement/gensler-amac-2021-07-07.

Gensler revealed he asked the SEC staff to consider ways to enhance transparency to improve diversity and inclusion practices within the asset management industry.

LEGISLATIVE DEVELOPMENTS

The future of ESG disclosure initiatives has not been limited to the SEC. On June 16, 2021, the U.S. House of Representatives narrowly approved the ESG Disclosure Simplification Act of 2021.[12] This would, among other things, require registrants to disclose (1) ESG metrics in any filing requiring audited financial statements, and (2) in their proxy materials, their views about the link between ESG metrics and long-term business strategy as well as a description of the process used to determine the impact of such ESG metrics on their long-term business strategy.

The bill would also deem ESG to be *de facto* material and create a permanent Sustainable Finance Advisory Committee of the SEC. It requires the SEC to issue rules within two years that must:

(1) Be specialized, to the extent feasible, for finance, insurance, transportation, power, mining and nonrenewable energy businesses;

(2) Require the disclosures to incorporate social costs attributable to greenhouse gas emissions (both direct and indirect emissions);

(3) Include standards for disclosing greenhouse gas emissions and assets related to fossil fuels; and

(4) Direct companies to consider analyzing scenarios that align with the Paris Agreement's greenhouse gas reduction targets.

As of the date of this article, this bill's path to law through the U.S. Senate is challenging as it is highly unlikely to garner enough votes to overcome a filibuster.

CURRENT EXPECTATIONS FOR ESG DISCLOSURES FOR FINANCIAL INSTITUTIONS

Following the 2020 rulemaking by the SEC, nearly every large financial institution included a risk factor addressing climate change in their 2020 Form 10-Ks. In the financial services industry, the risks associated with climate change expand farther than merely operational risk, but also physical risk, transition risk, enterprise risk, regulatory risk, internal control risk, and valuation risk.

---

[12] https://rules.house.gov/sites/democrats.rules.house.gov/files/BILLS-117HR1187RH-RCP117-5.pdf.

Looking ahead, financial institutions will need to consider how their disclosures about climate risk harmonize with their enterprise risk management, internal controls and (potentially) methodologies for valuing certain financial instruments. The balance sheets of financial institutions are more likely than registrants in other industries to be comprised predominantly of financial instruments, including those requiring periodic remeasurement. Therefore, the valuation methods used to value such financial instruments and their inputs—particularly those methods using the "income approach," which attempt to project and discount future cash flows to the balance sheet date—may have to reflect the financial institution's disclosed climate change risks.

Further, financial institutions will need to have in place satisfactory internal controls around the gathering of such valuation inputs, data and assumptions, which can be challenging as the data around climate risk is continually developing. This concern is at the crossroads of Commissioner Lee's assertions regarding materiality and Commissioner Roisman's concerns regarding the data accuracy and the desire for heightened verification of such data. Financial institutions therefore should consider how changes to the ESG disclosure requirements affect and are consistent with other aspects of their overall corporate governance. Examples may include: considering climate change risk (and related geographic concentration risk, as applicable) in loan origination policies, the valuation of such loans' underlying collateral, stress testing scenarios, and the institution's overall risk management framework.

Likewise, financial institutions should also consider how their disclosures about their human capital resources align with their enterprise risk management. Should the SEC require quantitative diversity disclosures, registrants will not only need to ensure that the collection of such data results in accurate disclosure, but they will also need to consider how such diversity figures might affect reputational risk and whether any corporate governance changes may be needed to mitigate those concerns.

ADDITIONAL RECOMMENDATIONS

As discussed, the SEC is expected to issue proposed rules surrounding ESG disclosures as early as October 2021. In recognition of the SEC's emphasis on rulemaking in this area and the groundswell of support among large institutional investors for enhanced disclosures, we recommend the following additional considerations for financial institutions as they prepare their Form 10-Qs for the second quarter of 2021 and for advance planning for the 2022 annual reporting and proxy season:

- Expect to include a risk factor addressing climate change risks going forward, and expect the robustness and scope of that risk factor to increase. This should include both (a) physical risks (i.e., uncertain costs and losses resulting from damage to property or assets, such as a mortgage portfolio, caused by weather events, sea-level rise, increasing temperatures, etc.), and (b) transition risks (i.e., the uncertain timing and magnitude of government policies, technological innovation and consumer demand that will accelerate the transition to lower-carbon economy). Recent Form 10-K climate-related Risk Factors should be evaluated for completeness and enhanced as needed in upcoming Form 10-Qs.

- Consider disclosing how your organization plans to achieve goals set by any public pledges already made or intended to be made, such as "net zero by 2050," if applicable, and to what extent your organization has the necessary mechanisms in place to measure progress against such goals (which is an area of focus of the SEC's Division of Examinations—see its Risk Alert[13]).
- Expect ESG disclosure requirements to be more prescriptive than the 2020 Regulation S-K modernization changes and for quantitative ESG disclosures to become more sophisticated. In that regard, prepare to identify the appropriate sources of such information in a manner subject to customary internal controls, especially where those quantitative figures intersect with the valuation of financial instruments.
- Establish a strong corporate governance framework to evaluate ESG factors throughout your organization. Attention should focus not only on identification of ESG risks, but on the evaluation, monitoring and strategic planning with respect to these risks and the escalation to the appropriate committees and/or the Board. Further attention should be given to how boards and board committees become well-informed with respect to decision-making and oversight responsibilities in connection with ESG matters.
- Factor ESG disclosure into disclosure controls and procedures, at the Disclosure Committee, the Audit Committee, and the Risk Committee.
- Consider whether and how to align executive compensation with relevant ESG metrics and other strategic goals, as appropriate.

[13] https://www.sec.gov/files/esg-risk-alert.pdf.