# Bond Case Briefs

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## The SEC's Proposed New Climate-Related Disclosure Requirements for Public Companies: What Do They Mean for Municipal Issuers and Borrowers? - Orrick

**Summary Statement**

- In March 2022, the U.S. Securities and Exchange Commission ("SEC") released proposed rules that would require public companies to include certain climate-related disclosures in their registration statements and periodic reports, including information about climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition, and certain climate-related financial statement metrics in a note to their audited financial statements.
- While the SEC's recently proposed disclosure rules for public companies regarding climate-related disclosures do not apply to municipal issuers and borrowers (unless the borrower is a public company) and are not final, they do provide helpful context and guidance for how the SEC may view climate-related disclosures in the municipal market.
- In light of these considerations, issuers and borrowers in the municipal market should:
  – Review the SEC's proposed climate-related disclosure rules and their implications for the municipal market, specifically as it relates to disclosure of climate-related risk and governance and management of such risks in offering documents and continuing disclosure filings.
  – Assess climate-related risks to their organization and consider whether improvements need to be made to the governance and management of such risks and whether it is advisable to establish climate-related goals and policies.

**Current Climate [PUN INTENDED!]**

In March 2022, the SEC released proposed rules that would require public companies to include certain climate-related disclosures in their registration statements and periodic reports, including information about climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition, and certain climate-related financial statement metrics in a note to their audited financial statements. The required information about climate-related risks also would include disclosure of a public company's greenhouse gas emissions, which have become a commonly used metric to assess a public company's exposure to such risks.

In May 2022, the SEC released proposed amendments to enhance and modernize the Investment Company Act "Names Rule" to address changes in the fund industry and compliance practices that have developed in the approximately 20 years since the rule was adopted. According to a statement by SEC Commissioner Allison Herren Lee, the SEC's proposed changes to the "Names Rule" have implications for funds using terms like "ESG" or "sustainable" or "green" or "social" in their names to ensure that such concepts truly align with a fund's investment decisions. While the May 2022 proposed amendments to the "Names Rule" are not the topic of this article, they illustrate the SEC's current focus on promulgating guidance that impacts the ESG investment community.

The SEC does not have the authority to adopt similar climate-related disclosure rules for issuers and borrowers (unless the borrower is a public company), and the proposed rules relating to such climate-related disclosures **do not** apply to issuers and borrowers. They do, however, provide helpful context and guidance as to how the SEC may view climate-related disclosures in the municipal market.

Orrick's corporate ESG group published an article summarizing the proposed rules as applied to public companies generally and proposing steps public companies could consider taking now. Our public finance team has prepared this supplement to that article, summarizing the key takeaways for issuers and borrowers. **We encourage you to read this supplement together with the underlying article.**

**Applying the SEC's Proposed Rules to the Municipal Market**

There are some key takeaways from the SEC's proposed rules for issuers and borrowers as it relates to disclosure of climate-related risks and governance and management of such risks in offering documents and continuing disclosure filings.

**Climate-Related Disclosure**

**Proposed Rules:**

In its registration statements and annual reports, a public company would be required to disclose climate-related risks, including information about:

- how any climate-related risks identified by the public company have had or are likely to have a material impact on its business and consolidated financial statements, which may manifest over the short-, medium-, or long-term;
- how any identified climate-related risks have affected or are likely to affect the public company's strategy, business model, and outlook;
- the public company's processes for identifying, assessing, and managing climate-related risks and whether any such processes are integrated into the public company's overall risk management system or processes;
- the impact of climate-related events (severe weather events and other natural conditions as well as physical risks identified by the public company) and transition activities (including transition risks identified by the public company) on the line items of a public company's consolidated financial statements and related expenditures, and disclosure of financial estimates and assumptions impacted by such climate-related events and transition activities;
- the oversight and governance of climate-related risks by the public company's board and management; and
- the public company's climate-related targets or goals, and transition plan, if any.

The proposed rules would also require a public company to provide greenhouse gas ("GHG") emissions metrics for investors to assess those risks, and in certain instances the GHG emissions metrics disclosures would be subject to third-party verification requirements. Further, the proposed rules would allow for disclosure regarding a public company's climate-related opportunities.

**Application to Municipal Market:**

A registration statement for public companies is similar to an offering document like an official statement or offering memorandum for issuers and borrowers in the municipal context. Issuers and borrowers often have a practice of disclosing risks factors relevant to the security for and sources of payment of the securities being issued and, in many cases, risks relevant to an issuer's or borrower's operations and finances. It is not uncommon to see risk factors in an offering document for municipal securities relating to climate change, like global warming and even GHG emissions, or climate-related events like earthquakes, wildfire, floods, and tsunami, as and if relevant.

For issuers and borrowers that do not routinely include climate-related risk disclosure in their offering documents, the SEC's proposed rules suggest the time has come to start doing so.

For issuers and borrowers that already have a practice of disclosing climate-related risks in their offering documents, the SEC's proposed rules provide more detailed and focused considerations for developing their existing climate-related risk disclosure. Issuers and borrowers should partner with their disclosure counsel to think through each of the bullets above and consider if relevant and how to best disclose and address. The bulk of the disclosure points summarized above from the proposed rules are valuable guidance as to what issuers and borrowers should consider and discuss in developing their climate-related risk disclosure.

The annual reports prepared by a public company could be analogized to the annual reports prepared by issuers or borrowers for continuing disclosure purposes. While issuers and borrowers are only obligated to provide information in annual reports that they have contractually agreed to provide at the time of issuance of the debt instrument (often in the form of a continuing disclosure agreement or continuing disclosure certificate), there may be a push by ESG investors for issuers and borrowers to start including updates to their climate-risk disclosure as part of their annual reporting obligations going forward. Annual updates regarding climate-related risks are relevant to the secondary market – especially to ESG investors – who are buying and selling securities long after the publication of the related offering document.

Whenever an issuer or a borrower makes a public disclosure in the form of an offering document or an annual report, it is speaking to the municipal market and such statement is subject to SEC Rule 10b-5. SEC Rule 10b-5 states in relevant part: "It shall be unlawful for any person, directly or indirectly … *to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."*

SEC Rule 10b-5 sets a high bar for public disclosures, including climate-related disclosure; there can be no errors or omissions of material facts. Materiality is the primary tool that issuers and borrowers have to guide disclosure practices. However, materiality is not based on what is material to the issuer or borrower making the disclosure; instead, it is based on what would be **material to the investment decision of a reasonable investor**.[1] What is material to a reasonable investor as it relates to climate-related risks and disclosure will require issuers and borrowers to have conversations with disclosure counsel, underwriters, and other professionals to ensure they are not omitting any aspect of their climate-related story that may be relevant to a reasonable investor – not just an ESG investor.

It is important to note that if an investor is specifically choosing to be an ESG investor, then an issuer's or borrower's climate-related policies and risks would be a top-of-mind factor when such investor is making investment decisions.

**Audited Financial Statements**

**Proposed Rules:**

Public companies would be required to include certain climate-related financial statement metrics and related disclosure as a note in their audited financial statements. The proposed financial statement metrics would consist of disaggregated climate-related impacts on existing financial statement line items. As part of the audited financial statements, the climate-related financial statement metrics would be subject to audit by an independent registered public accounting firm.

**Application to Municipal Market:**

Most issuers prepare their audited financial statements in accordance with standards and guidance promulgated by the Governmental Accounting Standards Board ("GASB"). It will be important to watch GASB closely in the coming years to see if it issues any proposals relating to the incorporation of climate-related metrics in audited financial statements for governmental agencies. To understand the risks imposed by climate-related conditions and events and adequately disclose them, it may be useful or even necessary for an issuer or borrower to quantify the climate-related costs incurred and reserves available to address climate-related risks should they occur. If such quantification of climate-related risks gains traction, GASB may decide to provide guidance on how to undertake this effort in a governmental agency's audited financial statements and in doing so subject an issuer's quantification to independent audit.

**Implications for ESG Investing**

Investor interest in ESG investments has grown significantly in recent years. According to one estimate, the "U.S. sustainable investment universe" has grown to over $17 trillion, which represents an increase of over 42% since 2018. Despite the growing interest in ESG investing and demand for ESG investments, there is no clear definition or description of what constitutes ESG investments, and ESG investors look for different markers, indices and evidence in their assessment of whether an investment qualifies as an ESG investment. Further, rating agencies are increasingly analyzing ESG factors as part of their credit analysis, with some agencies releasing "scorecards" for certain sectors of the municipal market, but there is no clear guidance on the factors considered and the importance in a given issuer's or borrower's credit analysis.

**In light of the SEC's proposed rules, some of the looming questions for ESG investing include:**

- How will the expectations from the ESG investor community develop concerning climate-related disclosures?
- How will ESG investors and rating agencies and other third-parties utilize the proposed rules when evaluating the ESG quality of municipal securities and making an investment decision?
- Will the ESG investing community coalesce around more standardized approach to ESG at least as it relates to assessing environmental and climate-related governance issues?
- To what extent will ESG information become material to the reasonable investor and will the omission of it run afoul of SEC Rule 10b-5?

As noted earlier, the ESG investment market is sizable and growing, and may at some point drive a change in the municipal market even though the proposed rules if adopted would not be applicable to issuers and borrowers. Issuers or borrowers who fail to carefully assess climate-related risks and fail to take actions to manage and improve such risks and then are not able to provide the climate-related disclosure that the ESG community expects may face a more limited set of investors, which could in turn impact borrowing costs.

The question will be if the loss of ESG investors will be enough of a detractor for issuers and borrowers to change their approach and practices related to climate issues. Even more, if such climate-related practices and disclosures become more prevalent in the municipal market, the expectation may extend to investors outside the ESG market.

Dave Sanchez, Director of the Office of Municipal Securities at the SEC, seems to suggest things might come to that in statements made at the National Federation of Municipal Analysts' 2022 Annual Conference: "It's not a violation of securities laws to say you're not going to do anything [on ESG], that you are going to stick your head in the sand…maybe nobody will buy your bonds."[2]

**What's Next**

The SEC's proposed rules for public companies regarding climate-related disclosures are not yet final. Orrick will continue to monitor the proposed rules and any related enforcement actions by the SEC, along with potential implications for issuers and borrowers in the municipal market.

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[1] *See Basic Inc. v. Levinson*, 485 U.S. 224, 224 (1988) (holding that for purposes of SEC Rule 10b-5, an omitted fact is material if there is a substantial likelihood that its disclosure would have been considered significant by a reasonable investor).

[2] See "SEC's Sanchez offers Guidance on ESG," by Connor Hussey, published on May 18, 2022 in *The Bond Buyer*, available at https://www.bondbuyer.com/news/secs-sanchez-offers-guidance-on-esg.

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June 9, 2022

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