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# The Wave of Mandatory ESG Financial Disclosures Has Begun. When Will the Wave Hit the U.S.?

Over the past two years, the world has seen **Environmental, Social and Governance (ESG)** disclosure requirements grow at a rapid pace, and the first sets of ESG financial disclosures go into effect. Now, a trend of mandatory ESG financial disclosures has begun. From required stress tests in Q1 2022 mandated by the European Central Bank to New Zealand's new law enshrining a global climate-related disclosure framework, 2022 will go down in history as a period of change. Here, we help investment managers understand mandated requirements and what U.S.-based companies can expect in 2022.

## A GLOBAL PERSPECTIVE

Before considering where U.S. regulators may go, it's important to understand where Europe started and is heading. The European Union set the pace for required ESG financial disclosures across the world and continues to push forward with an aggressive ESG agenda in support of the United Nations 2030 Sustainable Development Plan.[i]

The **Sustainable Financial Disclosure Regulation (SFDR)** passed into European Law in 2019. SFDR required "financial market participants (FMPs) and advisors" to provide ESG disclosures both at an entity and product level, and forced firms to modify prospectuses, websites and annual reports starting in March of 2021. The impact of SFDR was not just felt inside the 27-member bloc, but also by non-EU firms that market their products in the EU.

SFDR is made up of two implementation levels, the first of which went into effect in March 2021. At the product level, Level 1 requires FMPs to categorize funds into three categories based on the level of transparency with regards to the sustainability of investments. At the entity level, Level 1 required FMPs to disclose "on a comply or explain basis" where they consider principal adverse impacts of investment decisions on sustainability factors and provide a statement on due diligence policies with respect to those impacts.[ii] The second level of SFDR will go into effect in January 2023 and will further define requirements for reporting of principal adverse impact statements, and additional disclosures needed at fund levels.

SFDR principal adverse indicator metrics required non-financial data from EU companies. By design, the EU had an existing law that mandated large public interest firms with more than 500 employees to disclose non-financial information on their social and environmental impact.[iii] The non-financial information consisted of environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters. The 2014 legislation and 2019 updates to the law required firms to make annual disclosures on a "comply or explain" basis with a brief description of the group's business model, a description of the policies pursued by the group in relation to those ESG matters, including due diligence processes implemented; the outcome of those policies, the principal risks related to those matters linked to the group's operations, and non-financial key performance indicators relevant to the particular business.[iv]

A new Corporate Sustainability Reporting Directive (CSRD) is seeking to update the non-financial reporting requirements to extend the scope to all large companies and all companies listed on regulated markets, requiring the audit of reported information. It also introduces more detailed reporting requirements, requires reports aligned with mandatory EU sustainability reporting standards and requires companies to digitally "tag" the reported information so it is machine-readable and feeds into the European single access point.[v]

The CSRD takes concepts and guidance from another climate-related reporting framework into consideration.

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## A CLEAR BASELINE FOR INTERNATIONAL REGULATION

The Task Force on Climate-Related Financial Disclosures (TCFD) designed standardized guidelines to help organizations disclose material climate risks, explain their plans to manage exposure and describe how a transition to a zero-carbon economy would affect their operations.[vi] Additionally, the TCFD recommendations were designed in a manner that could be adopted regardless of jurisdiction or industry. TCFD was not a rulemaking body, thus the recommendations could be adopted voluntarily. Since the release of TCFD recommendations in 2017, support has poured in from across the globe.

From 2018 to 2021, the TCFD recommendations saw a 410% increase in support from companies, governments, inter-governmental groups, standard-setting organizations and others. In the past year alone[vii], endorsements for the TCFD came in from key sources such as:

- The G7: "We support moving towards mandatory climate-related financial disclosures that provide consistent and decision-useful information for market participants and that are based on the Task Force on Climate-Related Financial Disclosures (TCFD) framework, in line with domestic regulatory frameworks."[viii]
- The G20: "We will work to promote implementation of disclosure requirements or guidance, building on the FSB's Task Force on Climate-Related Financial Disclosures (TCFD) framework, in line with domestic regulatory frameworks, to pave the way for future global coordination efforts…"[xi]
- The European Commission: "The Commission supports initiatives by the G20, the G7, the Financial Stability Board and others to develop a baseline of global sustainability reporting standards that would build on the work of the Task Force on Climate-Related Financial Disclosures."[x]

**Multiple jurisdictions are implementing the TCFD framework into their mandatory regulations[xi]**

With growing international support, others have begun to impose mandatory climate-related, or ESG-related disclosures based on the TCFD recommendations.

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Oceania
- New Zealand became the first country to mandate TCFD-based disclosures by law to financial firms in October 2021.[xii]

Asia
- In Japan, the Tokyo Stock Exchange revised securities listing regulations in 2021 to require certain companies report in alignment with the TCFD framework.[xiii]
- In Hong Kong, the Green and Sustainable Finance Cross-Agency Steering Group published a new Strategic Plan, announcing that TCFD-aligned disclosures, among others, "will be mandatory" across relevant financial sectors by 2025.[xiv]

Non-EU Europe
- In 2020, The UK's Financial Conduct Authority (FCA) mandated Premium Listed Companies to report on a "comply or explain" basis, whether they made disclosures in line with the TCFD recommendations, and if so where they can be found. In 2021, the FCA updated the regulation to extend the scope to all UK-listed companies, pension funds and asset managers.[xv]
- Switzerland has announced it will make TCFD-based reporting "binding" for large companies with draft legislation to be ready by summer 2022. Binding implementation of TCFD is expected to take place going forward from 2024 for the 2023 financial year.[xvi]

North and South America
- Brazil announced mandatory disclosures in 2021 that are similar to TCFD and set to begin in 2022.[xvii]
- Canada required companies to disclose climate reporting in order to receive pandemic bailout funding, and mandated TCFD-aligned mandatory reporting to begin by 2024.[xviii]

## A CLEAR BASELINE FOR INTERNATIONAL REGULATION (CONTINUED)

International standard setters are also using TCFD as a baseline for implementing sustainable disclosures. The International Financial Reporting Standards (IFRS) Foundation announced the formation of a new International Sustainability Standards Board (ISSB) to develop — in the public interest — a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs.[xix]

Lastly, the TCFD recommendations may be a baseline for part of U.S. financial disclosure rule(s) that could be released in 2022.

## MOMENTUM TOWARDS U.S. MANDATORY ESG FINANCIAL DISCLOSURES

Today, U.S. firms are required to report climate-related impacts or policies based on a 2010 SEC guideline. This guideline, an 'interpretive release'[xx], requires companies to disclose 'material' impacts of climate-related events, or local, regional and state climate or ESG-related laws. However, the 2010 guidance did not mandate where to report the impacts or the company's policies towards assessing them. This leaves companies to decide what to disclose and where to disclose it. As a result, 92% of companies in the S&P 500 and 70% of the Russell 1000 issued a sustainability report in 2020[xxi], but the quality and depth of the current state is inconsistent and lacks substance for the appetite of investors.

Beginning in January 2021, the Biden administration signaled its ESG intentions with the Executive Order on Tackling the Climate Crisis at Home and Abroad. This executive order mandated a government-wide approach to combat the climate crisis.[xxii] In March 2021, the SEC created the Climate and ESG Task Force in the Division of Enforcement. Consistent with increasing investor focus and reliance on climate and ESG-related disclosure and investment, the Climate and ESG Task Force was tasked to develop initiatives to proactively identify ESG-related misconduct.[xxiii]

The SEC also opened a period to solicit comments from the public about mandatory climate reporting. Over 550 comments were received, of which three out of every four comments supported mandatory climate-related financial disclosures. As a result, Chair Gary Gensler indicated that the SEC would have a proposed rule by the end of 2021, and release it either at the end of 2021, or early 2022[xxiv]. The proposed rule did not come out in 2021, and we continue to stand by for an update.


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Additionally, the Department of Labor proposed a rule that, if implemented, will remove barriers to plan fiduciaries' ability to consider climate change and other ESG factors when selecting investments and exercising shareholder rights.[xxv]

"The proposed rule announced today will bolster the resilience of workers' retirement savings and pensions by removing the artificial impediments – and chilling effect on environmental, social and governance investments – caused by the prior administration's rules," said Acting Assistant Secretary for the Employee Benefits Security Administration Ali Khawar. "A principal idea underlying the proposal is that climate change and other ESG factors can be financially material and when they are, considering them will inevitably lead to better long-term risk-adjusted returns, protecting the retirement savings of America's workers."[xxvi]

With this new rule, ERISA fiduciaries will be able to consider ESG factors when making decisions about qualified default investment options, proxy voting and risk assessments. As a result, ERISA fiduciaries may be faced with the need to make changes to qualified default investment options in their technologies, published marketing materials and disclosures. In addition, ERISA fiduciaries will need to integrate ESG data into their risk assessment and investment analysis processes used to select funds and vote on proxies.

**What could we expect from the upcoming SEC rule?**

Clues to what could be expected from the upcoming SEC rule can be derived from speeches, statements from the SEC Chair Gary Gensler, other SEC commissioners, and the SEC Asset Management Advisory Committee. The proposed rule(s) could likely include: Recommended disclosures from the Diversity and Inclusion Report in the Asset Management Industry, which recommend implementation of rules for disclosures regarding:

- Transparency of Diversity Within a Firm,
- Fund Board and Fund Adviser Diversity,

## MOMENTUM TOWARDS U.S. MANDATORY ESG FINANCIAL DISCLOSURES (CONTINUED)

- Business Practices for Consultants Who Recommend Investment Advisers and Investment Funds[xxvii]

In a July 2021 speech, SEC Chair Gary Gensler said, "When it comes to climate risk disclosures, investors are raising their hands and asking regulators for more." He went on to outline 10 further considerations he was asking SEC staff to use in the rule-making process.[xxviii]

1) There will likely be a mandatory set of climate disclosures
2) There will be a standardized location for US companies to publish disclosures and reports and it may be in 10-Ks or within other filings
3) Disclosures will likely include both qualitative and quantitative information about climate risk
4) Qualitatively, companies will have to disclose how the leadership manages climate-related risks and opportunities, and how those factors feed into the company's strategy
5) Quantitative measures will likely include metrics related to greenhouse gas emissions, financial impacts of climate change on the business, and the company's progress towards any climate-related goals or pledges
6) Companies might have to disclose their Scope 1 and Scope 2 emissions, and some companies may have to disclose Scope 3 emissions under special circumstances
7) Likely, there will be industry-specific metrics and requirements for industries such as banking, insurance, and transportation
8) Scenario analysis similar to TCFD scenario analysis may be needed to illustrate how businesses might adapt to possible physical, legal, market and economic changes in the future (changes due to climate change)
9) The SEC rule may be based upon or partly based on the recommendations from the TCFD
10) Firms that market investment products they produce as "Green" or "Sustainable" may have to back up those claims by disclosing the criteria and underlying data they use to decide its sustainability or green status. And if the SEC updates its Names Rule, firms may need to disclose a material threshold of 80%+ of investments that are in the investment type, industry, ESG category and geographic location their names suggest.

Chair Gensler reaffirmed in Prepared Remarks Before the Asset Management Advisory Committee requirements of the SEC staff to consider ways to enhance updates to the Names Rule and to consider ways to enhance transparency for diversity and inclusion.[xxix] In further speeches through 2021, Gensler spoke about many of the 10 considerations mentioned above, showing a consistency of his requests made to the SEC staff in preparation to drafting the rule.

It should also be noted that speeches from other SEC commissioners in 2021[xxx] spoke at a personal level both for mandatory ESG disclosures and against mandatory ESG disclosures. Thus, the SEC rule-making process will likely be evenly matched in opinions and based in legal precedents based on the legislation that the SEC supports. A key discussion point will be about the materiality of Environmental, Social and Governance disclosures.

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## A LOOK AHEAD

As the wave of mandatory ESG disclosures crashes into U.S. shores, firms should be preparing for changes that will occur based on the Department of Labor rule and the upcoming SEC rule. While the SEC rule implementation could take place in 2022, it still has a ways to process given the fact that the first release could be changed based on public comments after it is proposed. That said, U.S. firms should not wait for the final SEC rule to be released to prepare for disclosures and instead identify any gaps and areas of improvement:

- In maintaining or creating an environmental or climate strategy and set of scenarios to test the strategy
- In reviewing the financial impacts of climate change on its business operations and financial results, and reporting upon the results of your analysis
- Through evaluating current pre-contractual, website and annual report ESG disclosures, (or lack thereof)
- By reviewing current naming conventions for any ESG-related funds

Tackling these areas may seem like a daunting task, especially when considering it could require new sources of data, new ways to analyze and synthesize the data and new requirements for integrating ESG or climate-related information into regular reporting.

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## HOW MERADIA CAN HELP

Whether your firm is motivated by impending regulations, the pursuit of a competitive edge or responding to new client demands, Meradia can help you assess your data needs, establish appropriate sourcing and governance, then follow through with enhancements to reporting systems and processes.

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brings a well-rounded data management perspective to Meradia's global portfolio of clients. Throughout his career, Andrew has supported constituents across the investment management industry, including retail investors, advisors, wholesale teams and institutional investors. He is a seasoned investment professional with diverse experience in business and entrepreneurship, possessing strong acumen of front office operations, data governance and management, and retail client journeys. Andrew's passion for helping people and driving outcomes aligns with Meradia's principles of Perspective, Passion and Impact.


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