January 10, 2023

Key ESG Considerations for U.S. Financial Institutions in 2023

Review of Significant ESG Developments and Additional Considerations for 2023

SUMMARY

As U.S. financial institutions assess their ESG risks, opportunities, policies and procedures for 2023, key considerations include the numerous significant ESG developments in 2022—in particular, recent proposals and initiatives announced by financial regulators with respect to climate-related risk management and disclosures—and overarching regulatory, political, investor and litigation trends. This memorandum summarizes several ESG considerations that are expected to be particularly relevant.

SIGNIFICANT LEGAL AND REGULATORY DEVELOPMENTS IN 2022

SEC's proposed climate-related disclosure rules: On March 21, 2022, the Securities and Exchange Commission proposed expansive climate-related disclosure requirements in a proposing release that, if adopted, would require U.S. public companies and foreign private issuers to dramatically expand the breadth, specificity and rigor of climate-related disclosures in their SEC periodic reports and registration statements. Although the proposed rules do not impose industry-specific requirements, certain areas would have a particularly significant impact on financial institutions. In particular, the disclosure of Scope 3 greenhouse gas ("GHG") emissions (which include financed emissions) and of climate scenario analysis could be mandatory for many financial institutions under the proposed rules. Voluntary climate-related transition plans, targets and goals, which many financial institutions have adopted or set, also would need to be disclosed. See S&C's memo for more information.

The final rules were originally expected as early as October 2022 but have been delayed, with SEC speakers declining to discuss the scope and timing of the final rules in recent remarks. According to the Fall 2022 Unified Agenda of Regulatory and Deregulatory Actions released by the Office of Management

and Budget's Office of Information and Regulatory Affairs in early January 2023 (the "Fall 2022 Unified Agenda"),[1] the SEC is expected to take final action on the climate-related disclosure rule in Spring 2023. In the interim, many financial institutions have been assessing their ability to comply with the proposed requirements. While monitoring developments on the SEC's proposed rules, financial institutions also should continue to assess their climate-related disclosures under the SEC's 2010 Guidance Regarding Disclosure Related to Climate Change and the SEC's Sample Letter to Companies Regarding Climate Change Disclosure, which address the SEC's expectations on climate-related disclosures under its existing framework. An area of potential focus includes the consistency of the information disclosed across an institution's various climate-related disclosures, including SEC reports and any other publicly available information, such as corporate social responsibility or sustainability reports.

Scenario analysis: Financial regulators around the world have identified scenario analysis as a potential tool for assessing and managing financial institutions' exposure to climate-related financial risks. U.S. regulators have begun to explore how to use scenario analysis to better assess the long-term, climate-related financial risks faced by financial institutions, and how these risks may manifest and differ from historical experience. For example, in September 2022, the Board of Governors of the Federal Reserve System announced its plan to work with six large U.S. banks on a pilot climate scenario analysis to measure climate-related financial risks starting in early 2023. The Federal Reserve anticipates publishing insights gained from the pilot at an aggregate level. At the state level, the New York Department of Financial Services issued final guidance on how New York domestic insurers should take a strategic approach to managing climate risks, which outlines, among other things, New York DFS's specific expectations for insurers' use of scenario analysis to monitor climate risks. See S&C's memo and November 2021 ESG newsletter for more information. Given the increasing focus on scenario analysis, in 2023, financial institutions should continue to explore the feasibility of incorporating scenario analysis into their climate-related risk assessment and management tools.

U.S. federal and state banking regulators' proposed guidance on climate-related financial risk management: The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve have each proposed a set of substantially similar principles for climate-related financial risk management for large financial institutions (i.e., those with over $100 billion in total consolidated assets) over the course of the past 12 months. The proposed principles provide a high-level framework for the safe and sound management of climate-related financial risk exposure by outlining six key aspects of climate-related financial risk management: (1) governance; (2) policies, procedures and limits; (3) strategic planning; (4) risk management; (5) data, risk measurement and reporting; and (6) scenario analysis. In addition, the proposed principles offer risk assessment principles for incorporating climate-related financial risks in various traditional risk categories. The U.S. federal banking regulators have sought public comment on the proposed principles and have indicated their intention to work with each other to promote consistency in this area through final interagency guidance. See S&C's memo for more

information. While continuing to monitor developments on the final interagency guidance, large financial institutions may want to start considering the proposed principles in managing their climate-related financial risks. It also would be prudent for smaller financial institutions to monitor development of the guidance as well, because it reveals the direction of banking regulators' supervisory expectations, in particular with respect to board and management responsibilities.

In addition, on December 21, 2022, the New York DFS proposed guidance for New York state-regulated banking and mortgage institutions relating to management of material financial risks from climate change. The proposed guidance focuses on the management of safety and soundness risks from climate change through corporate governance, internal control framework, risk management process, data aggregation and reporting, and scenario analysis. The New York DFS is seeking feedback on the proposed guidance and has indicated that the guidance is intended to align with the work of federal and international banking regulators on the management of climate-related financial risks.

ESG rule developments relevant to the asset management industry: On May 25, 2022, the SEC proposed amendments to rules and reporting forms relating to the incorporation of ESG factors by registered investment companies and business development companies (collectively, "funds") and advisers. These proposed changes would categorize funds that consider ESG factors in their investment process into three broad categories—"Integration Funds," "ESG-Focused Funds" and "Impact Funds"—depending on how central ESG factors are to a fund's strategy,[2] and would, among other requirements, (1) require additional specific disclosure regarding ESG strategies in both fund and adviser disclosures; (2) implement a prescriptive, tabular disclosure approach for ESG-Focused Funds to facilitate investor comparisons of such funds; and (3) require ESG-Focused Funds that consider environmental factors as part of their investment strategies to disclose Scope 1 and Scope 2 GHG emissions associated with their portfolio investments, normalized by net asset value and by portfolio revenue, and Scope 3 emissions to the extent reported by their portfolio companies. On May 25, 2022, the SEC also proposed amendments to Rule 35d-1 under the Investment Company Act of 1940 (the "Names Rule"), which currently generally requires that if a fund's name indicates a focus on a particular type of investment, or investments in a particular industry, or geographic region, the fund must adopt a policy to invest at least 80% of the value of its assets in the type of investment, or investments in the industry or geographic region, suggested by its name. Among other requirements, the proposed amendments to the Names Rule would extend the 80% investment policy requirement to any fund name with terms suggesting that the fund focuses on investments with particular characteristics, including fund names with terms indicating that the investment decisions incorporate ESG factors, and would prohibit the use of ESG terminology in the name of Integration Funds. According to the Fall 2022 Unified Agenda, the SEC is expected to take final action on these proposed amendments in Fall 2023. Going forward, investment companies and asset managers should continue to expect a heightened focus from the SEC on ESG-related practices and disclosures. See S&C's memos on

the Names Rule and ESG disclosures for investment advisers and investment companies for more information.

In addition, on November 22, 2022, the U.S. Department of Labor's Employee Benefits Security Administration finalized a rule permitting retirement plan fiduciaries to consider climate change and other ESG factors when selecting investments and exercising shareholder rights. The rule will be effective on January 30, 2023. The rule rolls back Trump-era rules that prohibited retirement plan fiduciaries from selecting investments and investment courses of action based on "non-pecuniary" factors. The rule deletes the "pecuniary/non-pecuniary" terminology from the current regulation and adds language recognizing that a fiduciary's duty of prudence may often require evaluation of the economic effects of climate change or other ESG factors on a particular investment or investment course of action. See S&C's memo and November 2022 ESG newsletter for more information.

Moreover, the SEC has confirmed in a Staff FAQ that investment advisers may consider diversity, equity and inclusion ("DEI") factors in recommending financial advisers for their clients, so long as the use of such factors is consistent with the client's objectives, the scope of the client-adviser relationship and the adviser's disclosures.

Insurance regulators' disclosure and supervisory guidance on climate-related risks: The National Association of Insurance Commissioners ("NAIC") announced on April 8, 2022 that it has adopted a new standard for insurance companies to report climate-related risks in alignment with the Task Force on Climate-related Disclosures ("TCFD") reporting standards, asking insurance companies to respond to an annual survey by November 2022. NAIC's revised survey asked companies to identify and assess climate-related risks on insurance and reinsurance portfolios by geography, business division or product segments. More than 15 U.S. jurisdictions have committed to requiring the NAIC survey in 2022 for insurance companies licensed in their jurisdictions, representing approximately 80% of the U.S. insurance market. In addition, on October 18, 2022, the U.S. Treasury's Federal Insurance Office ("FIO") issued a notice and request for comment proposing to collect zip code-level data from property and casualty insurers for assessing climate-related exposures. FIO's request relates to its mandate to analyze the potential impact of climate change on the affordability and availability of insurance, including the potential of major disruptions in the private insurance market due to climate-related disasters.

At the individual state level, New York and Connecticut insurance regulators have issued guidance for their respective domestic insurers. As noted above, in November 2021, the New York DFS released final guidance for New York domestic insurers on managing financial risks from climate change. In the guidance, the New York DFS explains its supervisory expectations that insurers take a strategic approach to managing climate risks that considers both current and forward-looking risks and identifies actions required to manage those risks in a manner proportionate to the nature, scale and complexity of insurers' businesses. On September 15, 2022, the Connecticut Insurance Department issued a bulletin setting forth

its expectations for how Connecticut domestic insurers will manage the financial risks of climate change. Insurers should continue to monitor new guidance and requirements on the management of climate-related risks as state and federal regulators are likely to continue to focus on this area in the coming year. See S&C's November 2021 and October 2022 ESG newsletters for more information.

State anti-ESG legislations: As of 2022, more than 10 U.S. states have enacted or proposed "anti-ESG" legislation aimed at curtailing consideration of ESG factors by financial institutions and other companies. For example, in August 2022, Governor Ron DeSantis and the State Board of Administration of Florida passed a resolution prohibiting Florida's fund managers from considering ESG matters when investing state funds. The resolution requires that investment decisions must be based on "pecuniary factors" that "do not include the consideration of the furtherance of social, political or ideological interests." In addition, states like Texas and West Virginia have also enacted laws that require state governmental entities to divest publicly traded securities of financial institutions that boycott fossil fuel-based energy companies and prohibit state governmental entities from contracting with such financial institutions. Financial institutions should be prepared for additional scrutiny on their ESG activities from these states in 2023 and beyond.

International ESG developments that may affect certain U.S. financial institutions: The following key international developments may be relevant to many U.S. financial institutions, either because they may be applicable directly to U.S. entities or to their subsidiaries, clients, investors and/or competitors:

- ***UK Climate Disclosures for Financial Institutions.*** Certain U.K. subsidiaries of U.S. financial institutions will be required to report TCFD-aligned disclosures in 2023, and per UK Financial Conduct Authority rules, large asset managers, life insurers and FCA-regulated pension providers must publish annual entity-level and product-level reports with TCFD-aligned disclosures. See S&C's May 2022 ESG newsletter for more information.
- ***EU and UK Prudential Climate Risk Assessments and "Dear CEO" Letters.*** The European Central Bank and the UK Prudential Regulation Authority released the results of their latest climate risk stress tests and the PRA wrote to CEOs of financial institutions, warning that little progress had been made on implementing climate-related risk management frameworks. See S&C's May 2022 and November 2022 ESG newsletters for more information.
- ***EU Corporate Sustainability Reporting Directive.*** The EU finalized its Corporate Sustainability Reporting Directive, which will introduce detailed sustainability reporting requirements, including for many EU subsidiaries of U.S. financial institutions and for U.S. financial institutions themselves if they meet certain thresholds for net turnover in the EU and have an EU subsidiary or branch. See S&C's memo for more information.

ADDITIONAL CONSIDERATIONS FOR 2023 AND BEYOND

U.S. financial institutions should also consider the following trends, which will likely have an impact on their ESG activities in 2023 and beyond.

Climate targets and net-zero alliances under increasing scrutiny: Although international forums such as the United Nation's Race to Zero initiative have strengthened their membership criteria (including a requirement to "phase down and out all unabated fossil fuels"), there has been increasing pushback on

net-zero targets and alliances from certain U.S. states. In addition to the anti-ESG legislations discussed above, certain U.S. states have pushed back against net zero alliances such as the Net-Zero Banking Alliance ("NZBA") and the Net Zero Asset Managers Initiative ("NZAM"). For example, in August 2022, attorneys general from 19 states signed a letter claiming that these alliances "appear to intentionally restrain and harm the competitiveness of energy markets." Additionally, in November 2022, a group of 13 state AGs wrote to the Federal Energy Regulatory Commission requesting that FERC deny Vanguard's application to extend its authorization to invest in publicly traded utilities, arguing that by making net-zero pledges, Vanguard "abandoned its status as a passive investor in public utilities and adopted a motive consistent with managing the utility" and expressing their concern that Vanguard's actions with respect to influencing environmental corporate policy will increase consumer energy costs. Vanguard subsequently announced its decision to withdraw from the NZAM on December 7, 2022.

Further, financial institutions that are members of net-zero alliances should consider potential U.S. antitrust scrutiny as well. In September 2022, when testifying before the Senate Judiciary Subcommittee on Antitrust, Competition Policy and Consumer Rights, the U.S. Federal Trade Commission Chair Lina Khan and the Department of Justice Antitrust Division Assistant Attorney General Jonathan Kanter were asked whether ESG coordination among financial institutions (e.g., participation in climate alliances) runs afoul of antitrust laws. FTC Chair Khan stated that she would want to look at the issue more closely before opining on its legality, while AAG Kanter noted that, generally speaking, collusion is anticompetitive and "when firms have substantial power and they use that power to achieve anticompetitive ends, that should be actionable under the antitrust laws." These trends demonstrate the uncertainties and challenges that members of net-zero alliances can face as they navigate conflicting demands from various stakeholders.

Continued focus on board diversity and human capital management and emerging focus on biodiversity: The Fall 2022 Unified Agenda highlighted corporate board diversity and human capital management as areas of the SEC's rulemaking focus in 2023. Although the SEC's Investment Advisory Committee did not make a recommendation related to disclosure requirements on human capital management at the Committee's September 2022 meeting, the Committee noted that it was continuing to discuss human capital management and suggested that the most useful information to allow investors to evaluate risks and opportunities related to human capital management could include information on wages (potentially benchmarked against an average "living wage"), hours worked, DEI statistics, turnover percentage and investment in training. Under Nasdaq's board diversity rules, approved by the SEC on August 6, 2021, each Nasdaq-listed company, subject to certain exceptions, must disclose certain board-level diversity statistics and have (or explain why it does not have) at least two diverse directors. See S&C's November 2021 ESG newsletter for more information. Given these developments, U.S. financial institutions should prepare for continued focus on their board composition and workforce over the coming year.

Further, as demonstrated by recently proposed priorities by the International Sustainability Standards Board, BlackRock's 2023 proxy voting guidelines and the work of the Taskforce on Nature-Related Financial Disclosures, market participants are also becoming more focused on the management of nature-related risks and opportunities. Financial institutions should also monitor developments in this area and begin to consider such risks and opportunities (and the appropriateness of related disclosures) with relevant internal and external stakeholders.

Active ESG-related enforcement and litigation landscape: There has been an increase in ESG-related enforcement over 2022, focused on increasing transparency and reducing "greenwashing." The SEC also has brought some actions related to misleading statements and misrepresentations concerning the degree of consideration given to ESG principles. In addition to continued "greenwashing" litigation arising from ESG-related disclosures, financial institutions should be aware that ESG-related legislations and rules at the federal and state levels are increasingly subject to challenge in court, increasing the amount of uncertainty for companies subject to these requirements. For example, the California board diversity laws (AB 979 and SB 826) were struck down in court in 2022. Earlier that year, California superior courts issued injunctions against their implementation and enforcement on the ground that they are unconstitutional; the injunctions were temporarily lifted as the state appealed, until a California appeals court recently restated the injunctions upon its denial of a procedural motion by the state. More generally, the Supreme Court's decision in *West Virginia* v. *EPA* has potentially significant impacts on U.S. federal regulatory authority with respect to climate- and other ESG-related rulemaking, including the authority of the SEC. See S&C's podcast on recent developments in SEC enforcement, and S&C's memos on AB 979, SB 826, our November 2022 Securities Enforcement and Litigation Update, and the 2021 S&C Supreme Court Business Review for more information.

Increasing shareholder engagement on ESG: ESG-related shareholder proposals at public U.S. financial institutions have increased in number and granularity in recent years. For example, during the 2022 proxy season, 63% of the proposals submitted to financial institutions were environmental, social and political proposals, consisting of 27% environmental proposals (e.g., proposals for increasing environmental disclosures and adopting climate-related targets) and 36% social/political proposals (e.g., proposals for racial equity or civil rights audits and for greater disclosure of DEI data). Both "pro-ESG" and "anti-ESG" proponents were active in submitting proposals in 2022. In the 2022 proxy season, 24% of proposals from "anti-ESG" proponents targeted financial institutions, ranging from proposals to report on charitable contributions to civil rights audits that relate to political and religious ideology.[3]

U.S. financial institutions should expect robust shareholder engagement and potentially increased shareholder activism on ESG matters in the 2023 proxy season, especially considering that the new universal proxy rules could significantly reduce the cost of a contested election. In addition, with the SEC's current approach to no-action relief under Staff Legal Bulletin No. 14L and its proposal to further narrow the

basis for excluding shareholder proposals, we expect to see a greater number of ESG-related proposals go to a vote. See S&C's memos on universal proxy cards and Rule 14a-8 for more information.

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The topics addressed above discuss considerations that we expect to be relevant to many U.S. financial institutions as they assess their ESG programs and initiatives in 2023. However, since this space is evolving rapidly and each institution's ESG profile is unique, there will likely be a number of other factors to consider based on each institution's particular facts and circumstances. Given the complexity and breadth of the issues involved, it will be essential for financial institutions to coordinate among the various internal and external stakeholders responsible for their ESG disclosures, policies and initiatives.

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ENDNOTES

[1] The Unified Agenda of Regulatory and Deregulatory Actions describes the current status and expected procedural timelines for certain agency rulemakings. The agenda often reflects an agency's relative prioritization of various rulemakings; however, the expected timeline of regulatory and deregulatory actions may change.

[2] "Integration Fund" would be defined as a fund that considers one or more ESG factors alongside other, non-ESG factors in its investment decisions, but those ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio. "ESG-Focused Fund" would be defined as a fund that focuses on one or more ESG factors by using them as a significant or main consideration (1) in selecting investments or (2) in its engagement strategy with the companies in which it invests. "Impact Fund" would be a subset of ESG-Focused Funds—those that seek to achieve a specific ESG impact or impacts.

[3] Based on data on shareholder proposals used in our 2022 Proxy Season Review. For further information, see our "2022 Proxy Season Review," *available at* https://www.sullcrom.com/2022-proxy-season-review.

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