4Q Update – ESG Regulation & Financial Reporting

This article summarizes the latest updates on global environmental, social, and governance (ESG) rule-making activity, with a focus on mandated U.S. financial statement reporting requirements. While the fourth quarter closes without the SEC final climate disclosure rule, the state of California is filling the void with rules that will impact both public and private companies, independently from where they are headquartered. With European ESG reporting deadlines looming, some effective date relief is being proposed. Here are the latest updates with links to resources from **FORVIS** for a deeper dive.

A. U.S. Updates

FRB/FDIC/OCC

1. Principles for Climate-Related Financial Risk Management for Large Financial Institutions

On October 24, 2023, the Office of the Comptroller of the Currency (OCC), the FDIC, and the Federal Reserve Board (FRB) jointly issued Principles for Climate-Related Financial Risk Management (Principles), finalizing the versions previously proposed and released from each agency individually.

The Principles present a high-level framework for large financial institutions with at least $100 billion in total consolidated assets to incorporate management of emerging physical and transition climate risk into board and management routines and decision making.

The final version is very similar to the proposed ones. Some clarifications were made to areas such as governance and the acknowledgment of impact on lower- and moderate-income (LMI) consumers and communities, among others. The Principles retain and address the following six main components: Governance; Policies, Procedures, and Limits; Strategic Planning; Risk Management; Data, Risk Measurement, and Reporting; and Scenario Analysis.

The Principles also maintain their draft approach to climate risk as a horizontal risk transversing commonly considered risk types, including liquidity, credit, other financial and non-financial, operational, and legal and compliance risks. Banks will need to assess their current state and key gaps toward compliance with the Principles.

2. Semiannual Risk Perspective for Fall 2023

On December 7, 2023, the OCC released its semiannual risk report. The OCC will continue its review of large banks' (more than $100 billion in assets) climate-related financial risk management programs. The report highlights the following findings:

- Efforts to incorporate climate-related financial risk in strategic planning remain in the early stages of development.
- Most of these banks also are still in the early stages of integrating climate-related financial risk into their broader risk appetites, and some have developed quantitative risk appetite metrics. Banks are reporting on climate-related financial risk to senior management and the board and indicated that reporting will become more detailed moving forward.
- Banks continue to face challenges and limitations on obtaining granular data for their climate-related financial risk analysis.

- Banks have generally developed or are planning to implement climate-related credit risk assessments to evaluate borrowers' and clients' exposures to high-risk sectors and industries.
- Banks are in the very early stages of understanding the impacts of climate change and ways to mitigate climate-related financial risk on low- and moderate-income communities they serve. Bank management teams generally have focused their initial work on the physical risks, *e.g.*, flooding, of residential real estate.

SEC

Recent Rulemaking

1. Fund Names Rule

On September 20, 2023, the SEC issued a final rule updating the 20-year-old "Names Rule" to ensure that a fund's name accurately reflects the fund's investments and risks. The rule broadens the scope of the 80% investment policy requirement (for at least 80% of a fund's assets to be invested in ways reflective of the fund's name) to cover an additional 2,200 funds and more clearly address the use of "thematic" strategies—artificial intelligence, health and wellness, travel/tourism, or ESG funds.

A fund's prospectus must now include the definitions of terms used in its name, including the criteria used to select investments that each term describes. New quarterly investment reviews are mandated for consistency with the 80% investment policy requirement.

Effective Date
December 11, 2023

Fund Assets Greater Than $1 Billion
December 11, 2025

Fund Assets Less Than $1 Billion
June 11, 2026

Resource: SEC Updates Fund Names Rules

2. Cybersecurity Disclosures – Registrants

In July 2023, the SEC voted to formalize standardized disclosures about cybersecurity risk management, strategy, governance, and material cybersecurity incidents by public companies subject to the reporting requirements of the *Securities Exchange Act of 1934*. Highlights include:

- **New Item 1.05 of Form 8-K:** Registrants will be required to disclose on this item any cybersecurity incident they determine to be material and to describe the material aspects of the incident's nature, scope, and timing, as well as its material impact or reasonably likely material impact on the registrant. This will generally be due four business days after a registrant determines that a cybersecurity incident is material. The disclosure may be delayed if the U.S. attorney general determines that immediate disclosure would pose a substantial risk to national security or public safety with written notification to the SEC.
- **New Regulation S-K Item 106:** Will require registrants to describe, on an annual basis, their processes, if any, for assessing, identifying, and managing material risks from cybersecurity threats, as well as the material effects or reasonably likely material effects of risks from cybersecurity threats and previous cybersecurity incidents. Item 106 also will require registrants to describe the board of directors' oversight of risks from cybersecurity threats and

management's role and expertise in assessing and managing material risks from cybersecurity threats. These disclosures will be required in a registrant's annual report on Form 10-K.

Resource: Details on SEC's New Cybersecurity Disclosures

Regulatory Agenda

On December 6, 2023, the SEC released its fall regulatory agenda. Most of the ESG-related projects have been delayed despite the previously published target dates. The following ESG-related topics continue to be carried forward from the 2022 agenda:

Proposals

- Corporate board diversity
- Human capital management
- Payments by resource extraction issuers

Final Rules

- Climate change disclosures (registrants)
- ESG investment practices (funds and advisers)
- Cybersecurity (funds)
- Cybersecurity risk management (broker-dealers)

Resources:

- Investment Advisers & Companies Face New ESG Disclosures
- 2Q 2023 ESG Regulation & Financial Statement Updates
- How Federal Contractors Can Meet Proposed GHG Reporting Rules (Federal Government)

Final Rule SEC Climate Disclosure Rule for Registrants

SEC staff have been tight-lipped about the timing on the issuance of a final rule for registrants on climate disclosures. However, in recent speeches, SEC officials have indicated a willingness to scale back some of the requirements of the climate disclosure rules to avoid legal challenges.

"We got a lot of comments around what's called Scope 3 disclosures, and that's what we're trying to move forward on."

SEC Chair Gary Gensler, September 12, 2023 testimony before the Senate Committee on Banking, Housing, and Urban Affairs.

"Before the Commission adopts any final rule that significantly deviates from the proposal, it should seriously consider re-proposing the rule with revised rule text and an updated economic analysis".

SEC Commissioner Mark Uyeda, November 7, 2023 remarks at the Practising Law Institute's 55th Annual Institute on Securities Regulation.

In the absence of a final rule, registrants should continue to follow the SEC's 2010 interpretive guidance (see Appendix A).

Exam Priorities

On October 16, 2023, the SEC's Division of Examinations released its 2024 priorities, which include (1) information security and operational resilience, (2) crypto assets, (3) regulation systems compliance and integrity, and (4) anti-money laundering. Notably, the SEC's 2024 examination priorities do not include a direct reference to ESG topics, representing a departure from the examination priorities reports for the past three years.

Resource: SEC Releases 2024 Examination Priorities

State of California

In the absence of federal regulations, the state of California is moving ahead with its own regulatory regime that will affect both public and private companies outside the state.

GHG & Climate Reporting

On October 7, 2023, California Gov. Gavin Newsom signed into law Senate Bill (SB) 253, *Climate Corporate Data Accountability Act*, and SB 261, *Greenhouse Gases: Climate-Related Financial Risk*. SB 253 requires U.S. companies doing business in California with more than $1 billion of annual revenue—regardless of where that revenue is earned—to submit assured annual reports of greenhouse gas (GHG) emissions starting with their fiscal year 2025 emissions reported in 2026. SB 253 requirements will impact more than 5,000 companies. Under SB 261, U.S. companies doing business in California that produce more than $500 million of annual revenue—regardless of where that revenue is earned—are required to submit a report of climate-related financial risk every other year with the first report due by January 1, 2026. The SB 261 requirements will impact more than 10,000 companies.

On the same day, a third bill (Assembly Bill 1305), *California's Voluntary Carbon Market Disclosures Act*, also was signed into law to promote transparency and integrity through public annual disclosures (on a company's website) for all companies operating in California and marketing, selling, purchasing, or using voluntary carbon offsets or making emissions neutrality or reductions claims. The bill is effective from January 1, 2024 but doesn't specify the required date for the first disclosures, although the bill sponsor, Jesse Gabriel, indicated in writing his intent for the first due date to be January 1, 2025. In the absence of a legislative record, though, many companies are scrambling to prepare their first disclosures by next month.

Diversity

On October 8, 2023, California enacted a new law, *Investing in Equity Act*, requiring venture-capital firms to provide data on the gender and racial makeup of the startups they fund. Firms also will be required to annually survey their founders—who can opt out—on their gender identity, race, ethnicity, disability status, and veteran status. This information will be published in an online searchable database. This law is scheduled to take effect in March 2025. (Similar information is already required by the state of Illinois, including the Chicago Teachers' Pension Fund and the Illinois Municipal Retirement Fund.)

Industry participants note that the scope is overly broad and there is confusion over what qualifies as a venture capital firm that operates in California. A firm could be covered even if it does not have an office in California, *e.g.*, firms that invest in the state or solicit investments from California residents. Other interpretations note that an investment firm that manages money for outside investors could be covered by this regulation, potentially including pension funds, private equity, family offices, and business development companies. Upon signing the legislation, Newsom noted the measure "contains problematic provisions and unrealistic timelines."

Resource:

California Enacts GHG & Climate Reporting Laws Requiring Major Action by US Companies

U.S. Treasury

With the passage of the *Inflation Reduction Act of 2022*, companies can sell their energy tax credits to a third party under §6418. Tax-exempt entities, states, and political subdivisions will be able to receive "direct pay" or cash as a tax refund from the government under §6417. The rules also clarify that an instrumentality of the state is eligible for direct pay. Prior to the guidance, some universities, hospitals, and school districts were uncertain if they qualified because instrumentalities were omitted from the law.

The U.S. Department of the Treasury is considering allowing individuals to buy these clean energy tax credits from companies.

Resources:

Monetizing Clean Energy Tax Credits for Tax-Exempt Organizations

Clean Energy Tax Incentives in the Franchise Space

Committee of Sponsoring Organizations (COSO)

COSO has developed a framework used to establish internal controls to provide reasonable assurance that an organization is operating ethically, transparently, and in accordance with accepted industry standards. Earlier this year, COSO issued guidance on effective internal controls over sustainability reporting and ESG disclosures.

Resources:

Attestation and Internal Control Considerations for ESG Programs

Five Critical Insights in Applying COSO's Guidance for ICSR

Behind the Curtain: What You Need to Know About ESG Assurance

B. European Developments

The European Parliament recently rejected a motion to dilute the European Sustainability Reporting Standards (ESRS), which underpin the Corporate Sustainability Reporting Directive (CSRD), set to become effective in 2024 for the largest

European Union (EU) companies. Small and midsize companies and foreign companies with a large European Union (EU) presence will be subject to the ESRS beginning in 2028.

CSRD

On October 18, 2023, the European Commission proposed to postpone its deadlines for adopting two sets of standards under the CSRD from June 30, 2024 to June 30, 2026. The effective dates would be delayed for sector-specific ESRS and standards that specify reporting obligations for large non-EU companies operating in the EU. Comments are due by December 19, 2023.

European Banking Authority (EBA)

On October 12, 2023, the EBA published the "Role Of Environmental and Social Risks in the Prudential Framework" for banks and investment firms on how to incorporate environmental risks into the Pillar One framework of Basel **III** (which defines banks' minimum capital requirements). The report includes a number of short-term and medium- to long-term actions to accelerate integration of environmental and social risks across Pillar One. The recommendations include, among other things, requiring institutions to consider environmental and social risks as part of stress-testing programs and competent authorities to verify that due diligence requirements explicitly integrate environmental aspects. The report considers how scenario analysis could be used to enhance forward-looking elements of the prudential framework.

Conclusion

Whether you are publicly traded or privately held, **FORVIS** can provide an independent and objective view into your financial reporting. We leverage some of the latest technologies and process automation tools to provide companies assurance on their financial statements to help meet stakeholders' needs. The ESG & Climate Risk team at **FORVIS** provides consulting services for ESG investment policy and process development, financed emissions, climate physical and transition risk management, ESG software selection and implementation, voluntary and regulatory sustainability disclosures, ESG ratings management and ESG metrics assurance, among others.

For more information, visit **forvis.com**.

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Appendix A – 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:

- 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