# Invesco US Government Affairs

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# Washington Commentary

Invesco

## ESG Outlook

As President Joe Biden moves into the Oval Office, the typical buzzwords of the presidential transition are popping up everywhere. Biden's "No Malarkey" bus tour message has been replaced by "Build Back Better." His Cabinet picks reflect that "Personnel is Policy." And with Democrats' clean sweep of the White House, Senate, and House of Representatives, the gridlock in Washington may finally be breaking.

The Biden administration's financial services policy agenda, however, may be defined less by buzzwords than by "buzz letters" – namely ESG – short for environmental, social, and governance standards that have become en vogue over the past decade and that appear poised to jump to the top of the regulatory agenda under Biden. As the term is most commonly used, ESG standards measure a company's societal impact and are used by socially conscious investors to guide their investment decisions. ESG is most often associated with environmental issues, such as a company's response to climate change. However, it covers a much wider range of corporate conduct and activities, such as a company's approach to human capital and human rights, employee and board diversity, executive compensation, and political spending, to name just a few.

In stark contrast to the Trump administration's approach, pro-ESG initiatives are expected to feature prominently in Biden's regulatory agenda, including at the financial services regulatory agencies, which are expected to rely heavily on "disclosure mandates" to drive the president's policy goals related to ESG. Under Biden, we are likely to see agencies such as the Securities and Exchange Commission (SEC) require companies to disclose additional ESG-related information. Disclosure mandates, of course, were a core feature of the Dodd-Frank Act that was championed by the Obama administration in response to the financial crisis, and we can expect to see more of the same on Biden's watch. Of course, we also expect to see opposition from some issuers, specifically in the energy sector, as well as many Republicans in Congress, concerned that disclosures will be used by activists and politicians to "name and shame" companies into changing their behavior.

In the wake of the Georgia runoffs, which handed control of the Senate to the Democrats, it is clear that Biden will have strong support from Capitol Hill in pursuing ESG initiatives. ESG is likely to feature prominently in Congressional oversight activities, including in hearings and investigations, and we can expect to see the resurfacing of legislative proposals such as Elizabeth Warren's Climate Risk Disclosure Act, which would require disclosure of information about climate-related risks. However, actually moving legislation in the ESG space could be challenging given the extremely tight margins in both houses of Congress.

Regardless, the Biden team already has very powerful tools to implement his agenda administratively through rulemakings, guidance, and enforcement proceedings. Indeed, some of his early personnel announcements offer hints that he plans to act aggressively (or some would say, progressively) on the topic of ESG. Biden's appointments of Obama alums, such as John Kerry for Climate Envoy and former Blackrock Global Head of Sustainable Investment Brian Deese as Director of the National Economic Council, send a clear and pointed message that ESG will be a priority for the next administration.

As expected on Inauguration Day, Biden illustrated his commitment to the environment by rejoining the Paris Climate agreement, revoking a key permit for the Keystone pipeline, and targeting a host of recent Trump-era Environmental Protection Agency (EPA) regulations for delay. Additionally, Janet Yellen, who has been recently confirmed to serve as the Secretary of Treasury, made clear during her confirmation hearing that she will be creating a new Treasury "hub" that would examine financial system risks arising from climate change, and she vowed to appoint a "very senior-level" official to lead climate efforts at Treasury. As the head of the Financial Stability Oversight Council (FSOC) her prioritization of this issue could play a significant role at the FSOC.

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## ESG Under Trump

Any attempt to divine how Biden will approach ESG issues necessarily starts with an analysis of how the Trump team responded to the chorus of ESG proponents during his tenure. Unsurprisingly, Trump's financial services regulatory agencies did not embrace mixing ESG with regulatory policy. Indeed, many of Trump's appointees actively worked to minimize ESG considerations from the decision-making process.

For example, at the SEC, Chairman Jay Clayton and his fellow Republican commissioners repeatedly fought off calls for enhanced mandatory climate and diversity disclosures, reasoning that such disclosures are only warranted to the extent they are "material" and "decision-useful" to investors. Clayton opposed the imposition of rigid standards or metrics for ESG disclosures on all public companies, reasoning that doing so "would be inconsistent with our mandate, would be a departure from our long-standing commitment to a materiality-based disclosure regime, and could effectively substitute the SEC's judgment for the company's judgment on operational matters." Clayton also routinely called into question the efforts of progressive groups and even some market participants to advance the ESG "brand," observing that "ESG" is not monolithic and that "E" and "S" and "G" should each be viewed within their own context.

Taking an even harder line, Trump's Labor Secretary Eugene Scalia waged battle against ESG proponents directly through the rulemaking process. Late last year, the Department of Labor (DOL) adopted a final rule amending the "investment duties" regulations under retirement securities law, ERISA, to require plan fiduciaries to select investments based solely on "financial considerations relevant to the risk-adjusted economic value of a particular investment" – and not on the basis of ESG factors. And in another final rule issued by the DOL, retirement plan fiduciaries are prohibited from casting corporate-shareholder proxy votes in favor of ESG positions that do not advance the financial interests of retirement plan participants.

Trump's banking regulators also showed their anti-ESG stripes through the rulemaking process, with the Office of the Comptroller of the Currency (OCC) issuing a proposal that would force banks to rely solely on financial considerations when making lending decisions. The proposal was highly critical of lending decisions based on criteria unrelated to safe and sound banking practices, including "personal beliefs and opinions on matters of substantive policy that are more appropriately the purview of state and federal legislatures."

## Recent Groundswell of ESG Proponents

In stark contrast to the Trump administration's cold-shoulder approach to ESG issues, there has been a steady drumbeat of regulatory proposals on climate and other initiatives from those within the Democratic Party in the run-up to the presidential election and during the Biden transition.

In September of last year, an advisory committee to the Commodity Futures Trading Commission (CFTC), sponsored by Democratic Commissioner Rostin Benham, published a 165-page report containing no fewer than 53 recommendations to address the risks climate change poses to the US financial system. Chief among the report's recommendations were calls for mandating carbon pricing—translation: "carbon tax"—and rulemaking by the SEC to mandate wide-ranging climate risk disclosures. Although the report was not an official statement from the CFTC itself, it has been touted as a regulatory playbook for the Biden climate agenda.

Meanwhile, the Democratic commissioners at the SEC, Allison Lee and Caroline Crenshaw, have been laying their own groundwork for an ESG-focused agenda in the next term. Both commissioners have publicly stated that how a company manages climate risk is material

information that should be disclosed in securities filings. They also have argued that the existing principles-based approach, coupled with voluntary disclosure, results in non-standardized, inconsistent, and incomparable disclosures and have issued calls for a more prescriptive rule set applicable to both company issuers and asset managers. In a speech focused on enhancing diversity in the capital markets regulatory space, Lee observed that the "Commission has long-recognized that influencing corporate behavior is an appropriate aim of our regulations" and pointed to disclosure as the "most obvious tool in the SEC's toolkit" to exert such influence.

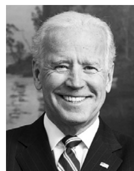
Unsurprisingly, the Federal Reserve (Fed) has also entered the fray. For the first time, the Fed identified climate risk as a potential threat in its biannual Financial Stability Report, warning of the potential for abrupt changes in asset values in response to a warming planet. In an apparent nod to the Biden administration's expected re-entry to the Paris Climate Agreement, just last month the Federal Reserve announced that it had become a member of the Network of Central Banks and Supervisors for the Greening of the Financial System.

On the diversity front, even the private markets are weighing in with innovative ways to try to influence corporate behavior. Take, for example, a recent proposal advanced by NASDAQ, which would require companies listed on that exchange to have at least two "diverse" board members – including at least one director who self-identifies as female and one director who self-identifies as an underrepresented minority or LGBTQ+. The proposed rule would apply to all existing issuers listed on NASDAQ, approximately 75% of which would not comply based on current board member composition. There is a phase-in period for the proposed rule, and there is no delisting requirement for failing to meet the new standard.

Democrats on the Hill are similarly gearing up for a legislative push on diversity, with Rep. Maxine Waters (D-California) leading the charge in her role as chairwoman of the House Financial Services Committee (HFSC). Over the past two years, Waters has been targeting a wide spectrum of the financial services industry, including banks and asset managers, to enhance their disclosures on diversity and to take steps to foster a more diverse and inclusive workforce. In addition to holding hearings on the topic, Waters has sent a series of letters to large financial services corporations asking for information about their diversity practices. Waters also spearheaded an HFSC report on diversity and inclusion in the banking industry, calling on banks to share more diversity data with their regulators and the public, tracking their spending with diverse firms, and requiring banks to publicly disclose the diversity of their boards.

And lest we not forget – the ESG train left the station long ago in Europe and developments continue daily on the continent, many of which could provide useful air cover to US regulators and other interested parties in pushing their agendas. A report issued in the fall by the Financial Stability Board highlighting how physical and transition risks could impact the financial system is certain to feature prominently in the prep materials for the newly constituted FSOC under Biden. In the capital markets regulatory space, the International Organisation of Securities Commissions (IOSCO) recently endorsed efforts to establish a uniform ESG reporting standard being advanced by the International Financial Reporting Standards (IFRS), even going so far as to observe that "it is almost universally accepted that failure to integrate environmental, social, and governance (ESG) factors into investment decisions constitutes a failure to meet the fiduciary duty to clients and beneficiaries." These are but two examples of ESG-focused policy initiatives being advanced on the global stage that will likely be heralded by policymakers in the new administration.

## ESG Under Biden



So what can we expect on the ESG front early in Biden's term? Given the challenges of moving legislation in a divided Congress, most of the early action is likely to take place at the SEC. While there are several initiatives related to ESG that the SEC will ultimately pursue, we expect the SEC to begin with issuer disclosures. Absent legislation, the SEC will need to rely on its existing statutory authority to advance disclosure initiatives, which begs the question of what authority it already has.

Under the federal securities laws, the SEC has considerable legal authority to require public company issuers to make disclosures about items that are "material" to an investor's decision about whether to buy or sell the issuer's securities. The Senate Report for the

Securities Exchange Act of 1934 makes this clear, stating that "[t]he Commission is given complete discretion . . . to require in corporate reports only such information as it deems necessary or appropriate in the public interest or to protect investors." The United States Court of Appeals for the DC Circuit cited the aforementioned report in an opinion where it stated that "the Commission has been vested by Congress with broad discretionary powers to promulgate (or not to promulgate) rules requiring disclosure of information beyond that specifically required by statute. Rather than casting disclosure rules in stone, Congress opted to rely on the discretion and expertise of the SEC for a determination of what types of additional disclosure would be desirable."

As the regulator of the capital markets, the SEC also has broad authority to require disclosures of potential risks and other information by a wide spectrum of SEC registrants, including asset managers, mutual funds and ETFs, index funds, certain private funds, broker dealers, exchanges and other trading venues, and rating agencies. Given that ESG will be a clear priority for the Biden administration, we can expect Biden's SEC chair to get to work quickly on various ESG initiatives, including:

**Corporate Disclosure Mandates:** Perhaps the biggest target for Democratic leadership at the SEC will be amendments to Regulation S-K, which governs disclosures by public company issuers. In contrast to the principles-based approach followed by Chairman Clayton, we can expect Biden's SEC chairman to mandate a laundry list of specific disclosures about climate risks, carbon use, diversity of a company's workforce, and human rights practices, to name a few. And look for the SEC to take a very expansive view of ESG-related information as "material" to an investment decision.

**Asset Manager Disclosure Mandates:** With its broad authority to mandate disclosures by asset managers and funds, look for Biden's SEC to call for more robust disclosure about the rationale and justification for touting a fund as ESG, and for enhanced disclosure of a fund manager's quantitative and qualitative evaluation of ESG-related metrics in making investment decisions. We could also see enhanced due diligence requirements for funds related to ESG.

**Disclosure Mandates for Other Market Participants:** It is also possible that the SEC could require enhanced disclosures related to ESG by other market participants, such as credit ratings-agencies, proxy advisory firms, index providers, and exchanges.

**Standards and Taxonomy:** Part and parcel of the SEC's expected disclosure agenda will be the establishment of a uniform set of standards and taxonomy for measuring the performance of an issuer or market participant with respect to ESG-related activities. In doing so, there is no shortage of frameworks for the SEC to rely on that have already been adopted by standard setters, such as the Financial Accounting Standards Board (FASB), the Task Force on Climate-Related Financial Disclosure (TCFD), and the Sustainability Accounting Standards Board (SASB).

Of course, disclosure mandates are not the only arrow that the SEC has in its quiver to drive ESG initiatives. Under Clayton, the agency adopted Regulation Best Interest, which heightened the obligations of brokers making investment decisions for their customers. Look for Biden's SEC chairman to add consideration of ESG factors into the mix of financial professionals' responsibilities, either through additional rulemaking or through guidance, examinations, and enforcement. The SEC is also likely to take a close look at the proxy advisory and shareholder proposal rulemakings that were finalized during the Trump administration, as both rulemakings are viewed as helping shield issuers from investor pressure, including on ESG matters.

## Department of Labor

We can also expect a significant amount of activity on ESG-related issues at the Department of Labor under Biden. With jurisdiction over the pension and retirement asset sector, the DOL has wide latitude to influence behavior and regulate the activities of investment managers. Biden's announcement of Marty Walsh as the nominee for DOL secretary sends a clear signal that ESG will be a priority. As the mayor of Boston, Walsh has been a huge proponent of ESG initiatives, including spearheading a $200 million program to invest state funds in securities of companies that maintain strong corporate ESG practices.

In the target zone will be the final rules adopted under Secretary Scalia that seek to keep ERISA plan fiduciaries from prioritizing ESG factors over financial considerations in making investment decisions for plan beneficiaries or in casting corporate-shareholder proxy votes. Overturning these actions, however, will require a long and drawn out rulemaking process, so look for more immediate action in the form of temporary non-enforcement and sub-regulatory guidance such as advisory opinions and FAQs.

## Financial Stability Oversight Council

Another source of potential scrutiny of ESG-related practices will likely come through the lens of so-called "financial stability" regulation. We can expect to see entities like the FSOC, which was created in the wake of the financial crisis to monitor threats to the stability of the US economy, shift its gaze to potential risks associated with ESG factors such as climate change.

While the FSOC played a less active role in the Trump administration, we should look for the FSOC to ramp up its activities under President Biden, including reviews of potential risks related to ESG, such as climate change. Count on practices related to ESG to be squarely in the target zone of Biden's reconstituted FSOC.

**Conclusion**
As the saying goes, what a year this month has been. We are living in a time of unprecedented political upheaval and uncertainty. However, one thing is certain with Biden in the White House and control of Congress in the hands of the Democrats – a firm commitment to ESG-related initiatives. Through legislation, administrative rulemaking, or other means, we can count on the public sector to use these buzz letters as tools to exert significant pressure in shaping the behavior of corporate America.

# Invesco US Government Affairs

**Andy Blocker**
Head of US
Government Affairs

**Andy Blocker** serves as Head of US Government Affairs for Invesco. In this role, he drives Invesco's legislative and regulatory advocacy initiatives with policymakers, engages with clients and opinion leaders on public policy developments, and seeks to maximize the company's political footprint. Previously, Mr. Blocker served as executive vice president of public policy and advocacy for the Securities Industry & Financial Markets Association, where he led a team engaging lawmakers on international, federal, and state issues impacting the financial services industry. Mr. Blocker spent five years as managing director for the US Office of Public Policy for UBS. He also served as vice president of government relations for the New York Stock Exchange, as managing director of government and international affairs for American Airlines, and for the White House as special assistant to the president for legislative affairs.

**Jennifer Flitton**
Vice President of Federal
Government Affairs

**Jennifer Flitton** is Vice President of Federal Government Affairs with the US Government Affairs team, where she advocates on behalf of Invesco's policy initiatives with policymakers and regulators and ensures the firm is an influential part of the Washington conversation. Ms. Flitton joined Invesco from the Securities Industry and Financial Markets Association, where she led lobbying initiatives on behalf of the asset management and broker dealer industries. She spent 16 years on Capitol Hill, last serving as the deputy chief of staff and legislative director for Congressman Patrick McHenry and as Congressman McHenry's designee to the House Financial Services Committee's Oversight and Investigations Subcommittee.

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