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WHITE PAPER

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Biden's Executive Order on Climate-Related Financial Risk: What's Next for Financial Institutions?

President Biden issued an Executive Order asking the Secretary of the U.S. Department of the Treasury to work with the Financial Stability Oversight Council to assess risks that climate change poses to the financial system. The Executive Order highlights the growing regulatory focus on climate-related financial risks, which will likely manifest itself through a growing number of related supervisory initiatives. This *White Paper* describes the Executive Order, along with recent guidance and statements of the U.S. federal and state financial services regulators, and offers a look ahead at what's next.

TABLE OF CONTENTS

EXECUTIVE ORDER ON CLIMATE-RELATED FINANCIAL RISK 1

ESG-RELATED ACTIONS AND ANNOUNCEMENTS OF FSOC MEMBER AGENCIES 2

U.S. Department of the Treasury 2

SEC 3

CFTC 3

Federal Reserve Board 3

OCC 3

FDIC 4

CFPB 4

FHFA 4

Federal Agency Actions and Announcements Focused on Human Trafficking 4

STATE ESG-RELATED ACTIONS AND ANNOUNCEMENTS 4

KEY TAKEAWAYS 5

CONTACTS 6

President Biden's Executive Order on *Climate-Related Financial Risk* ("Climate Risk Executive Order") instructs the Secretary of the U.S. Department of the Treasury ("Treasury Secretary"), as Chairperson of the Financial Stability Oversight Council ("FSOC"), to work with members of the FSOC to assess the risks that climate change poses to the U.S. financial system, laying the foundation for future regulatory direction. The FSOC is a collaborative body that brings together the expertise of the federal financial regulators, state regulators, and an independent insurance expert, appointed by the President, to identify risks and respond to emerging threats to U.S. financial stability.

Management of environmental, social, and governance ("ESG") risks is emerging as a top challenge for financial institutions and their customers. While U.S. regulators have not yet issued significant rules with respect to what a financial institution must do to address these risks, international and U.S. regulators and policymakers are focused on development of an appropriate ESG-related regulatory and supervisory framework.

The Climate Risk Executive Order contemplates, among other actions, that the FSOC will issue a report to the President, by November 17, 2021, that describes the efforts of the FSOC member agencies to integrate consideration of climate-related financial risk into their policies and programs and that recommends risk mitigants, including new or revised regulatory standards. As the agencies collaborate and develop new regulatory standards on climate-related risks, financial institutions may expect to see additional climate-related supervisory guidance and new regulations.

This *White Paper* describes the Climate Risk Executive Order, along with recent guidance and statements of the U.S. federal and state financial services regulators, and offers a look ahead at what's next. The environmental portion of ESG generally considers how a financial institution performs as a steward of natural resources. Although the "E" in ESG is receiving the greatest regulatory attention, international and domestic legal and regulatory ESG-related initiatives will continue to evolve at an increasing pace, with attention to issues beyond climate change. Jones Day will publish additional analyses as significant ESG-related initiatives are announced.

EXECUTIVE ORDER ON CLIMATE-RELATED FINANCIAL RISK

An important goal of the Climate Risk Executive Order is to encourage the FSOC member agencies to share climate-related financial risk data and information among themselves and with other executive branch departments and agencies to help ensure sound decision-making. (Read our previous *Alert*, "White House Instructs Agencies to Analyze and Mitigate "Climate-Related Financial Risk.") The Climate Risk Executive Order directs the Treasury Secretary, as the Chairperson of the FSOC, to engage with FSOC members to consider several enumerated climate-related actions by the FSOC. Altogether, these actions are intended to promote the FSOC member agencies' assessment, coordination, and sharing of information on climate-related financial risks. Although the Climate Risk Executive Order does not apply to the independent agencies that are members of the FSOC, such as the federal bank regulators, these agencies are likely to participate in the FSOC's analysis and activities pursuant to the Climate Risk Executive Order as well as to engage in additional analysis and activities aligned with the objectives of the Climate Risk Executive Order.

The Climate Risk Executive Order envisions that the FSOC member agencies will assess climate-related financial risks, including physical and transition risks, to the stability of the U.S. financial system, in a detailed and comprehensive manner. Physical risks the agencies will review include the potential for loss resulting from climate-related damage to the value and use of assets and from disruption of business operations, capital, and economic activity. Transition risks the agencies will review include the potential for loss resulting from decreasing valuations due to gravitation toward a lower-carbon economy, consumer sentiment about environmental risks, and technological innovations.

Pursuant to the Climate Risk Executive Order, the FSOC will issue a report to the President, by November 17, 2021, on efforts by the FSOC member agencies to integrate consideration of climate-related financial risk into their policies and programs. This report to the President is separate from the FSOC's annual report to Congress, and the Climate Risk Executive

Order provides that the FSOC's annual report to Congress will include an assessment of climate-related financial risks.

The FSOC climate-related financial risk report to the President will include a discussion of necessary actions and potential impediments to those actions, and will recommend risk identification processes and steps for mitigating risk. Specifically, the FSOC climate-related financial risk report to the President will discuss:

- The necessity of any actions to enhance climate-related disclosures by regulated entities to mitigate climate-related financial risk to the financial system or assets and a recommended implementation plan for taking those actions;
- Any current approaches to incorporating the consideration of climate-related financial risk into their respective regulatory and supervisory activities and any impediments they faced in adopting those approaches;
- Recommended processes to identify climate-related financial risk to the financial stability of the U.S.; and
- Other appropriate recommendations on how the identified climate-related financial risk can be mitigated, including through new or revised regulatory standards.

Further, the Climate Risk Executive Order requires that the Treasury Secretary direct the Treasury Department's Federal Insurance Office ("FIO"), which is a nonvoting member of the FSOC, to assist with climate change assessments in two respects. First, FIO will assist with assessing climate-related issues or gaps in the supervision and regulation of insurers, including as part of the FSOC's analysis of financial stability, and, second, in consultation with states, FIO will assist with assessing the potential for major disruptions of private insurance coverage in U.S. regions that are particularly vulnerable to climate change impacts. These assessments may impact financial institutions' risk assessments.

Additionally, the Climate Risk Executive Order requires that the Treasury Secretary direct the Office of Financial Research to assist the Treasury Secretary and the FSOC in assessing and identifying climate-related financial risk to financial stability, including the collection of data and the development of research on climate-related financial risk to the U.S. financial system.

The Climate Risk Executive Order also provides that the Director of the National Economic Council and the National Climate Advisor, in coordination with the Treasury Secretary and the Director of the Office of Management of Budget, must develop a comprehensive, government-wide strategy on climate measuring, financing, and public-private roles by September 18, 2021.

The Executive Order is consistent with President Biden's prior Executive Orders on *Protecting Public Health and the Environment and Restoring Science to tackle the Climate Crisis* (January 20, 2021), *Tackling the Climate Crisis at Home and Abroad* (January 27, 2021), *Rebuilding and Enhancing Programs To Resettle Refugees and Planning for the Impact of Climate Change on Migration* (February 4, 2021), and *Establishment of the Climate Change Support Office* (May 7, 2021).

ESG-RELATED ACTIONS AND ANNOUNCEMENTS OF FSOC MEMBER AGENCIES

Prior to issuance of the Climate Risk Executive Order, some FSOC member agencies had already begun to analyze financial risks associated with ESG, and had issued related supervisory guidance, sought public input on ESG-related initiatives, and appointed personnel to spearhead their efforts. Most of the FSOC member agencies' actions have focused on climate change and related environmental issues, the "E" in ESG.

U.S. Department of the Treasury

The Department of the Treasury announced a coordinated climate policy strategy in April 2021 to "leverag[e] finance and financial risk mitigation to confront the threat of climate change." To implement this strategy, Treasury announced that it will focus on its climate-related policy work connected to climate transition finance, climate-related economic and tax policy, and climate-related financial risks. As part of this strategy, Treasury created a new Climate Hub and appointed John E. Morton as Climate Counselor to coordinate and lead its efforts to address climate change.

SEC

The Securities and Exchange Commission ("SEC") has created a Climate and ESG Task Force in the Division of Enforcement and appointed a Senior Policy Advisor for Climate and ESG. The SEC issued interpretive guidance for public companies in 2010, *Commission Guidance Regarding Disclosure Related to Climate Change*. Recently, in light of increasingly high demand for climate change information and questions about whether current disclosures adequately inform investors, the SEC has solicited public comment on climate change disclosure from investors, registrants, and other market participants, with comments due mid-June 2021. Among other questions, the SEC has asked how it can "best regulate, monitor, review, and guide climate change disclosures in order to provide more consistent, comparable, and reliable information for investors while also providing greater clarity to registrants as to what is expected of them."

The SEC has denied no-action requests from oil and gas companies seeking to exclude from their voting proxies shareholder proposals on greenhouse gas emissions. The SEC announced in March that its 2021 examination priorities include a greater focus on climate-related risks and on whether investment advisers' compliance programs match disclosures on their ESG strategies. Following the announcement, the SEC's examination unit issued a risk alert in April 2021, providing "observations of deficiencies and internal control weaknesses from examinations of investment advisers and funds regarding ESG investing," and further noted that it has observed instances of potentially misleading statements regarding ESG alignment and a lack of policies addressing ESG investing analyses, decision-making, and compliance oversight. We anticipate that the SEC will provide further insight on how to carry out its ESG-related mandates through enforcement actions once a new director of the Division of Enforcement is appointed.

It is possible that some state attorneys general may challenge potential future regulations issued by the SEC to compel public companies to make certain statements regarding ESG on First Amendment grounds (*see, e.g.,* West Virginia Attorney General's comment letter to SEC).

CFTC

The Commodity Futures Trading Commission ("CFTC") has created a Climate Risk Unit to focus "on the role of derivatives in understanding, pricing, and addressing climate-related risk and transitioning to a low-carbon economy." The Commodity Futures Trading Commission's Climate-Related Market Risk Subcommittee of the Market Risk Advisory Committee released a report in September 2020 entitled *Managing Climate Risk in the U.S. Financial System*, which concluded, among other things, that climate change poses a major risk to the stability of the U.S. financial system, and exacerbates financial system vulnerabilities that have little to do with climate change.

Further, this report concluded that U.S. financial regulators should move urgently and decisively to address these risks and help promote the role of financial markets as providers of solutions to climate-related risks, starting by using existing law to this end. The report made numerous recommendations for mitigating climate-related risks with a focus on the types of actions the federal financial regulators, including the CFTC, should take.

Federal Reserve Board

Members of the Board of Governors of the Federal Reserve System (the "Federal Reserve") have increasingly addressed ESG goals by encouraging "standardized, reliable, and mandatory disclosures" to provide access to data needed to appropriately manage risks. In December 2020, the Federal Reserve joined the Network for Greening the Financial System, a group of central banks and supervisors focused on defining and promoting best practices for green finance.

In March 2021, the Federal Reserve created the Financial Stability Climate Committee to consider the potential for complex interactions across the financial system at a macroprudential level. The work of the Financial Stability Climate Committee complements the work of the Federal Reserve's Supervision Climate Committee, which is responsible for ensuring the resilience of supervised firms to climate risks.

According to recent media reports, Federal Reserve supervisors are encouraging large banks to describe the measures they are taking to mitigate climate change-related risks to their balance sheets. Based upon these reports, Federal Reserve supervisors may be expecting large banks to submit information on their internal risk management testing, including the exposure of bank assets to physical risks by geography and industry sector.

OCC

In January 2021, the Office of the Comptroller of Currency ("OCC") adopted, and then paused, publication of a final rule

on fair access to bank services, capital, and credit to allow the next Senate-confirmed Comptroller of the Currency the opportunity to review the final rule and the public comments as part of an orderly transition. The fair access final rule would have required OCC-supervised banks to conduct individual risk assessments of customers by identifying, measuring, monitoring, and seeking to control risks in conjunction with providing bank products and services, including access to credit.

Upon his appointment on May 10, 2021, Acting Comptroller Michael Hsu stated that the OCC will analyze and address climate change which, he said, "poses new risks and challenges for banks." The Acting Comptroller also indicated that the OCC needs to make sure the agency understands climate change risks and is capable of managing them. In testimony before the U.S. House Financial Services Committee, the Acting Comptroller endorsed a two-pronged approach to addressing climate change through collaboration with the Basel Committee on Banking Supervision and participation in the Network for Greening the Financial System and also through development of climate risk management practices based upon a review of existing practices.

FDIC

The FDIC has similarly taken measures to address climate change. FDI Chair Jelena McWilliams stated at the March 2021 FSOC meeting that the FDIC has "long expected financial institutions to consider and appropriately address potential climate risks that could arise in their operating environment as a meaningful safety and soundness concern." To that end, the FDIC's 2021 Risk Review indicates that, when considering energy-related banking transactions, banks have been and should continue to consider climate change risk mitigation, especially in geographies with exposure to traditional energy resources.

CFPB

The Acting Director of the Consumer Financial Protection Bureau ("CFPB"), Dave Uejio, has sharpened the agency's focus on the social aspects of existing fair lending rules and unfair, deceptive, and abusive acts and practices. A key priority for the CFPB is to identify and pursue enforcement actions and civil money penalties against unlawful lending conduct that "disproportionately impacts communities of color and other vulnerable populations."

FHFA

The Federal Housing Finance Agency ("FHFA") issued a request for information in January 2021 entitled *Climate and Natural Disaster Risk Management at the Regulated Entities* to solicit public input on climate change risk to the country's housing finance system and to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The FHFA request for information sought comments from the public on ways in which the agency can strengthen supervision and reporting on the physical and transition risks that may arise from climate change.

Federal Agency Actions and Announcements Focused on Human Trafficking

Although it has not received the same level of attention as climate change, social considerations, the "S" in ESG, are under scrutiny by federal regulatory and law enforcement agencies, especially with respect to financial institutions that may be seen as facilitating or benefiting from human slavery or trafficking. Multiple U.S. government agencies, including the Department of State, Department of Justice, Department of Homeland Security, Treasury Department, and Financial Crimes Enforcement Network, are increasingly focused on investigating, prosecuting, and preventing human trafficking.

Indeed, the Treasury Secretary recently released a statement expressing support for enactment of the United Kingdom's ("UK") new Global Anti-Corruption Sanctions Regime because it provides opportunities for the United States and UK to "take complementary sanctions actions" to investigate, penalize, and sanction financial institutions or other actors that finance or support corruption or human rights abuses. The Treasury Secretary's statement makes clear that advancing efforts around social issues is within the scope of the Treasury Department's anti-corruption initiatives, indicating that sanctions "can further incentivize businesses to adopt a more proactive corporate risk and due diligence approach, which takes into account both human rights and corruption issues."

STATE ESG-RELATED ACTIONS AND ANNOUNCEMENTS

The New York Department of Financial Services ("DFS") appointed Nina Chen, Ph.D., in May 2020 as the DFS's first Sustainability and Climate Change Director. In September

2020, the DFS issued a circular letter to all New York-regulated domestic and foreign insurance companies outlining its expectations related to addressing the financial risks from climate change. A month later, the DFS issued a similar letter to all New York-regulated financial institutions.

The DFS released and is inviting public comment on proposed guidance for New York domestic insurers on managing climate change-related financial risks, which outlines the DFS's expectation that New York insurers start integrating the financial risks from climate change into their governance frameworks, risk management processes, and business strategies, and developing their approach to climate-related financial disclosure. With respect to governance issues, the DFS released a circular letter in March 2021 to all New York-regulated insurers, expressing its expectation that insurers make the diversity of their boards and senior management a business priority. On April 13, 2021, Superintendent of Financial Services Linda A. Lacewell announced the DFS's new Statewide Office of Financial Inclusion and Empowerment, underscoring DFS's ongoing efforts to facilitate broader financial inclusion and empowerment for minorities and underserved communities. We expect to see more states follow suit on their ESG initiatives and regulations.

State attorneys general and municipalities, too, have exhibited an increasing willingness to hold companies accountable for climate change through state actions. Some of the lawsuits filed assert general tort claims or consumer protection claims with a focus on alleged damage caused by oil and gas companies' failure to disclose knowledge of climate risks, misleading the public on how fossil fuels contribute to climate change, and/or use of less demanding metrics internally to account for the costs of climate change than disclosed to the public.

Some of these state actions were rejected by the courts because either the disclosures of the companies were not misleading or material, *see e.g., People by James v. Exxon Mobil Corp.*, Index 452044/2018 (N.Y. Sup. Ct. 2018), or because issues such as global warming and emissions invoke questions of federal and foreign policy that are "not well-suited to the application of state law." *See e.g., City of New York v. Chevron Corp.*, No. 18-2188, 2021 WL 1216541, at *1 (2d Cir. Apr. 1, 2021). However, plaintiffs in the state actions have shifted their legal theories in the state actions, and an increasing number of climate liability cases are being brought against oil and gas companies in state courts across the United States. *See, e.g. City of New York v. Exxon Mobil Corp.*, No. 451071/2021 (NY. Sup. Ct. Apr. 22, 2021) (second lawsuit filed by New York City, this time in New York State Supreme Court, against three oil and gas companies and American Petroleum Institute alleging that the defendants violated the City's Consumer Protection Law by engaging in greenwashing and affirmatively misrepresenting the environmental benefits of their fossil fuel products). Financial institutions may face secondary litigation risk due to their unique roles as lenders, investors, or fiduciaries of the oil and gas companies, or in relation to their underwriting of transactions for these companies.

KEY TAKEAWAYS

- President Biden's Climate Risk Executive Order lays the foundation for future U.S. regulatory direction and standards. While the FSOC member agencies are already evaluating ESG-related risks, the Executive Order provides a collaborative platform for the assessment, coordination, and sharing of information among the agencies to diminish risks to U.S. financial stability. As the agencies collaborate and develop new regulatory standards on ESG-related risks, financial institutions should monitor both international and domestic regulatory, supervisory, and enforcement developments.

- It is possible the FSOC and each of its constituent agencies will engage with the public through a combination of meetings with financial industry representatives and/or symposia. Financial institutions should participate in these opportunities to convey their views and assist with producing feasible outcomes.

- While the FSOC member agencies are sharpening their focus on ESG-related risks, financial institutions should continue to adhere to applicable law and regulations around climate-related risks issued by the FSOC member agencies.

- The SEC is considering how to integrate ESG considerations into disclosure requirements. Financial institutions

should consider the SEC's regulatory and enforcement posture, as well as third-party litigation risks, to avoid making voluntary public statements that may be considered materially misleading or false ESG-related disclosures under existing materiality standards or even under an expanded concept of materiality, if adopted.

- Financial institutions should prepare to address and mitigate risks relating to allegations of facilitating or benefiting from human trafficking as well as climate change lawsuits by state actors.

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