AN OVERVIEW OF ESG REGULATION IN THE UNITED STATES

By Adam J. Wasserman
July 19, 2022 (Updated September 21, 2022)

ESG regulation in the United States is not nearly as advanced as what is found in the European Union. Indeed, the Trump Administration (from 2017-2020) was more focused on anti-ESG regulation (such as a Department of Labor rule restricting the ability of retirement plans to offer ESG investment options). Still, since 2021, the Biden Administration has worked to establish ESG as a crucial part of its regulatory agenda. These efforts have included: (1) President Biden's Executive Orders; (2) rule making and other actions by the Securities and Exchange Commission (SEC); (3) the rolling back of Trump era rules at the Department of Labor (DOL); and (4) the passing of the Inflation Reduction Act (IRA). By understanding the U.S. ESG regulatory landscape, companies can work to assure that their ESG programs comply with both existing and expected rules.

President Biden's Major Executive Orders Relating to ESG

One key way that the federal government can impact policy is through presidential executive orders. Since taking office, President Biden has issued two major ESG-related executive orders: (1) a May 20, 2021 Executive Order on Climate-Related Financial Risk (EO 14030), and (2) a December 8, 2021 Executive Order Catalyzing Clean Energy Industries Through Federal Sustainability (EO 14057).

May 20, 2021 Executive Order on Climate-Related Financial Risk[1]

On May 20, 2021, President Biden issued an executive order to, among other things, advance climate-related financial risk disclosures and help achieve the target of a net-zero emission economy by 2050. The order's key provisions include:

- Directing the National Economic Council and National Climate Advisor (in coordination with the Director of Office of Management and Budget (OMB) and the Treasury Secretary) to develop a government-wide strategy regarding: (1) climate-related financial risks to the federal government, (2) the financing needed to achieve net-zero emissions, and (3) ways that public and private investments can meet these financing needs.

[1] https://www.whitehouse.gov/briefing-room/presidential-actions/2021/05/20/executive-order-on-climate-related-financial-risk/

- Directing the Treasury Secretary to work with the Financial Stability Oversight Council (FSOC) members to: (1) assess climate-related financial risks to financial stability, (2) share climate-related financial risk data and information, (3) issue a report on FSOC members' efforts to integrated consideration of climate-related financial risk in their policies and programs, and (4) consider climate-related issues or gaps in the regulation of insurers.

- Directing the Secretary of Labor to assess ways to protect retirement savings from climate-related financial risks and to consider rescinding Trump Administration rules restricting ERISA fiduciaries from considering ESG when making investment and proxy voting decisions.

- Directing various agencies to consider requiring major federal suppliers to disclose greenhouse gas (GHG) emissions and incorporating GHG costs into procurement decisions.

- Directing the Departments of Housing and Urban Development, Agriculture, and Veterans Affairs to consider integrating climate related financial risks into underwriting standards and loan terms/conditions.

- Directing OMB (among others) to incorporate climate related financial risks into the President's budget.

<u>December 8, 2021 Executive Order Catalyzing Clean Energy Industries</u>[2]

On December 8, 2021, President Biden signed an Executive Order Catalyzing Clean Energy Industries Through Federal Sustainability. This executive order is part of the administration's policy to "lead by example in order to achieve a carbon pollution-free electricity sector by 2035 and net-zero emissions economy-wide by no later than 2050." The order's key provisions include, *inter alia*:

- Using the federal government's procurement power to achieve, among other things:

    - 100% carbon pollution-free electricity by 2030;

    - 100% zero-emission vehicle acquisitions by 2035;

    - a net zero emissions building portfolio by 2045; and

    - a 65% reduction in scope 1 and 2 emissions by 2030 (compared to 2008 levels).

- Requiring the heads of all federal agencies to propose targets to meet the above goals.

[2] https://www.whitehouse.gov/briefing-room/presidential-actions/2021/12/08/executive-order-on-catalyzing-clean-energy-industries-and-jobs-through-federal-sustainability/

- Requiring the Government Services Administration (GSA) to track GHG emissions and mitigation efforts by major U.S. government suppliers.

- Directing agencies to incorporate environmental justice considerations into their sustainability and climate adaption programs.

- Reestablishing the Office of the Federal Chief Sustainability Officer and designating Chief Sustainability Officers at each federal agency.

Securities & Exchange Commission

In recent months, the SEC has taken a number of actions to regulate ESG – the most high profile being proposing a rule requiring public companies to disclose climate-related information. The SEC has also proposed Fund Names and Disclosure Rules, and has integrated ESG into its Examination and Enforcement programs.

Proposed Rules

- *Climate Disclosure Rule*:[3] On March 21, 2022, the SEC proposed a rule that would enhance and standardize public company climate disclosures. The proposed rule would require issuers to disclose information regarding: (1) the company's governance of climate-related risks and risk management process; (2) any material impact that climate-related risks are likely to have on the company's business and financial statements; (3) how climate-related risks are likely to affect the company's strategy, business model, and outlook; (4) the impact of climate-related events and transition activities on the company; and (5) the company's greenhouse gas (GHG) emissions. With regard to GHG, the rule would require disclosure of direct emissions (Scope 1) and indirect emissions related to electricity or other energy purchased by the company (Scope 2). Additionally, companies "would be required to disclose GHG emissions from upstream and downstream activities in its value chain (Scope 3), if material or if the registrant has set a GHG emissions target or goal that includes Scope 3 emissions." Certain companies (accelerated and large accelerated filers) would be required to include an independent attestation report addressing their Scope 1 and 2 disclosures. According to the SEC, "the proposed disclosures are similar to those that many companies already provide based on broadly accepted disclosure frameworks, such as the Task Force on Climate-Related Financial Disclosures and the Greenhouse Gas Protocol."

  The proposed Climate Disclosure Rule has received nearly 6000 public comments.[4] While many commentators have supported much of the rule,

[3] https://www.sec.gov/news/press-release/2022-46

[4] https://www.sec.gov/comments/climate-disclosure/cll12.htm

others have been vocal in raising concerns. Key criticisms[5] have included concerns that:

- The proposed rule does not address the increased liability risk created by the new disclosure requirements;
- The Scope 3 disclosure requirements are unduly burdensome;
- The requirement that companies disaggregate and disclose the financial impacts of climate-related impacts and expenditures if they exceed 1% of any financial statement line item is unduly burdensome and based on vague terms and definitions;
- Certain of the disclosures requirements are not tied to materiality; and
- The attestation requirement is overly burdensome (given concerns about the supply, quality, and costs of such attestations).

Most experts expect that the SEC will modify the rule (perhaps significantly) before it is finalized. (The SEC currently anticipates a final rule in October 2022).[6] And, even when finalized, it is very likely that the rule will quickly be challenged through litigation.

- *Fund Names Rule*:[7] On May 25, 2022, the SEC proposed a rule that would (if adopted) require funds to invest 80% of its assets in investments suggested by their name. This would impact not only "ESG" funds, but other funds who describe asset classes in their name (*e.g.,* "value" and "growth").

- *Fund Disclosure Rule*:[8] On May 25, 2022, the SEC proposed a rule that (if adopted) would require ESG-Focused Funds, Impact Funds, and Integration Funds (that integrate ESG and non-ESG factors in making investment decisions) to make a variety of disclosures supporting their strategies.[9] The greater a fund's ESG focus, the greater the reporting requirement would be. For example, under this proposal, ESG-Focused funds would need to provide a table that: (1) provides an overview of the fund's ESG strategy, (2) explains how the fund incorporates ESG factors in its investment decisions, and (3) describes how the fund votes proxies and/or engages with companies about

[5] https://www.businessroundtable.org/business-roundtable-urges-sec-to-revise-climate-disclosure-rule

[6] https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202204&RIN=3235-AM87

[7] https://www.sec.gov/news/press-release/2022-91

[8] https://www.sec.gov/news/press-release/2022-92

[9] https://www.sec.gov/news/press-release/2022-92

ESG issues.[10] Additionally, ESG-Focused Funds that consider environmental factors in their strategies would be required to disclose both their carbon footprint and the weighted average carbon intensity (WACI) of their portfolio.[11] Environmentally focused funds would also be required to disclose the financed Scope 3 emissions of its portfolio companies (to the extent that the portfolio companies report such information).[12]

Examinations

The Division of Examinations listed ESG as one of its key priorities in both 2021 and 2022. In its 2022 Examination Priorities, the Division stated that it would continue focusing on ESG-related advisory services and investment products and whether they are: (1) accurately disclosing their ESG investment approaches and implementing policies and procedures designed to prevent ESG disclosure violations, (2) abiding by their proxy voting policies and voting in line with their ESG-related disclosures/mandates, and (3) engaging in green washing by overstating or misrepresenting the ESG factors incorporated into portfolio selection.[13]

These priorities followed up on an April 2021 Report issued by the Division where the examination staff raised concerns about:[14]

- Portfolio management practices that "were inconsistent with disclosures about ESG approaches;"
- Controls that "were inadequate to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions;"
- Proxy voting that "may have been inconsistent with advisers' stated approaches;"
- Claims regarding ESG approaches that were "[u]nsubstantiated or otherwise potentially misleading;"
- Controls that were inadequate "to ensure that ESG-related disclosures and marketing are consistent with the firm's practices;"
- Compliance programs that "did not adequately address relevant ESG issues," and compliance personnel who "had limited knowledge of relevant ESG-

[10] https://www.sec.gov/rules/proposed/2022/ia-6034.pdf

[11] https://www.sec.gov/files/ia-6034-fact-sheet.pdf

[12] https://www.sec.gov/rules/proposed/2022/ia-6034.pdf

[13] https://www.sec.gov/files/2022-exam-priorities.pdf

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

investment analyses or oversight over ESG-related disclosures and marketing decisions;" and

- "[W]eaknesses in compliance controls regarding performance metrics included in marketing materials," and a lack of compliance review of the underlying data.

Enforcement

In March 2021, the SEC's Department of Enforcement created a more than 20-person Task Force on Climate and ESG issues.[15] The Task Force was charged with developing " initiatives to proactively identify ESG-related misconduct," focusing first on "material gaps or misstatements in issuers' disclosure of climate risks" and "disclosure and compliance issues relating to investment advisers' and funds' ESG strategies." [16]

Department of Labor

In October 2021, the Department of Labor published a proposal to reverse the Trump Administration's rules restricting the use of ESG factors by ERISA fiduciaries when selecting investments and engaging in proxy voting (and instead explicitly permit the consideration of these factors).[17] DOL has set a target date of December 2022 to release a final rule.[18]

The Inflation Reduction Act

On August 19, 2022, President Biden signed the Inflation Reduction Act (IRA), which though not as sweeping as the Green New Deal proposed by some Democrats, still marked the largest climate action ever taken by the federal government.[19] The IRA aims, by 2030, to cut emissions 40 percent from 2005 levels.[20] It earmarks approximately $370 billion for clean energy, electric vehicles, and capture storage. The act includes consumer provisions, such as tax rebates to encourage people (for example)

---

[15] https://www.sec.gov/news/press-release/2021-42

[16] https://www.sec.gov/news/press-release/2021-42

[17] https://www.federalregister.gov/documents/2021/10/14/2021-22263/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights

[18] https://www.napa-net.org/news-info/daily-news/dol-fiduciary-rewrite-esg-form-5500-proposals-delayed

[19] https://www.whitehouse.gov/briefing-room/statements-releases/2022/08/19/fact-sheet-the-inflation-reduction-act-supports-workers-and-families/#:~:text=The%20Inflation%20Reduction%20Act%20will%20protect%20Medicare%20recipients%20from%20catastrophic,for%20the%20first%20time%20ever.

[20] https://www.energy.gov/articles/doe-projects-monumental-emissions-reduction-inflation-reduction-act

to make homes energy efficient and buy electric vehicles.[21] It also includes tax credits for sustainable development (such as solar panels, wind turbines, carbon capture, clean hydrogen, and electric vehicles).[22]

***

While the United States is off to a slower start than Europe when it comes to ESG regulation, the Biden Administration is working to make up for lost time. Despite the administration's initial challenges in passing ESG focused legislation,[23] and the U.S. Supreme Court's June 2022 decision limiting the Environmental Protection Agency's power to broadly regulate carbon emissions,[24] the executive branch still has several tools at its disposal to promote sustainable development. Indeed, other potential rules and regulations addressing social and governance issues, are on the horizon -- including rules relating to board diversity,[25] human capital management,[26] and executive pay versus performance.[27] And, additional climate-related federal regulation and policies are likely to be developed in the coming months as agencies continue responding to the May and December 2021 Executive Orders. Finpublica will provide updates on the U.S. ESG regulatory landscape as it continues to evolve.

---

[21] https://www.whitehouse.gov/briefing-room/statements-releases/2022/08/15/by-the-numbers-the-inflation-reduction-act/

[22] https://www.natlawreview.com/article/what-s-inflation-reduction-act

[23] https://www.cnbc.com/2022/07/15/biden-says-he-will-act-on-climate-after-manchin-opposes-legislation.html

[24] https://www.npr.org/2022/06/30/1103595898/supreme-court-epa-climate-change

[25] https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202204&RIN=3235-AL91

[26] https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202204&RIN=3235-AM88

[27] https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202204&RIN=3235-AL00