ESG: What Is It and What Does It Mean for Compliance?

Robert B. Baker, Assistant Director, Asset Management Unit, SEC
Dan Mistler, Partner & Head of ACA ESG Advisory
Harriette I. Resnick, Acting Executive Deputy Superintendent, Climate Division, NYSDFS
Elaine Wood, Vice President, Charles River Associates, Former Assistant U.S. Attorney
Lanier Saperstein, Partner, Dorsey & Whitney LLP (Program Chair & Moderator)

September 22, 2022

Disclaimer: This presentation should not be considered or construed as legal advice on any individual matter or circumstance. The contents of this document are intended for general information purposes only and may not be quoted or referred to in any other presentation, publication or proceeding without the prior written consent of the New York City Bar Association and the panelists. The distribution of this presentation or its content is not intended to create, and receipt of it does not constitute, an attorney-client relationship.

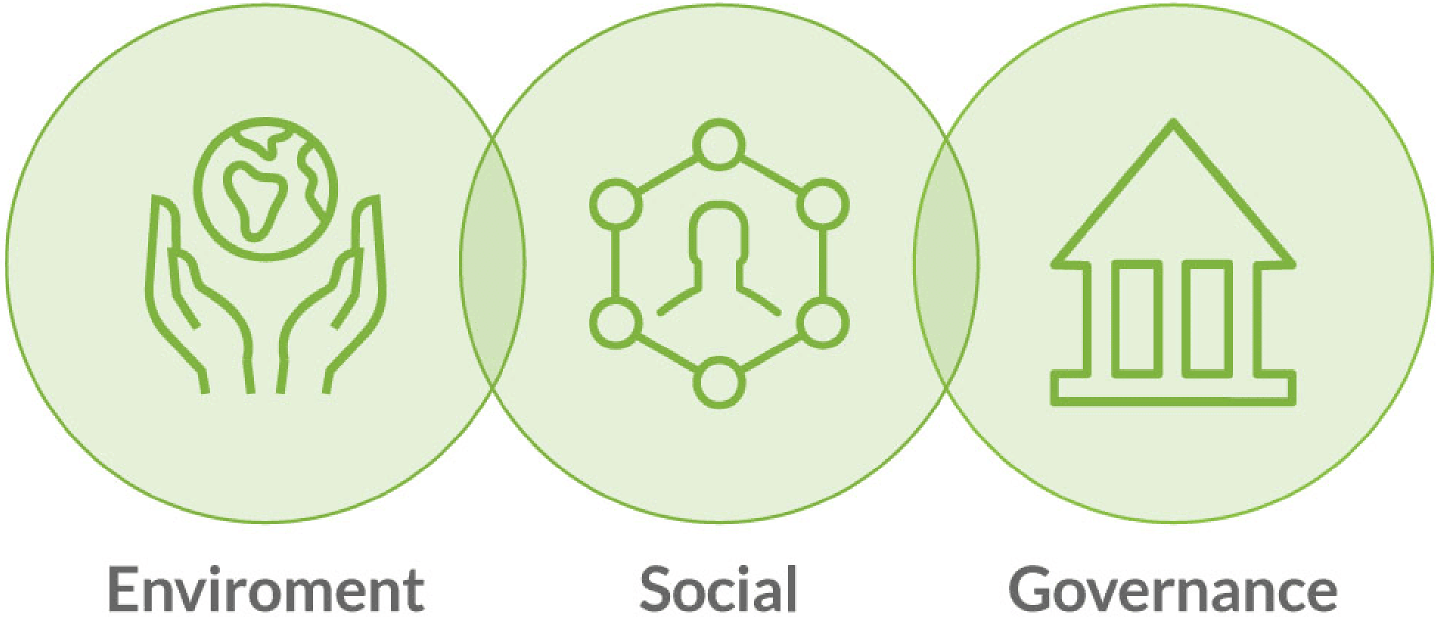
Agenda

- Introductions
- What is ESG?
- ESG in action – the SEC's exams, enforcements and rule making
- Leadership from the States – New York's DFS
- What's coming down the pike?
- Q&A



Polling Questions

What is ESG?



Climate risk management
Energy efficiency
Water efficiency
Biodiversity
Carbon intensity
…

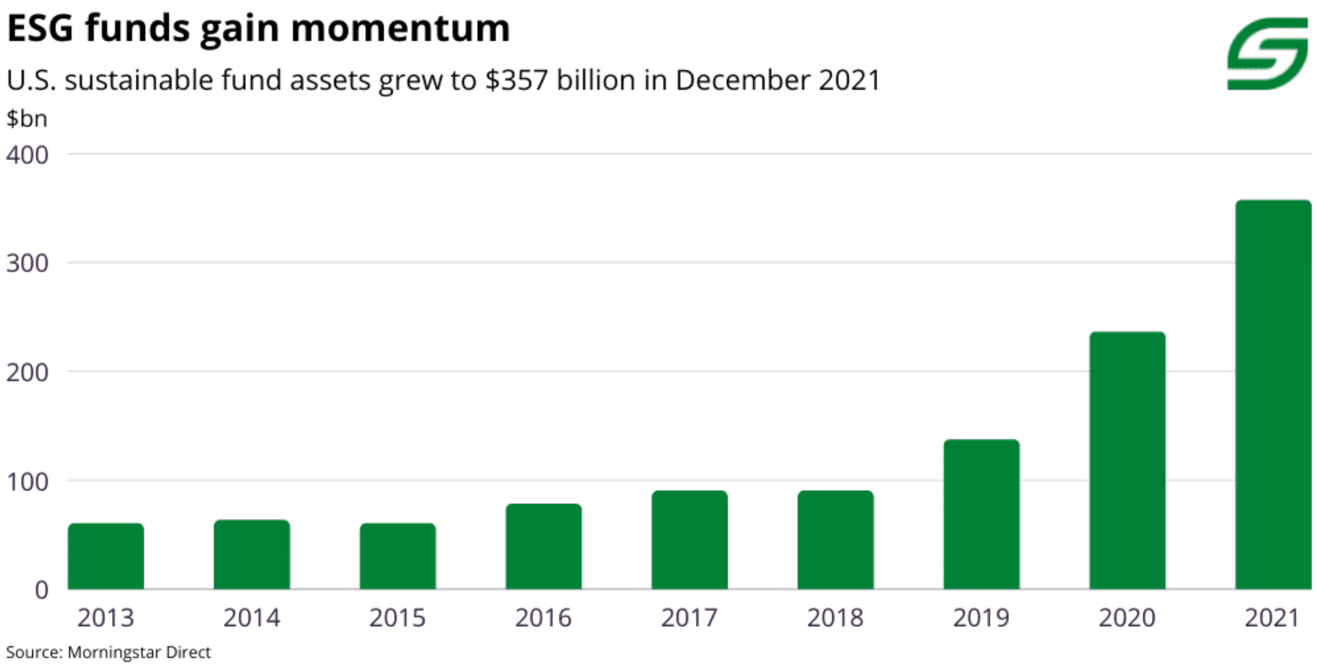
Human rights
Labor standard
Equal opportunities
Health and safety
Freedom of association
…

Diversity and inclusion
Compliance
Board independence
Executive compensation
Shareholder democracy
…

Source of picture: https://galooli.com/glossary/what-is-esg/

Growth of ESG

- Global sustainable fund assets reached $2.7 trillion in December 2021, from $1.65 trillion at the end of 2020 and $1.28 trillion at the end of 2019 (*Morningstar Direct*)
- In the U.S., ESG fund assets under management reached $357 billion in December 2021, up from $236 billion at the end of 2020 (*Morningstar Direct*)
- ESG assets are expected to hit $53 trillion in 2025, a third of global assets under management. (*Bloomberg Intelligence*)



“e” IN “esg”

Climate change is the most important ESG issue for money managers, representing $4.2 trillion of sustainably managed assets.

Source: US SIF (The Forum for Sustainable and Responsible Investment)

Overview

Miles' Law:

"Where you stand depends on where you sit."

The Regulators

Banking Regulators:

Source: Federal Reserve Bank of San Francisco

SEC:

Source: SEC

Push-Pull: Industry and The Regulators

- With a focus on E, S and G, the regulators are responding to the industry's emphasis on the "E" in ESG.

- An "existential threat to our environment and ecosystems" that "is creating increasing and significant economic costs" -- *Nellie Liang, Undersecretary for Domestic Finance, Treasury*

- The "aggregate cost of billion-dollar natural disasters in the U.S. more than quadrupled from the 1980s to the 2010s." *NYSDFS Open Letter, Oct. 29, 2020*

- The risk in NYC alone is staggering: Single- and multi-family residential homes in New York City with $334 billion of reconstruction value are at high risk of storm surges

SEC Examinations

- On April 9, 2021, the SEC's Division of Examinations issued a Risk Alert which provides observations of deficiencies, internal control weaknesses as well as effective practices from examinations of investment advisers and funds regarding ESG investing

- Examinations of investment advisers and funds claiming to engage in ESG investing will focus on, among other matters:
  - Portfolio management
  - Performance advertising and marketing
  - Compliance program

SEC Enforcement Actions

- July 30, 2008, the SEC charged Pax World Management Corp. with violating investment restrictions in socially responsible mutual funds to which it was investment adviser

PAX

Pax World Investments

- Pax World agreed to settle the SEC charges and was ordered to pay a penalty of $500,000

- Pax World violated the funds' socially responsible investing (SRI) restrictions by making purchases in the securities of companies that
  - derived revenue from the manufacture of alcohol or gambling products,
  - derived more than 5% of their revenue from contracts with the DoD, or
  - failed to satisfy the funds' environmental or labor standards

SEC Enforcement Actions (Con't)

- May 23, 2022, the SEC charged BNY Mellon for alleged misstatements and omissions about ESG considerations
- BNY Mellon agreed to a cease-and-desist order, a censure and paid a $1.5 million penalty
- BNY Mellon represented/implied in various statements that all investments in the funds had undergone an ESG quality review, even though allegedly that was not always the case

BNY MELLON

SEC's Proposed Rules

In May 2022, the Division of Investment Management released its proposed rules regarding ESG investment practices:

- proposing to amend the rules to require registered investment advisers and others "to provide additional information regarding their environmental, social, and governance … investment practices."
- designed to increase investor protection by "improving and clarifying the requirement for certain funds to adopt a policy to invest at least 80% of their assets in accordance with the investment focus that the fund's name suggests…"
- comment period ended on August 16, 2022

SEC's Proposed Rules

In March 2022, the Division of Corporate Finance released its proposed rules on climate-related disclosure:

- the "proposed rules would require information about a registrant's climate-related risks that are reasonably likely to have a material impact on its business, results of operations, or financial condition."

- comment period extended to June 17, 2022

- considerable public feedback

New York State Department of Financial Services Climate-Related Supervisory Initiatives

Harriette Resnick

Acting Executive Deputy Superintendent, Climate Division

Introduction to DFS & its Climate Division

- Supervises more than 1,200 banking and other financial institutions with assets totaling more than $3.3 trillion and more than 1,700 insurance companies with assets of more than $5.5 trillion.
- First U.S. financial regulator to join NGFS (2019).
- First U.S. financial regulator to issue expectations on managing climate-related financial risks (2020) and detailed insurance guidance (2021).
- First State financial regulator to form a Climate Division (2021).

DFS's Climate-Related Authority

- Statutory authority and regulatory mission:
    - Safety & soundness (banks)
    - Solvency & liquidity (insurers)
    - Fostering the growth of the financial industry in New York and state economic development
    - Fair, timely and equitable fulfillment of the financial obligations of financial service providers
- Relationship with climate objectives

Distinctive Nature of Climate Risks

- Far-reaching in breadth and magnitude
- Uncertain but foreseeable
- Dependent on short-term actions
- Hard to predict based on past experience

Guidance for New York Domestic Insurers on Managing the Financial Risks from Climate Change

1. Proportionate Approach
2. Materiality
3. Time Horizons for Business Decisions
4. Uncertainty and Data Gaps

Overarching themes

3.5 **Timeline for implementation**

6. **Risk Culture and Governance**
7. Business Models and Strategies
8. Risk Management
9. Scenario Analysis
10. Public Disclosure

Supervisory guidance

NAIC Climate Risk Disclosure Survey

- Established in 2009
- Administered by 13 states and DC, for insurers with annual countrywide premium > $100mm
- 8 questions, further updated in 2022 to align with TCFD
  1. Internal greenhouse gas management
  2. Governance
  3. Risk identification process
  4. Identified climate risks
  5. Investments
  6. Stakeholder engagement
  7. Encourage risk mitigation by policyholders
  8. Modeling

DFS Application of Disclosure Materials

1. Understand insurers' status in managing climate risks
2. Identify good practices to share with the industry
3. Support risk-based supervision
4. Verify compliance
5. Inform establishment of future timelines

Insurers' ratings are used for DFS's supervisory purposes and not publicly disclosed.

DFS Climate Initiatives:
Banking & Mortgage Institutions

- Industry Letter on Climate Change and Financial Risks (Oct. 2020)
- To come: Proposed supervisory guidance regarding management of material climate risks
    - Leveraged U.S. and international regulators' work
    - Collaborative engagement through industry roundtables
    - DFS will seek public feedback

Encouraging Investment for Climate Resilience

- Feb. 2021 DFS Industry Letter on CRA Consideration for Activities that Contribute to Climate Mitigation and Adaptation
- Under NYS CRA, obligation to help meet the credit needs of the local communities in which banks operate, including LMI communities.
- Industry Letter outlines opportunities for banks to receive credit for CRA-eligible activities that help revitalize or stabilize communities from climate-related impacts.
    - Examples of financing activities promoting climate resilience
- DFS expectations: Manage climate-related financial risks prudently and comply with obligations to ensure fair access to capital and credit.

So What's Next?

- Movement on new SEC rules – climate disclosure for public companies, ESG disclosure for advisors
- New enforcement cases – U.S. and elsewhere
- Additional movement from state-level actors – anti-ESG boycott and integration rules
- Continued "anti-ESG" turmoil in the US – some walking back of disclosures, softening of language
- Additional proposals in the EU and UK
- Regulatory scrutiny heightening pressure on voluntary disclosures
- New frontiers for greenwashing, driven by data expansion
- Prevalence of new/expanded ESG standards

Questions?