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Connecting Climate Change and the Law

December 13, 2022

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Join Cadwalader Partner **Jason Halper** and Special Counsel **Duncan Grieve**, along with Santamarina y Steta partner Juan Carlos Machorro G., for a webinar discussing one of the hottest of hot topic areas in the Latin American region on December 15 from 4-5 PM UTC. Find more details and register **here**.

Welcome Sukhvir Basran

December 13, 2022

We are pleased to welcome ESG finance and investment partner **Sukhvir Basran** in Cadwalader’s London office. Sukhvir advises a range of clients on ESG strategies, policies, frameworks, disclosure and reporting, ESG-related transactions and products, and the integration and alignment of ESG across investment processes. Look for her insights here in the future.

Investing: As Asset Manager Announces Withdrawal From NZAM, Some Question Whether Passive Managers Should Engage In Climate Stewardship

December 13, 2022

Investing

By Jason Halper
Partner and Co-Chair | Global Litigation

Last week, in a December 7 **statement** published on its website, one of the world's largest asset managers announced its withdrawal from membership of the Net Zero Asset Managers initiative (NZAM). This development follows pressure on the asset management industry over their ESG-related positions and investment practices, as we have regularly **reported** on, including last week's announcement from Florida's Chief Financial Officer and also a December 6, 2022 **report** by the Minority Staff of the U.S. Senate Committee on Banking, Housing and Urban Affairs regarding the influence of the "liberal views" toward ESG of the "Big Three" asset managers, Blackrock, State Street and Vanguard. The report asserts that, contrary to what it deems appropriate for passive investment strategies such as index funds, asset managers that are NZAM members commit to engage with portfolio companies toward a goal of achieving net zero emissions by 2050. The report recommends, among other things, increased disclosure in the form of more limited availability of Schedule 13G passive ownership reporting, and consideration of whether any of these managers could be deemed a bank holding company, and therefore subject to Fed regulation along with capital and liquidity requirements, to the extent that they "influenced at least one of the banking organizations in its respective investment funds to conform its lending activities to ESG principles or otherwise change corporate policies."

Vanguard, which joined NZAM in 2021, explained that industry initiatives can "advance constructive dialogue, but sometimes they can also result in confusion about the views of individual investment firms." It goes on to state that this "has been the case in this instance, particularly regarding the applicability of net zero approaches to the broadly diversified index funds" and that they are therefore withdrawing from NZAM to provide clarity "about the role of index funds and about how we think about material risks, including climate-related risks—and to make clear that Vanguard speaks independently."

Last month, NZAM, which launched in 2020, **announced** their membership had expanded to 291 firms, managing $66 trillion, which included 86 asset managers that had adopted initial net-zero targets.

Kirsten Snow Spalding, Vice President at Ceres, a founding partner of NZAM, stated "it is unfortunate that political pressure is impacting this crucial economic imperative and attempting to block companies from effectively managing risks—a crucial part of their fiduciary duty," and "[w]hile Net Zero Asset Managers recognize that there are challenges with measuring the alignment of passive portfolios with a 1.5 temperature rise limit and moving the companies in the index funds to rapidly decarbonize, these challenges can only be met by strong commitments to transitioning to the zero emissions economy by investors, companies and policymakers."

Taking The Temperature: The issues facing NZAM mirror the difficulties faced by the Glasgow Financial Alliance for Net Zero, which last month dropped its connection to the UN-supported Race to Zero campaign after several large U.S. banks threatened to withdraw over concerns about ESG backlash and potential antitrust implications associated with such commitments. Depending on whether other large asset managers follow suit, these developments could call into question the long-term viability of asset management and other industry climate coalitions. Also noteworthy is that both the Senate Banking Minority report and Vanguard's announcement one day later raise questions about what it means to be a passive investor. Passive investing typically is associated with an investment strategy that seeks to mirror the holdings and return of a designated index, in contrast to active stock picking that seeks to beat a benchmark index. The minority report explicitly, and the Vanguard announcement implicitly, questions whether the definition of passive investing is limited in scope to an actual investing strategy, but instead also requires that passive managers not engage with portfolio companies on climate or other stewardship issues. Were such a view to become the consensus, it would have enormous implications for the ability of the passive asset management industry to engage with portfolio companies. PricewaterhouseCoopers, for instance, estimates that passive investment strategies will represent 25% of global assets under management by 2025, for a total of $36.6 trillion AuM. The inability of passive asset managers to engage with companies in which their clients have invested such large amounts inevitably would radically change the landscape of investor-company engagement and have particularly substantial ramifications in the climate change area, where asset managers have been vocal advocates for greater climate-related disclosure and consideration by company boards of climate risks and opportunities.

Regulation: Australian Banks Expect to Reduce Exposure to Industries Affected by Climate-Risk

December 13, 2022

Regulation

By Rachel Rodman

Partner | White Collar Defense and Investigations

According to the results of a climate vulnerability assessment (CVA) conducted by the Australian Prudential Regulation Authority (APRA), Australia's largest banks have outlined how they would amend both their risk appetites and lending practices in response to increasing climate-related losses. Proposed responses include reducing high loan-to-value mortgage lending and minimizing exposure to sectors such as mining, manufacturing and transport. The APRA carried out its CVA with the country's five largest banks, which prepared estimates and carried out modeling to assess the potential financial impact of climate change on their business. The banks were further required to provide potential responses to both physical and transition-related climate risk.

The participating institutions based their analyses on two scenarios developed by the Network for Greening the Financial System: (i) a transition scenario with delayed action on climate change, followed by a substantial reduction in global emissions after 2030; and (ii) a "current policies" scenario, which represented a future with continued increases in global emissions beyond 2050. The study findings show that under the given scenarios, the banking system was unlikely to be severely impacted but that banks would likely experience increased losses from their lending portfolios in the medium to long term. The climate-related risks were found to be concentrated in specific regions geographically and in particular industries, including mining, manufacturing, transport, and wholesale trade.

APRA's Deputy Chair Helen Rowell stated that "The results suggest that banks' losses from their lending portfolios could rise in the medium to long term as climate change and the global response to it unfolds. Although those impacts are not expected to cause severe stress to the banking system, climate change could lead to the banking sector being more vulnerable to future economic downturns."

The CVA also found significant variability in the bank's results, which in part was caused by different modeling approaches but primarily was due to the availability and quality of data. The report concludes that "[t]hese assessments indicated that climate-related data quality and accessibility remain a challenge. From a transition risk perspective, inputs and estimates essential to modelling a transition to a lower emissions economy scenario remain a significant challenge ... These data challenges are being experienced more broadly across industries, and [the Australian regulators] recognise that understanding the gaps in the availability and quality of data is important for the development of high-quality climate risk assessments." APRA advises that "data limitations do not provide a justification for delaying initiatives to better understand climate risk” and that the findings show that “climate scenario analysis approaches can deliver valuable climate risk insights now, and that these insights can inform climate-related planning and decision-making. Financial institutions can adopt a staged approach to climate risk assessment, leveraging available data while building their internal capacity, and incorporating modelling and data developments over time.”

Taking The Temperature: Financial prudential regulators around the globe have adopted a more active approach toward attempting to assess potential climate-related impacts on financial stability. The European Central Bank (ECB) recently published the results of its thematic review into climate-related and environmental risks. As part of its review, the ECB looked at 186 banks with total combined assets of €25 trillion (approximately $25 trillion). In September 2022, the Federal Reserve Board announced that six of the nation’s largest banks would participate in a pilot climate scenario analysis exercise designed to enhance the ability of supervisors and firms to measure and manage climate-related financial risks. The Board “anticipates publishing insights gained from the pilot at an aggregate level” toward the end of 2023, “reflecting what has been learned about climate risk management practices and how insights from scenario analysis will help identify potential risks and promote risk management practices.” And just this month the Fed published a climate-related regulatory framework, which we separately discuss today. In the UK, the Financial Conduct Authority, the Prudential Regulation Authority, and The Pensions Regulator, each published Climate Change Adaptation Reports in October 2021 providing for their respective regulated institutions regarding climate-related risk assessment. As with many climate-focused regulatory initiatives, the challenge will be to form something approaching a global consensus so that institutions operating across jurisdictions do not have to navigate conflicting schemes.

Regulation: Federal Reserve Announces Consultation on Climate Risk

December 13, 2022

Regulation

By Daniel Meade
Partner | Financial Regulation

Earlier this month, the Federal Reserve Board of Governors, **announced** a public consultation on a proposed "framework for the safe and sound management of exposure to climate-related financial risks for large banking organizations." The proposals would apply to banks with over $100 billion in total assets and would cover both physical and transition risks associated with climate change. The proposed principles cover six areas: governance; policies, procedures, and limits; strategic planning; risk management; data, risk measurement and reporting; and scenario analysis. Comments on the proposals, which according to the press release are substantially similar to proposals issued by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, can be submitted for 60 days following the announcement. These proposals follow a **letter** sent to the Federal Reserve by eight consumer advocacy and climate organizations calling for the Federal Reserve Board to issue principles for managing climate-related financial risks for large institutions under its supervision.

The proposal already has encountered resistance within the Board of Governors. Fed Governor Michelle Bowman **stated** that "I believe it is critical that any final principles complement the existing supervisory framework supporting the safety and soundness of financial institutions, and that the Board consider the costs and benefits of any new expectations." Governor Christopher Waller did not support the issuance of the guidance, **stating** that "[c]limate change is real, but I disagree with the premise that it poses a serious risk to the safety and soundness of large banks and the financial stability of the United States. The Federal Reserve conducts regular stress tests on large banks that impose extremely severe macroeconomic shocks and they show that the banks are resilient."

Taking The Temperature: The Federal Reserve announcement underscores the importance of climate-related risk for directors of financial institutions, but its articulation of broad-based principles is equally applicable as a matter of best practices for boards of companies in all industries. The principles also appropriately acknowledge that a one-size-fits-all approach likely is inappropriate: "Effective risk management practices should be appropriate to the size of the financial institution and the nature, scope, and risk of its activities. In keeping with the Board's risk-based approach to supervision, the Board anticipates that differences in financial institutions' complexity of operations and business models will result in different approaches to addressing climate-related financial risks." The Board added its recognition that "expertise in climate risk and the incorporation of climate-related financial risks into risk management frameworks remains under development in many financial institutions and will continue to evolve over time." The proposal also comments on the need to address

specific risk areas, including credit, liquidity, operational, and legal and compliance risk. We will continue to monitor the accelerating development of global financial regulatory guidance in the climate area.

Regulation: SEC's Peirce Criticizes Climate-Related Disclosure Proposal

December 13, 2022

Regulation

By Sara Bussiere
Associate | Global Litigation

Securities and Exchange Commissioner Hester Peirce, in a **speech** delivered before a panel at the American Enterprise Institute, expressed her concern about the SEC's proposed climate-related disclosure rule. Peirce, one of two Republican commissioners on the five-member commission **voted against** the March release of the proposal. The SEC, which has recently re-opened the consultation period, has now received over 11,400 comment letters.

In her speech, Peirce stated that "[t]he SEC should not inundate investors with immaterial items but should focus their attention on material information," and that the disclosures "will require companies to speculate about fundamentally unknowable risks." Peirce expressed her view that "[p]rinciples-based mandates enable companies to present information about risks and opportunities that are material to them and omit information that is not financially material. The climate proposal, by contrast, through numerous specific disclosure mandates, could elicit granular, immaterial information." Peirce also explained that she understood why great attention had been given to the proposed Scope 3 disclosures "given the anticipated expense and, in some cases, the impossibility of producing disclosures that are anything better than best guesses." Peirce stated that "these patently difficult requirements may be distracting the public from other requirements proposed in the rule, which also could be extremely challenging from a compliance perspective and of limited or negative value to investors."

The panel reflected varying views on the SEC's proposal. Former SEC Commissioner Paul Atkins argued that the proposal exceeds the scope of the SEC's congressionally delegated authority by requiring disclosure of large amounts of immaterial information. Melissa McGregor of the Securities Industry and Financial Markets Association affirmed the importance of increased climate-related disclosures, but also contended that the proposal would require excessive disclosure, resulting in an undue burden on corporations and making it more difficult for investors to find material information. Madison Condon, a professor of environmental and corporate law at Boson University, asserted that the proposed disclosures are not as burdensome as some commentators suggest and are necessary for the SEC to keep pace with regulators in other jurisdictions. Former SEC Commissioner Robert Jackson rejected complaints about the proposal, highlighting that the SEC has required climate-related disclosures for decades, with the first such rule being issued during the Nixon administration. He also disagreed with concerns about providing investors with too much information, arguing that more information would result in more accurate asset prices.

Taking The Temperature: The debate at the American Enterprise Institute reflects the differing views currently being expressed by investors and financial institutions across the marketplace. To those opposed to proposal, the views expressed by Commissioner Peirce in this speech appropriately raise concerns regarding the potential for excessive regulatory burden being placed on corporations as a result of proposed disclosure requirements, particularly with respect to Scope 3 disclosure requirements. Other concerns include that existing broad-based disclosure requirements are adequate to cover climate change issues, obviating the need for specific climate guidance, and that the costs of compliance are excessive. Whatever their merit, in our view, these criticisms miss the point from the perspectives of directors and senior management. Whatever the content of the final SEC rule, the current Chair and Staff have articulated their views on required disclosure, and companies ignore that guidance at their peril, at least with respect to the many "traditional" areas of corporate operations and performance addressed by the proposed rule and which already typically are subject to disclosure, including aspects of governance, risk and opportunity assessment, and actual or anticipated material financial impact. And, for companies that operate in multiple jurisdictions, particularly Europe and the UK, climate-related disclosure along with enterprise-wide risk and opportunity assessment already is, or is likely to become, mandatory. Excessive focus on the more challenging aspects of the SEC's proposed rule therefore seems, to us, to be a case of missing the forest for the trees, an approach boards should avoid.