# 4Q 2022 ESG Regulation & Financial Statement Updates

The long-awaited SEC final rule on climate disclosure was unexpectedly delayed due to a technical glitch. The more aggressive European targets have encountered speed bumps, but the European Commission (EC) recently approved 12 standards that will be effective for large companies on January 1, 2024.

Given the results of the U.S. midterm elections, global inflation, and economic uncertainty, will domestic environmental, social, and governance (ESG) financial statement mandates have the same urgency in 2023? This article highlights recent regulatory developments for U.S. public companies and *Employee Retirement Income Security Act of 1974* (ERISA) plans.

## A. U.S. Updates

### FASB

In December 2021, FASB added a project on accounting for environmental credit programs. Since then, FASB met once in May to define the project's scope, "to improve the recognition, measurement, presentation, and disclosure requirements for participants in compliance and voluntary programs that result in the creation of environmental credits and for the nongovernmental creators of environmental credits." FASB tentatively limited the project's scope to environmental credits that are legally enforceable and can be traded. Project scope excludes the accounting for tax credits, tax incentives, or investments in renewable energy structures or entities.

FASB previously released an educational paper clarifying its role on ESG matters noting that, "While the FASB does not establish standards for ESG reporting, the application of many current accounting standards requires an entity to consider changes in its business and operating environment when those changes have a material direct or indirect effect on the financial statements and notes thereto."

### U.S. Department of Labor (DOL)

On November 22, 2022, the DOL issued a final rule, "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights," that requires a fiduciary to consider all relevant factors in investment decisions, including selecting qualified default investment alternatives (QDIAs); exercising shareholder rights, such as proxy voting; and the use of written proxy voting policies and guidelines. This reverses a November 2020 final rule, "Financial Factors in Selecting Plan Investments," issued under the Trump administration, which generally required plan fiduciaries to select investments based solely on consideration of pecuniary factors. One of the 2020 amendments *prohibited* adding or retaining any investment fund, product, or model portfolio as a QDIA if the fund, product, or model portfolio includes even one non-pecuniary objective in its principal investment strategies. In January 2021, five days after the effective date of the "Financial Factors in Selecting Plan Investments," President Biden signed an executive order, "Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis." Agencies were directed to review all rules issued under the Trump administration to ensure they complied with the nation's "abiding commitment to empower our workers and communities;



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promote and protect our public health and the environment." The DOL announced that pending review, no enforcement actions would be taken against any plan fiduciary that failed to comply with the November 2020 final rule. The DOL was concerned that the 2020 rule created a perception that fiduciaries are at risk if they included any ESG factors in the financial evaluation of plan investments, and that they would need to have special justifications for even ordinary exercises of shareholder rights.

The November 2022 final rule does not change two long-standing principles:

- The duties of prudence and loyalty require ERISA plan fiduciaries to focus on relevant risk-return factors and not subordinate the interests of participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of plan benefits.
- The fiduciary duty to manage plan assets that are shares of stock includes the management of shareholder rights, such as the right to vote proxies.

The November 2022 final rule makes the following changes:

- Deletes "pecuniary/non-pecuniary" terminology
- Amends the current regulation to make it clear that a fiduciary's investment decisions must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis and that such factors may include the economic effects of climate change and other ESG factors on the particular investment or investment course of action
- Removes the stricter rules for QDIAs—the same standards apply to QDIAs as to investments generally
- Amends the "tiebreaker" test, which permits fiduciaries to consider collateral benefits as tiebreakers in some circumstances. A fiduciary is now required to conclude prudently that competing investments equally serve the plan's financial interests over the appropriate time horizon. A fiduciary is *not prohibited* from selecting the investment based on collateral benefits other than investment returns
- Removes the current regulation's special regulatory documentation requirements in favor of ERISA's generally applicable statutory duty to prudently document plan affairs
- Clarifies that fiduciaries do not violate their duty of loyalty solely because they take participants' preferences into account when constructing a menu of prudent investment options for participant-directed individual account plans
- Eliminates the statement "the fiduciary duty to manage shareholder rights appurtenant to shares of stock does not require the voting of every proxy or the exercise of every shareholder right"
- Removes two "safe harbor" examples for proxy voting policies:
    - A policy to limit voting resources to types of proposals that the fiduciary has prudently determined are substantially related to the issuer's business activities or are expected to have a material effect on the investment's value
    - A policy of refraining from voting on proposals or types of proposals when the plan's holding in a single issuer relative to the plan's total investment assets is below a quantitative threshold
- Eliminates specific monitoring obligations on the use of investment managers or proxy voting firms. Monitoring obligations are covered in another provision of the regulation that more generally covers selection and monitoring obligations
- Eliminates a specific requirement on maintaining records on proxy voting activities and other exercises of shareholder rights

The rule will be effective 60 days after **Federal Register** publication.



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# SEC

While most press coverage has focused on the “E” of ESG reporting, with the delay in the issuance of a final rule on climate disclosures, the SEC is ramping up action on ESG’s social and governance components.

| Category | Common Disclosure Topics |
|---|---|
| Environmental | ▪ GHG Emissions<br>▪ Energy Consumption<br>▪ Water Usage<br>▪ Waste Generation<br>▪ Targets/goals related to the above metrics |
| Social | ▪ Diversity and Inclusion<br>▪ Human Capital<br>▪ Data Privacy and Security<br>▪ Community Impact<br>▪ Workplace Safety |
| Governance | ▪ Board Diversity<br>▪ Executive Pay<br>▪ Risk Assessment Process<br>▪ Business Ethics |

## Environmental

On October 7, 2022, the SEC reopened the comment period for 12 recently issued proposals due to a technical glitch in its internet comment form. The comment periods were reopened until November 1, 2022, for reposting of any missing comments and submission of new comments. This affected the following ESG-related proposals:

**I. The Enhancements & Standardization of Climate-Related Disclosures for Investors**. This rule would apply to all SEC reporting companies, even those with no publicly listed securities. Required disclosures would include:

- Climate-related metrics and related note disclosure in audited financial statements that would be subject to internal control over financial reporting requirements
- Climate-related physical and transition risks over the short, medium, and long term and their actual and potential impact on business activities
- Governance and risk management of identified climate-related risks
- Greenhouse gas (GHG) emissions, including:
    - Scope 1 and Scope 2 emissions, *i.e.*, from a registrant’s owned or controlled operations and purchased or acquired electricity, steam, heat, or cooling, which would be subject to assurance
    - Scope 3 emissions are emissions a company is indirectly responsible for in its value chain. Disclosure would be required if the emissions are material or if a registrant has set a GHG emissions reduction target including its Scope 3 emissions. Scope 3 disclosures would be covered by a safe harbor provision



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- Information about climate-related targets and goals, internal carbon price, and transition plan, including progress against the plan, targets, or goals

More than 40,000 comment letters were received before the comment period was reopened, a new SEC record. While there was overall agreement that a single set of reporting requirements would be an improvement over the patchwork of voluntary reporting and disclosure frameworks for both investors and financial statement preparers, areas of pushback were substantial, including:

- Scope 3 emissions disclosures. Scope 3 emissions refer to GHG emissions from other businesses in a company's supply chains and users of their products.
- Auditor signoff. Preparers cited the increased cost and potential for delayed SEC filings. Auditors highlighted that there is no current auditing guidance on ESG disclosures.

**Resource**: SEC's ESG Climate Proposal – What You Need to Know

**II. ESG Disclosures for Investment Advisers & Investment Companies**. This proposal requires new disclosures to give investors consistent, comparable, and reliable information on funds' and advisers' use of ESG factors. Highlights include:

- New disclosures on ESG strategies in fund prospectuses, annual reports, and adviser brochures
- Implementing a layered, tabular disclosure approach for ESG funds to allow investors to easily compare ESG funds
- GHG emissions disclosure would be required for certain environmentally focused funds for portfolio investments

**Resource**: Investment Advisers & Companies Face New ESG Disclosures

III. **Fund-Naming Rules**. The proposal would update the 20-year-old "Name Rule" that ensures a fund's name accurately reflects the fund's investments and risks. The proposal would make the following changes:

- Updates to the 80% investment policy requirement
- Prevent the misleading use of ESG terminology
- Enhance prospectus disclosure, reporting, and record-keeping

The SEC must now review any additional comments received before issuing final rules on the reopened proposals. These would all be considered significant or major rules and must be published in the **Federal Register** at least 60 days prior to their effective date. Any future rules implemented also faces significant legal challenges. The U.S. Supreme Court decision in *West Virginia v. Environmental Protection Agency* found that federal agencies need specific congressional authorizations before issuing regulations that deal with major questions. This could tie up any final rules issued in court battles for years.

In the absence of new regulations, the SEC's Climate and ESG Task Force continues to leverage 2010 interpretive guidance. The 2010 guidance clarifies what companies should be doing—making disclosure about the effects of climate-related legislation, regulation, and international accords, if material to their business. See Appendix.

**Resource:** SEC Lays Out ESG Reporting Expectations

## Social

The SEC is planning to release a proposed rule requiring more robust workforce disclosures by December 2022. In 2020, the SEC adopted a principles-based requirement for companies to disclose the size of their employee base and human capital measure or objectives used to manage their business if ***material***. Many felt the materiality criteria was too flexible



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and the resulting disclosures fell short of shareholder activist and investor wishes. While SEC officials have not publicly indicated what might be in the proposal, activists have requested that the rule require more details on diversity, part-time, full-time, and contingent workers, workforce expenses, and employee turnover.

## Governance

The SEC recently launched a letter campaign ahead of next year's proxy season in an effort to get companies to describe how their boards of directors evaluate risks, whether they consult with outside advisors to anticipate future threats and trends, and how their risk oversight process aligns with disclosure controls and procedures. Some companies were asked to justify their leadership structure and spell out circumstances under which they would have the company chair and CEO roles filled by the same person. Traditionally, companies seldom received queries on their annual proxy statements; rather, questions about proxy statements would be raised concurrently with financial information in other filings, such as 10-Ks and 10-Qs. In addition, the SEC recently finalized rules on executive pay to complete a long-outstanding Dodd-Frank requirement.

### *Final Rules*

**I. Executive Pay Clawbacks**. New Rule 10D-1 addresses standards for exchange-listed companies for the recovery of erroneously awarded compensation to executive officers, known as a clawback policy. The executives covered are broad and include the issuer's president; principal financial officer; principal accounting officer; any vice president in charge of a principal business unit, division, or function; and any other officer who performs policymaking functions.

**Resource:** SEC Finalizes Executive Pay Clawback Rules

**II. Pay Versus Performance**. The final rule requires new narrative and quantitative disclosures detailing how executive compensation for the principal executive officer (PEO) and other named executive officers (NEOs) relates to a registrant's financial performance. New Regulation S-K Item 402(v) requires a five-year table that includes "actual" compensation paid and several performance measures:

- Registrant's total shareholder return (TSR)
- TSR for the registrant's peer group
- Registrant's net income
- Registrant's selected performance measure that represents the most important metric to link pay to performance

A registrant also will be required to list at least three and up to seven of its most important performance measures used to link compensation actually paid to performance for the most recently completed fiscal year. Several accommodations are available for smaller reporting companies.

**Registrants must include these new disclosures in proxy and information statements for fiscal years ending on or after December 16, 2022.**

**Resource:** SEC's New Pay Versus Performance Disclosures



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*Proposals*

The SEC could soon finalize two other governance related proposals that were not impacted by the re-opened comment period.

**I. Shareholder Proposal Exclusion**. The proposal would update three of the substantive bases for excluding a shareholder proposal from a company's proxy statement. The changes would restrict the grounds for excluding shareholder proposals and, if adopted, would most likely increase the number of shareholder proposals that would have otherwise been excluded under prior SEC conclusions.

**Resource:** Excluding Shareholder Proposals May Get Tougher with SEC Proposal

**II. Rule 10b5-1 Plans & Insider Trading**. Rule 10b5-1(c) established an affirmative defense to insider trading if trades met certain conditions. Many observers have raised concerns over the years that Rule 10b5-1 may help shield opportunistic insider trading from legal, regulatory, and market scrutiny, and questioned whether the rule needs to be strengthened. This SEC proposal addresses these concerns.

**Resource**: SEC to Update Rules on Insider Trading & 10b5-1 Plans

# Federal Reserve Board (Fed)

## Climate Scenario Analysis

The Fed announced six large banks[1] would participate in a 2023 pilot climate scenario analysis exercise designed to enhance the ability of supervisors and banks to measure and manage climate-related financial risks. The banks will run scenario analysis under different hypothetical climate variables. This climate scenario analysis is distinct and separate from bank stress tests and has no capital consequences. Insights gained from the pilot are expected to be published in aggregate to help identify potential risks and promote risk management practices (no bank-specific information will be released).

# FDIC

At a November appearance before the House Financial Services Committee, FDIC Acting Chair Martin Gruenberg acknowledged that the agency does not currently incorporate the financial risk of climate change into its supervisory program.[2]

"We're just beginning this process, but from my standpoint, there needs to be active engagement, explain what we're doing, listen to the industry, and proceed thoughtfully and carefully. There will be clear distinction in how we approach the larger institutions as opposed to the smaller ones. The agency needs to clearly communicate what its intentions are as it begins to explore those risks," Gruenberg said.

[1] Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, and Wells Fargo

[2] ABA Banking Journal, November 16, 2022



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## State Level

In August 2022, Florida Gov. Ron DeSantis' administration approved a resolution to bar the state's $186 billion pension fund from considering ESG factors when making investment decisions.[3] In 2021, Texas enacted laws that prohibited municipalities from contracting with banks that have certain ESG policies. More recently both Texas and West Virginia have banned additional banks and investment funds for allegedly boycotting fossil fuel-based energy companies critical to each state's economy. Large pension funds such as the Teacher Retirement System of Texas will now be required to divest from companies and funds that have been banned.

Other states including Arizona, Indiana, Kentucky, Missouri, Ohio, Oklahoma, South Dakota, and Wyoming have similar proposals that are currently going through the legislative process.

# B. European Developments

## European Central Bank (ECB)

### Climate Risk Stress Test Results

In July 2022, the ECB published the results of its climate risk stress test. Forty-one significant banks participated and the test required banks to project losses due to extreme weather events and under transition scenarios with both short- and long-term time horizons, highlighted in the graphic below. This stress test will not have any direct capital implications for the participating banks. While banks have made some progress since 2020, they have not yet sufficiently incorporated climate risk into their stress-testing frameworks and internal models. Notable findings include:

- Banks are still at an early stage in terms of factoring climate risk into their credit risk models. In many cases, credit risk parameters projected by banks were found to be fairly insensitive to the given scenario’s climate risk shocks.
- Most banks are making extensive use of proxies instead of actual counterparty data, *i.e.*, data directly available in the counterparty disclosure documentation, to measure Scope 1, 2, and 3 emissions.
- Banks should enhance their customer engagement to gain insights into their clients’ transition plans.
- Banks need to step up their long-term strategic planning, *e.g.*, green transition plans and targets. Many banks appear to lack clearly defined long-term strategies for credit allocation policies that reflect the various transition paths.
- Roughly 60% of banks do not yet have a well-integrated climate risk stress-testing framework, and most of those banks envisage a medium to long-term time frame for incorporating physical and/or transition climate risk into their framework.

Banks reported challenges in developing model loss projections over a 30-year time horizon and connecting scenario assumptions to credit risk parameters, characterizing extreme weather events, and anticipating changes in customers’ behaviors.

[3] S&P Global Market Intelligence, August 24, 2022



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## Overview of Scenarios & Risk Dimensions

| | Exposures | Scenario | Projections[1] | Horizon | Credit risk | Market risk | Operational risk |
|---|---|---|---|---|---|---|---|
| Transition risk | Global | Short-term stress | Baseline | 3 years (2022-2024) | Corporate loans (incl. SME, CRE) + mortgages | Bonds + stocks issued by NFCs[2] (incl. accounting and economic hedges) | Operational and reputational risks to be assessed via a qualitative questionnaire |
| | | | Stress | | | | |
| | | Long-term paths | Orderly | 30 years (2030, 2040, 2050) | Corporate loans (incl. SME, CRE) + mortgages | | |
| | | | Disorderly | | | | |
| | | | Hot house | | | | |
| Physical risk | EU countries | Drought & heat risk | Baseline | 1 year (2022) | Corporate loans (incl. SME) | | |
| | | | Stress | | | | |
| | | Flood risk | Baseline | 1 year (2022) | Mortgages + CRE loans | | |
| | | | Stress | | | | |

1.All projections with the exception of the long-term paths will be based on a static balance sheet.
2.The parent company needs to be an NFC, e.g. bonds issued by car financing company X are in scope.

Source: ECB, climate risk stress test 2022, methodology, October 2021.
Notes: CRE stands for commercial real estate; NFC stands for non-financial corporation; SMEs stands for small and medium-sized enterprises.

# Financial Reporting Council (FRC)

The FRC regulates auditors, accountants, and actuaries, and sets the UK's Corporate Governance and Stewardship Codes. An October 2022 review of existing climate-related reporting found that current disclosures were too high level and do not give investors enough information and identified three main areas that investors wanted to understand:

- A company's goal on reaching net zero GHG emissions: the commitment's scope, nature, and timing
- How a net zero plan impacts a company's strategy and business model, including details on uncertainties and risks
- How a company's progress toward net zero is being measured and how management is adapting to changes

# EC & European Financial Reporting Advisory Group (EFRAG)

In April 2021, the EC adopted the Corporate Sustainability Reporting Directive (CSRD) that requires in-scope companies to comply with European Sustainability Reporting Standards (ESRS). Under the CSRD, EFRAG was appointed technical adviser to the EC to develop draft ESRS. On November 28, 2022, the EC voted unanimously to approve the following standards:

Cross-cutting standards:

- ESRS 1 General requirements
- ESRS 2 General disclosures

Topical standards:

Environment:

- ESRS E1 Climate change
- ESRS E2 Pollution



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- ESRS E3 Water and marine resources
- ESRS E4 Biodiversity and ecosystems
- ESRS E5 Resources and circular economy

Social:

- ESRS S1 Own workforce
- ESRS S2 Workers in the value chain
- ESRS S3 Affected communities
- ESRS S4 Customers and end-users

Governance:

- ESRS G1 Business conduct

The reporting requirements will be phased in over time. The first companies must apply the standards in financial year 2024, for 2025 reports. Listed small and medium-sized enterprises (SMEs), small and noncomplex credit institutions, and captive insurance undertakings must comply for 2026 reports, with a further possibility of voluntary opt-out until 2028. Non-European companies will be required to report on 2028 results in 2029 for companies generating a net turnover of EUR 150 million in the European Union (EU) and which have at least one subsidiary or branch in the EU exceeding certain thresholds.

Sustainability disclosures must be audited and EU countries will be allowed to accredit independent assurance companies to avoid giving too much market clout to the Big Four auditors.[4]

These standards must be signed by the president of the European Parliament and the president of the Council and will be effective 20 days after publication in the Official Journal of the EU. The rules must be implemented by member states within 18 months.

EFRAG will continue its work on drafts for sector-specific standards—agriculture, coal mining, mining, oil and gas (upstream), oil and gas (mid- to downstream), energy production, road transport, motor vehicle production, food/beverages, and textiles.

## International Sustainability Standards Board (ISSB)

In October, the ISSB completed its review of feedback on its two March 2022 proposed standards—climate-related disclosures (IFRS S2) and sustainability-related disclosures (IFRS S1). More than 600 letters were received on the climate-related proposal and 700 on the sustainability-related proposal. Overall, while stakeholders agreed global reporting standards are needed to end conflicting voluntary standards from being used to report on ESG risks, there were numerous suggestions for improvement in the ISSB's approach:

- The importance of achieving interoperability with the proposals published in Europe and the U.S.
- All Big Four accounting firms cited the lack of definitions for key terms—significant, material, and vulnerable
- Some, including the ECB, felt the guidance was too narrowly focused on financial investors, suggesting instead looking at the broader "dual materiality" approach used by the EU in which companies show the damage they cause to the world as well as their impact on climate change and other threats

[4] Deloitte LLP, Ernst & Young LLP, KPMG LLP, and PwC



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The feedback on interoperability resulted in the ISSB calling two special meetings in November to ensure its final standards will be compatible with the EU reporting rules. At the first meeting on November 1, 2022, the ISSB agreed to four suggested changes to the March proposals, notably clarifying the definition of climate resilience and annual disclosure requirements. At the same meeting, the ISSB set up an advisory group, the Integrated Reporting and Connectivity Council (IRCC). The group consists of 90 members, including senior executives from BlackRock Inc., the World Bank, and major accounting firms. The IRCC will meet three times a year and advise both the IASB and the ISSB on how to integrate financial and sustainability reporting. At the second special meeting, the ISSB agreed that companies should detail plans to cut emissions to meet the Paris Agreement goals, including planning assumptions. However, companies would not be required to disclose if the assumptions are not met. Companies would be required to state the scope of their climate targets.

**Both the EU and the ISSB want to finalize climate reporting standards this year, with publication planned for 2023.**

## Conclusion

Whether you are publicly traded or privately held, **FORVIS** can provide an independent and objective view into your financial reporting. We leverage the latest technologies and process automation tools to provide companies assurance on their financial statements to help meet stakeholders' needs. For more information, visit forvis.com.

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## Appendix – Existing 2010 SEC Guidance

The 2010 document highlights the following existing requirements of Regulation S-K and S-X that may require disclosure related to climate change:

- **Description of business**. Regulation S-X Item 101 expressly requires disclosure regarding the costs of complying with environmental laws.
- **Legal proceedings**. Regulation S-K Item 103 notes the federal, state, or local provisions that have been enacted regulating the environmental discharge or protecting the environment will not be excluded from disclosure under the "ordinary routine litigation incidental to the business" safe harbor and must be described if:
    - Such proceeding is material to the registrant's business or financial condition
    - Such proceeding involves primarily a claim for damages, or involves potential monetary sanctions, capital expenditures, deferred charges, or charges to income and the amount exceeds 10% of the registrant's current assets on a consolidated basis
    - A governmental authority is a party to such proceeding and such proceeding involves potential monetary sanctions, unless the registrant reasonably believes that such proceeding will result in no monetary sanctions, or in monetary sanctions, exclusive of interest and costs, of less than $100,000
- **Risk factors**. Regulation S-K Item 503(c) requires a discussion of the most significant factors that make an investment in the registrant speculative or risky. Item 503(c) specifies that risk factor disclosure should clearly state the risk and specify how the particular risk affects the particular registrant; registrants should not present risks that could apply to any issuer or any offering. Registrants should consider specific risks they face as a result of climate change legislation or regulation and avoid generic risk factor disclosure that could apply to any company. For example, registrants that are particularly sensitive to GHG regulation, *e.g.*, the energy sector, may face significantly different risks from climate change regulation compared to registrants that currently are reliant on products that emit GHGs, *e.g.*, the transportation sector.

  Registrants whose businesses may be vulnerable to severe weather or climate-related events should consider disclosing material risks of—or consequences from—such events in their publicly filed disclosure documents. Significant physical effects of climate change, such as effects on the severity of weather, *e.g.*, floods or hurricanes, sea levels, the arability of farmland, and water availability and quality, have the potential to affect a registrant's operations and results. Possible consequences of severe weather could include:
    - For registrants with operations concentrated on coastlines, property damage and disruptions to operations, including manufacturing operations or the transport of manufactured products
    - Indirect financial and operational effects from disruptions to the operations of major customers or suppliers from severe weather, such as hurricanes or floods
    - Increased insurance claims and liabilities for insurance and reinsurance companies
    - Decreased agricultural production capacity in areas affected by drought or other weather-related changes
    - Increased insurance premiums and deductibles, or a decrease in the availability of coverage, for registrants with plants or operations in areas subject to severe weather
- **MD&A**. Regulation S-K Item 303 requires that disclosure decisions concerning trends, demands, commitments, events, and uncertainties generally should involve the:



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- Consideration of financial, operational, and other information known to the registrant
- Identification, based on this information, of known trends and uncertainties
- Assessment of whether these trends and uncertainties will have—or are reasonably likely to have—a material effect on the registrant's liquidity, capital resources, or results of operations. Registrants also should consider—and disclose when material—the effect on their business of treaties or international accords relating to climate change. Registrants whose businesses are reasonably likely to be affected by such agreements should monitor the progress of potential agreements and consider materiality and the above principles



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