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Kirkland Alert

Expected ESG and Climate Regulation Impacting Private Equity Under the Biden Administration

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In a July 2020 *KirklandPEN*, we highlighted recent actions by the U.S. Securities and Exchange Commission ("SEC") reflecting enhanced scrutiny of the accuracy of environmental, social, and governance ("ESG") marketing and disclosure, as well as a proposed U.S. Department of Labor ("DOL") rule that would set additional guiderails for ERISA fiduciaries considering ESG factors in investment decisions. Those developments came at a time of growing market demand for ESG investments. This *Alert* provides an update on ESG and climate regulatory developments in the U.S. that could impact private equity.

In the second half of 2020, demand for ESG-focused investments continued to accelerate, and data showing the outperformance of those investments during the COVID-19 pandemic has set the stage for robust demand to continue in 2021. In his recent letter to CEOs, BlackRock CEO Larry Fink highlighted that during 2020, 81% of a globally representative selection of sustainable indexes outperformed their parent benchmarks, indicating companies with better ESG profiles perform better than their peers. Private equity managers seem to agree: in a 2020 survey of over 50 private equity executives, 93% indicated that focusing on ESG themes generates good investment opportunities. Similarly, investors also have increased their focus on ESG, with 88% of limited partners taking into account a manager's consideration of ESG factors when conducting due diligence, up from 81% in 2020, according to Private Equity International's LP Perspectives 2021 Study.

At the same time, President Biden, with potential support in Congress, has promised bold action on key ESG priorities, including climate change. This article discusses recent regulatory developments in the U.S. relating to ESG that could provide tailwinds

to market trends, as well as increase the expectations that private equity sponsors provide robust, accurate ESG disclosures, including with respect to climate risk.

ESG Priorities Central to Biden Policy Agenda

In the first two weeks of his presidency, President Biden signed a number of executive orders that established ESG priorities as central to his policy agenda.[1] These orders create a government-wide framework and mandate to advance climate and environmental justice policies across all levels of government. We expect this mandate to translate into increased ESG regulatory activity across federal agencies that could impact private equity investing, even if indirectly through increased regulation of asset owners and lenders, as further discussed below.

SEC Signals Likely Increased Regulation and Monitoring of ESG

In addition to the Biden–Harris administration's focused agenda on ESG priorities, congressional leaders, such as Senator Elizabeth Warren (D-Mass.), with oversight with respect to the SEC have espoused the need for increased and mandated disclosure of climate risk in SEC filings.[2] The combined pressure from the administration and from Congress will likely result in ESG-related regulatory developments.

The SEC's Acting Chair Allison Herren Lee has acknowledged the "growing consensus that climate change may present a systemic risk to financial markets," sentiments that have been similarly shared by Senator Warren and Senator Dianne Feinstein (D-Calif.), among others.[3] This connection between climate risk and the financial system paves another avenue forward for SEC regulations vis-à-vis the SEC's tripartite mission and the Financial Stability Oversight Council's ("FSOC") charge of responding to emerging threats to the stability of the U.S. financial system.

Acting Chair Lee has also signaled a desire for the SEC to focus on ESG more generally, emphasizing the need for "uniform, consistent, and reliable" disclosures by corporate issuers and, specifically with respect to funds and their advisers, clarity around what is meant when ESG is used to describe a fund's principal strategies or risks. In addition, and particularly of interest to private fund sponsors, Acting Chair Lee has indicated an interest in rules that would require investment advisers to maintain and implement

policies and procedures governing their approach to ESG investment. Finally, she has indicated that the SEC intends to hire climate and sustainability experts and increase ESG training for staff. Consistent with this commitment, the SEC recently appointed Satyam Khanna, who previously served as a member of the SEC's Investor Advisory Committee and an adviser to the FSOC and has advised the UNPRI, as the first Senior Policy Advisor for Climate and ESG. In this role, Khanna will be responsible for overseeing and coordinating the SEC's efforts related to climate risk and ESG and will serve in Acting Chair Lee's office.

Additional SEC developments on ESG include the December meeting of the SEC's Asset Management Advisory Committee ("AMAC"), where the ESG Subcommittee presented draft recommendations for actions the SEC should take around ESG. The Subcommittee stated at the outset its belief that existing requirements mandating issuer disclosure of material risks are sufficient, but it suggested the SEC require the adoption of standards to guide corporate issuers' disclosure of ESG risks. The Subcommittee also recommended the SEC suggest best practices to enhance ESG investment product disclosure, including alignment with the taxonomy developed by the Investment Company Institute ESG Working Group and a clear description of each product's strategy and investment priorities. The Subcommittee plans to seek feedback on its recommendations and present final recommendations for a vote at the next AMAC meeting.

If adopted by AMAC, the ESG Subcommittee's recommendations could breathe new life into the SEC's 2020 focus on ESG during examinations of registered private equity fund advisers and ultimately lead to regulatory changes that impact both registered funds and publicly listed companies.

Uncertainty Regarding the Future of the DOL's Final Rule Impacting ERISA Plan Fiduciaries Considering ESG Factors

On January 12, 2021, the DOL's Financial Factors in Selecting Plan Investments rule became effective (the "Final Rule"). The proposal that preceded the Final Rule took aim at the consideration of ESG factors by plan fiduciaries and received several thousand negative comment letters. Unlike the proposal, the text of the Final Rule contains no direct references to ESG. However, in promulgating the Final Rule, the DOL conveyed its view in the preamble that "ESG investing raises heightened concerns under ERISA." The Final Rule codifies the bedrock principle of ERISA that fiduciaries may not subordinate returns or increase risks in an effort to promote non-pecuniary factors. The Final Rule also affirms the DOL's guidance regarding the "tie-breaker" scenario

(i.e., a fiduciary can use non-pecuniary factors to distinguish between economically similar investments) and the "direct relationship" principal (i.e., a fiduciary may consider factors that would materially impact the risk and/or return of an investment over an appropriate timeframe and in a manner that is consistent with a plan's objectives and policies); however, the Final Rule imposes additional documentation obligations on plan fiduciaries with respect to the "tie breaker" scenario. In response to the Final Rule, some ERISA-governed limited partners have requested information from private equity sponsors (including with respect to funds that do not operate subject to ERISA) regarding whether they intend to comply with the principles set forth in the Final Rule, while others have added pertinent questions to their due diligence questionnaires.

The future of the Final Rule is highly uncertain with the change in administration. President Biden's Executive Order on Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis, signed on his first day in office, directs all departments and executive agencies "to immediately review and, as appropriate and consistent with applicable law, take action to address the promulgation of federal regulations and other actions during the last four years that conflict with these important national objectives." An associated Fact Sheet lists the Final Rule as among the agency actions targeted for review. In response to this directive, the DOL could issue guidance to clarify the scope of the Final Rule, propose a new regulation acknowledging a place for ESG in a prudent investment analysis, or take a non-enforcement approach. It is also possible that Congress could pursue invalidation of the Final Rule via the Congressional Review Act; however, that solution may be viewed as suboptimal given that it would preclude the DOL from issuing a new rule in substantially the same form as the Final Rule unless specifically authorized by law.

Treasury Focuses on Climate, Driving Macro Economic Trends That May Impact Private Equity

Under President Trump, the Treasury Department took a number of actions consistent with his withdrawal of the U.S. from the Paris Agreement and promotion of fossil fuel development, including issuing voting guidance to its Multilateral Development Banks' ("MDB") representatives to encourage investment in fossil fuel projects in developing countries, abolishing the Treasury Department's Office of Energy and Environment, and withdrawing the remaining $2 billion of the $3 billion pledged to the Green Climate Fund under President Barack Obama.

In a sharp reversal, President Biden's Executive Order on Tackling the Climate Crisis at Home and Abroad directs the Secretary of the Treasury to help develop a "climate finance plan" for the U.S. Under the Executive Order, the Treasury's responsibilities include ensuring that the U.S. is present and engaged in international fora that work on the management of climate-related financial risks; promoting financing programs, economic stimulus packages, and debt relief initiatives that align with the goals of the Paris Agreement; promoting the protection of critical ecosystems that serve as global carbon sinks; and limiting international financing of carbon-intensive fossil fuel-based energy while advancing sustainable development. Secretary Janet Yellen has indicated that she will make climate change a priority through mechanisms such as "effective carbon pricing" and will start a new Treasury "hub" to examine financial system risks arising from climate change and related tax policy incentives.

Additionally, the FSOC, which is chaired by Secretary Yellen, could take action on climate as part of its mandate to identify and respond to emerging threats to financial stability, particularly in light of recent activities at the Commodity Futures Trading Commission ("CFTC") and Federal Reserve, discussed further below. While President Biden has not announced specific plans for the FSOC, in response to a question on the President's plans for the FSOC during a January 27, 2021 press conference, Press Secretary Jen Psaki replied that "addressing climate and the crisis of climate is an issue that the President has conveyed to members of his Cabinet and members of his senior team as an absolute priority."

Stage Set for Climate Action at the CFTC and Fed

In September 2020, the Climate-Related Market Risk Subcommittee of the Market Risk Advisory Committee ("MRAC") of the CFTC released a report on Managing Climate Risk in the U.S. Financial System, which argues that "climate change poses a major risk to the stability of the U.S. financial system and to its ability to sustain the American economy" and calls for a coordinated effort among federal regulators to address the risk. Although the CFTC has not yet moved forward to implement the report's recommendations, and President Biden has not yet nominated the Chair of the CFTC, Acting Chairman Rostin Behnam has expressed support for increasing the CFTC's focus on managing climate risk, saying the Commission needs to "move urgently and decisively." Possible actions include increased oversight of carbon derivatives trading or requiring climate risk analysis as part of the CFTC's capital and margin requirements on futures merchants and swap dealers.

In the same vein as the CFTC report, the U.S. Federal Reserve ("Fed") released its semi-annual Financial Stability Report shortly after the presidential election, marking the first time the Fed recognized climate change as a key risk to U.S. financial stability. One month later, in December 2020, the Fed Board of Governors announced the Fed had joined the Network of Central Banks and Supervisors for Greening the Financial System ("NGFS"). The NGFS, an international group of central banks, focuses on the development and exchange of environmental and climate risk management ideas and best practices for the financial sector. The Fed also recently hired Kevin Stiroh, the former head of the Federal Reserve Bank of New York's Supervision Group, to lead the Fed's supervisory work on financial risks of climate change. Mr. Stiroh will chair the Supervision Climate Committee, a first-of-its-kind committee created to bring together senior staff across the Fed's board and reserve banks and deepen the Fed's understanding of climate risks.

President Biden could bolster the Fed's climate focus through the appointment process. He currently has one vacancy to fill on the Fed's board and will also have the opportunity to replace or reappoint the current Fed chair, whose term ends in February 2022. Other opportunities to impact the Fed's climate agenda may come from Congress. For example, the Senate Democrats' Special Committee on the Climate Crisis has released a report on The Case for Climate Action, which calls upon the Fed to conduct stress testing and develop climate scenario analysis tools to measure individual firm resilience to climate risks.

Looking Ahead

The federal government appears to be moving quickly to align itself with ESG market trends, and private equity firms and other investors should expect regulatory and potentially legislative activity around ESG, and in particular climate change, in the months ahead. We intend to cover these developments in future newsletters.

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1. *See*, e.g., Executive Order on Advancing Racial Equity and Support for Underserved Communities Through the Federal Government, Executive Order on Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis, and Executive Order on Tackling the Climate Crisis at Home and Abroad ↩

2. *See* Senator Warren's Proposed Climate Risk Disclosure Act. Senator Warren is a member of the Senate Committee on Banking, Housing and Urban Affairs. ↩

3. *See* Senator Warren's Proposed Climate Risk Disclosure Act and Senator Feinstein's Proposed Addressing Climate Financial Risk Act.↩

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Suggested Reading

- 12 February 2021 In the News BlackRock Net-Zero Targets May Prove Net Positive for Activists
- 01 February 2021 Kirkland Governance Update r/BlackRockAnnualLetter: Climate Change and ESG in the Age of Reddit
- 22 October 2020 Speaking Engagement ESG and PE – The Missing Pieces!

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