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Regulatory Activity and Legal Liabilities Affecting Management of Financial Climate Risks

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Legal structures and liabilities can influence the ability of markets, companies, financial entities, and governments to adjust to climate change impacts. Climate change impacts will affect the entire economy, creating new economic leaders and resulting in losses in some areas of the economy. But such a realignment of our economic system does not automatically translate to systemic financial risks. The challenge for financial regulatory bodies is to foster an orderly adjustment to these impacts while avoiding destabilizing shocks. This means accounting for foreseeable risks and asset valuation shifts, countering mispricing, and regulating core financial system entities to encourage resilience to inevitable changes. In this memorandum I outline some legal considerations relevant to assessing and mitigating climate-related market risks.

Regulatory Structures That Can Minimize Risk

US financial regulatory bodies have not yet taken significant direct actions to address climate change risks, but are under pressure to do so. Most of the activity addressing climate-related risk in the economy has centered on more detailed and expansive disclosure by individual firms. The Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) galvanized these disclosure efforts and brought together a broad coalition of companies and investors to agree on general framework recommendations for climate-related disclosures. Organizations such as GRI, CDP, Carbon Tracker, Ceres, and SASB, have also made enhanced disclosure a priority.

The dialogue on climate-related risks and opportunities has evolved significantly in the last five years. What was once the exclusive purview of impact investors, has now moved squarely into the realm of mainstream asset managers and institutional investors. Investor focus on climate-related information has progressed from publicly stated concern, through engagement with companies about expanding disclosures, to a new phase that pairs continued engagement with efforts to actively incorporate climate change-related information into day-to-day decisionmaking and portfolio management. Investment firms, ratings agencies, and investment services companies have partnered with or bought climate data shops and are exploring ways to incorporate physical risk impact analysis into their financial models and investment assessments. Large asset managers like BlackRock announced changes to their voting practices and expectations for corporate management and boards.

Adding to pressure from advocates and investors, academics have proposed various approaches to revising Securities and Exchange Commission (SEC) disclosure requirements to expand discussion of sustainability issues, including climate. Eccles and Youmans (2016) suggest requiring a statement of significant audiences and materiality to better define what environmental, social, and governance issues boards consider material and the specific stakeholders to which they relate. Fisch (2019) proposes creating a new "SD&A" (sustainability, disclosure, & analysis) section of SEC filings modeled after the MD&A in which companies would identify and explain the three sustainability issues most significant to their operations. Esty and Karpilow (2019) suggest a three-tiered mandatory ESG reporting regime. These proposals would likely require additional SEC guidance on their applicability to climate-related topics should they be incorporated into SEC disclosure requirements.

The SEC has largely resisted calls to adjust disclosure requirements to specifically address climate change since issuing interpretive guidance in 2010 acknowledging the potential materiality of climate related information, followed by lackluster enforcement action and a limited impact on disclosure practices. (Fisch, 2019, pp. 934-941; Vizcarra, 2019a) No additional significant action by the SEC to directly address the materiality and disclosure of climate change information has occurred since. Yet, because the standard in US securities law is designed to evolve, we may already be within sight of an inflection point for the materiality of some types of climate-related information even absent regulatory action. (Vizcarra, 2020)

Two cases testing the waters on the materiality of climate-related information have resulted in opinions to date. A federal district judge denied a motion to dismiss in a shareholder suit against ExxonMobil, acknowledging that certain types of information related to climate change transition risks could be material to reasonable investors in the process. Ramirez v. ExxonMobil Corp., 334 F. Supp. 3d 832 (N.D. Tex. 2018). The New York attorney general brought the second case resulting in an opinion. In *New York v. Exxon Mobil Corp.*, the court considered whether ExxonMobil misled investors in disclosures about the potential impacts of future climate policies on product demand and about how ExxonMobil incorporated this information into its project-level business planning. Plaintiffs failed to convince the court of the materiality of the company's statements and supposed omissions. The court found plaintiffs' experts unpersuasive and no evidence of impact on investors' analyses or decisions during the relevant timeframe. New York v. Exxon Mobil Corp., 65 Misc. 3d 1233(A), 49 ELR 20199 (N.Y. Sup. Ct. 2019) (slip copy). These cases acknowledged the potential materiality of climate-related information but did not find the future cost estimates of an energy transition material to a reasonable investor's decisions made between 2013 and 2016, a finding that may change for more recent timeframes. (Vizcarra, 2019c)

The widespread, deepening interest by shareholders in various types of climate change information suggests future litigation around the materiality of such information is likely, particularly as climate change impacts become apparent in corporate bottom lines and acute events. As cases increase, trends in investor-corporate engagement and investor use of climate-related information indicate that courts are likely to find some of that information material. (Vizcarra, 2020) Yet, regulatory involvement may still be necessary to effectively manage climate risks at a systemic level. Given the opportunity to avoid or limit disclosure of climate-related information, individual firms could accumulate risk unnoticed. Risk accumulation that results in significant loss at the individual firm level may only harm that firm and its investors, but climate-related risks are often industry, region, or economy wide—raising the possibility of losses that could pose systemic problems.

The current administration seems unlikely to support the efforts of independent financial regulatory bodies. President Trump issued a directive to the Department of Labor in 2019 to review data on ERISA plans, identify trends in investments in the energy sector, and review guidance on fiduciary responsibilities for proxy voting. (Executive Order 13868, 2019) This may have been an effort to nudge DOL into revising earlier guidance relevant to ERISA plan consideration of environmental, social, and governance issues—perhaps to counter rising pension fund and asset manager pressure around climate change and other issues. (Vizcarra, 2019b) However, the financial system regulatory authorities have significant independence from the President, allowing for considered action despite potential resistance.

Federal Reserve System Responses to Rising Concerns of Climate Change

US Federal Reserve Chair Jerome Powell said in January that the Fed has a role to play "to ensure that the financial system is resilient and robust against the risks of climate change" and is working to understand how to do so. (Saphir, 2019) The Fed has not yet joined the Network of Central Banks and Supervisors for Greening the Financial System (NGSF) or publicly initiated a major climate change related study effort. However, Chairman Powell said the Fed would "probably" join at some point and has sent representatives to participate in NGFS meetings. The Federal Reserve Bank of San Francisco hosted a conference on climate change in 2019, commissioning a series of papers. The Executive Vice President of the Federal Reserve Bank of New York, Kevin Stiroh, delivered remarks on climate change and risk management in bank supervision at a March 4, 2020 event at Harvard Business School.

Comparative Approaches: Non-US Central Bank and Other Regulatory Actions

Other central banks are implementing new risk management assessment strategies. The Bank of England (BofE) plans to test the UK financial system's resilience to climate change risks in 2021 against three climate scenarios—including insurers as well as banks in the testing and using a 30-year modelling horizon to do so. (Bank of England Discussion Paper, 2019) The BofE's Prudential Regulatory Authority has also issued expectations for how banks and insurers should manage their climate-related financial risks, address them through risk management, conduct scenario analysis, and disclose. (Prudential Regulatory Authority, 2019) The Bank of Canada has initiated a multi-year research effort to assess climate-related risks and its government's Expert Panel on Sustainable Finance has released recommendations for supporting sustainable finance, including integrating climate risks into the supervision of federally regulated institutions. (Canada's Expert panel on sustainable finance, 2019) The European Central Bank listed climate change as a key risk driver in 2019. (ECB, 2019)

Non-US regulators have also issued new disclosure requirements for public companies and guidance on reporting climate-related issues. The European Union issued a non-financial reporting directive in 2014 and the European Commission released guidelines on reporting climate-related information in 2019. (European Commission, 2020) The UK's Financial Reporting Council has said that companies should report on the direct and indirect effects of climate change and, importantly, highlighted the importance of the auditor. (UK Financial Reporting Council, 2019) The UK's Financial Conduct Authority also recently proposed a new climate-related disclosure rule and technical note on disclosure obligations under existing rules. (UK Financial Conduct Authority, 2020) Australia has also updated its regulatory guidelines in 2019 to formally include climate change. (Baker McKenzie, 2019)

Litigation and its Potential to Heighten Risk

As communities feel the effects of climate change, litigation seeking to hold corporate actors accountable for climate change impacts and addressing property and constitutional concerns related to these impacts or government adaptation responses will grow in importance.

State attorneys general have brought cases seeking to hold private sector entities accountable for contributing to climate change. Massachusetts sued ExxonMobil in October 2019 alleging the company misled investors (similar to the New York case) and deceived consumers with misleading advertising under its business regulation and consumer protection statute. Complaint, Massachusetts v. ExxonMobil Corp., No. 19-3333 (Mass. Supp. Oct. 24, 2019). The District of Columbia's attorney general has hired outside counsel to handle potential litigation against ExxonMobil for possible violations of the Consumer Protection Procedures Act, awarding the job to Sher Edling LLP and Tycko & Zavareei LLP on Nov. 29,

2019. Given that Sher Edling also represents seven municipalities and the state of Rhode Island in climate change nuisance lawsuits against a host of oil and gas producers, any resulting DC complaint may focus on consumer protection and torts claims.

Nuisance and torts claims against energy companies also continue to emerge. (Sabin Center Climate Case Chart) They have yet to impose liability on corporate actors but do represent significant litigation costs and public relations concerns for targeted companies. These cases are distinct from environmental litigation tied to operations at specific facilities in that they seek to recover for widespread damages to communities. Parties in these cases continue to battle over whether they should be heard in federal or state courts—a federal venue more likely foreclosing the possibility of recovery for plaintiffs. Should any case survive and result in a decision on the merits in favor of the plaintiffs, it could increase litigation liabilities within the energy sector and possibly other industries as new cases are filed.

These cases also highlight the potentially crippling adaptation and resilience costs faced by cities and states in responding to increasing climate change impacts. (Leroy and Wiles, 2019) As cities and states better understand their climate-related risks and begin to more fully evaluate potential costs, the cost of mounting even long-shot litigation to help defray portions of the costs becomes a more reasonable calculation. Climate change impacts and adaptation costs in these communities threaten property values, tax bases, and municipal bond valuations. In some cases, local governments themselves could face tort claims for flood damage to private property. (Ruppert and Grimm, 2013)

Constitutional takings exacerbate this local cost concern. Takings case law foreshadows costly litigation as localities embark on forward-thinking regulatory, zoning, and land use approaches to prepare for climate change impacts. (Peloso, 2018) These cases are extremely fact specific and results differ from state to state because their outcomes depend on how the applicable state's law defines property rights. For example, a 2011 Florida case imposed a duty on a local government to maintain meaningful access to an area regardless of environmental conditions (and the costs of doing so), and suggested government inaction in the face of such duty could support a takings claim. (Ruppert, 2018) Differing treatments of property lines in the face of avulsive events will also impact state and local jurisdiction ability to absorb the costs of more severe weather events. (Sillman, 2020) A host of federal statutes and authorities impact the ability of states and communities to prepare for and respond to climate change impacts and land use regulation squarely within local jurisdictional powers can be curtailed by past takings jurisprudence. (Tarlock & Chizewer, 2016) Takings concerns have the potential to significantly hinder adequate localized response to climate concerns necessary to avoid rapid property value losses in large swaths of coastal and other climate-vulnerable communities.

Conclusion

The story of financial system response will hopefully be one of disclosure leading to effective risk management – developing appropriate, effective disclosure requirements for material climate-related issues that inform risk management at the firm, sector, and system levels. Regulatory action will likely be necessary to achieve the quality and consistency of disclosures needed to inform larger financial system risk analyses. However, flexibility in approach and experimentation is also important at the outset as organizations build their capacity to assess and disclose climate-related risks. Financial regulators should consider emerging litigation trends as they could have significant impacts on the financial fortunes of particular industries, regional governments, and large swaths of individuals in certain areas. This legal friction may heighten adaptation barriers as well as rapid shifts in local fortunes as judicial decisions set precedents in the face of new scenarios.

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