SENATE COMMITTEE ON
BANKING AND FINANCIAL INSTITUTIONS
Senator Monique Limón, Chair
2021 - 2022 Regular

Bill No:	SB 449	**Hearing Date:**	April 21, 2021
Author:	Stern		
Version:	April 13, 2021 Amended		
Urgency:	No	**Fiscal:**	Yes
Consultant:	Michael Burdick		

Subject: Climate-related financial risk

SUMMARY Requires specified businesses formed or licensed in California with annual revenue of at least $500 million to prepare and publish an annual climate-related financial risk report, as specified. Requires the Climate-Related Risk Disclosure Advisory Group established pursuant to Executive Order N-19-19 to analyze the reports and provide policy recommendations, as specified.

EXISTING LAW

1) Provides processes and requirements related to forming business entities, such as corporations, partnerships, and limited liability companies, and requires that specified documents and instruments related to business entities be filed with the Secretary of State. (Corporations Code Section 100 et al.)

2) Provides Executive Order N-19-19 related to climate change policies in state government, which requires, among other things, the Department of Finance to create a Climate Investment Framework to align the state's investment practices with its climate change goals.

THIS BILL

1) Defines "climate-related financial risk" as material risk of harm to immediate and long-term financial outcomes due to climate change, including, but not limited to, risks to corporate operations, provision of goods and services, real estate, supply chains, employee health and safety, capital and financial investments, institutional investments, financial standing of loan recipients and borrowers, shareholder value, insured assets, consumer demand, and financial markets and economic health.

2) Defines "covered entity" as any corporation, partnership, limited liability company, or other business entity incorporated, formed, or issued a license to operate or certificate of authority under the laws of the State of California, that had revenues of at least $500 million in the prior calendar year.

3) By December 31, 2022, and annually thereafter, requires a covered entity to prepare a climate-related financial risk report disclosing the following:

   a) Its climate-related financial risk, in accordance with the recommendations contained in the Final Report of Recommendations of the Task Force of Climate-Related Financial Disclosures.

b) Its measures to reduce and adapt to climate-related financial risk.

4) Requires a covered entity to submit its climate-related financial risk report to the Secretary of State and make the report available on the covered entity's website. Requires the covered entity to submit to the Secretary of State a statement affirming that the report discloses climate-related financial risk in accordance with the recommendations contained in the Final Report of Recommendations of the Task Force on Climate-Related Financial Disclosures.

5) Requires the advisory group established pursuant to Executive Order N-19-19 to collect and review the reports and annually prepare a public report that includes analysis of the reports and policy recommendations aimed to mitigate climate-related financial risk. Provides that the Governor's Office of Planning and Research shall serve as the administrative staff of the advisory group.

6) Makes findings and declarations related to the threat of climate change, the role of companies in emitting greenhouse gases, and the risk posed to the economy and investors if climate-related financial risk is ignored.

<u>COMMENTS</u>

1) PURPOSE

According to the author:

> Accurate and timely disclosure of how climate risks impact a company's finances will enable the transparency key to a well-functioning economy. Disclosure will mitigate the risk of over or undervaluing investments, that could slow economic growth and progress towards a healthier, more resilient carbon neutral future.
>
> SB 449 will require corporations, as defined to prepare an annual climate-related financial risk report and submit it to the Secretary of State. The Secretary of State would submit these reports to the Climate Risk Disclosure Advisory group established by Executive Order N-19-19.

2) BACKGROUND

The potential effects of climate change pose short- and long-term risks and opportunities to many businesses throughout the California economy. Businesses will be affected not only by the physical consequences of climate change, but also by the policy responses enacted by local, state, and national governments around the world as political leaders work to reduce greenhouse gas emissions and accelerate the transition to a lower-carbon economy. These changes may affect a business's operations, which has ramifications for a variety of stakeholders in the firm, including employees, investors, customers, suppliers, and governments.

Transparency is a necessary condition for well-functioning financial markets. In order for investors and creditors to allocate capital efficiently, the market must know about a firm's financial performance, governance, and risk management. In recent years, investors have expressed a growing demand for information on climate-related risks.[1] Even as some

[1] https://www.wri.org/news/what-investors-want-sustainability-data

companies have voluntarily moved forward with various disclosures, investment managers complain about the quality of the disclosures and the lack of standardization across firms. To address the issue of quality and standardization, several international efforts are underway to provide recommended frameworks for climate-related risk disclosures.

Information related to a firm's financial performance and business risk is typically disclosed in reports required by federal securities laws. Pursuant to the Securities Exchange Act of 1934, companies with more than 500 shareholders and $10 million in assets are required to file this information with the federal Securities and Exchange Commission (SEC), which makes the annual and quarterly reports available to the public. Occasionally, to assist those who provide such disclosures, the SEC provides guidance on how to interpret the disclosure rules on topics of interest to the business and investment communities. In 2010, the SEC issued interpretive guidance on existing SEC disclosure requirements as they apply to business or legal developments relating to the issue of climate change. The interpretative release does not create new legal requirements nor modify existing ones, but is intended to provide clarity and enhance consistency for public companies and their investors.[2]

3) THE TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

The Task Force on Climate-related Financial Disclosures (TCFD) was established in 2015 by the Financial Stability Board, an international body that monitors and makes recommendations about the global financial system. The purpose of the TCFD is to develop recommendations for more effective climate-related disclosures that could promote more informed investment, credit, and insurance underwriting decisions and, in turn, enable stakeholders to understand better the concentrations of carbon-related assets in the financial sector and the financial system's exposures to climate-related risks. The TCFD is chaired by Michael Bloomberg and is comprised of 31 members from across the world, representing both preparers and users of financial disclosures.

In 2017 the TCFD released climate-related financial disclosure recommendations designed to help companies provide better information to support informed capital allocation. [3] The disclosure recommendations are structured around four thematic areas that represent core elements of how organizations operate: governance, strategy, risk management, and metrics and target. The recommendations of the report are summarized below.

Governance: Disclose the firm's governance around climate-related risks and opportunities.

- Describe the organization's governance around climate-related risks and opportunities.
- Describe management's role in assessing and managing climate-related risks and opportunities.

Strategy: Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material.

- Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term.

[2] https://www.sec.gov/news/press/2010/2010-15.htm
[3] https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf

- Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning.
- Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.

Risk Management: Disclose how the organization identifies, assesses, and manages climate-related risks.

- Describe the organization's processes for identifying and assessing climate-related risks.
- Describe the organization's processes for managing climate-related risks.
- Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management.

Metrics and Targets: Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

- Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process.
- Disclose Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas (GHG) emissions and the related risks.
- Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets.

The TCFD published its third annual status report in September 2020, which reported significant momentum around adoption and support of its recommendations.[4] More than 1,500 firms globally have expressed support for the recommended disclosures, many of which have begun to implement the TCFD recommendations or continue to refine and improve their climate-related financial disclosures. The recommendations have also seen increased support among investors, regulators, and other government entities.

While expressed support for the TCFD framework is growing, few companies have fully adopted and implemented the recommended disclosures. In developing the status report, the TCFD reviewed a sample of disclosures from 1,700 firms worldwide. The analysis showed that no single TCFD recommendation was adopted by at least half of the firms in the sample and less than one quarter of firms adopted recommendations related to board oversight, resilience of strategy, and integration into overall risk management. In summary, complete adoption of the TCFD recommendations remains elusive, even among companies who state their support for the framework.

4) POTENTIAL ACTIONS AT THE FEDERAL LEVEL

The current federal administration has communicated that fighting climate change through many avenues of the federal bureaucracy will be a top priority. Treasury Secretary Janet Yellen said in March 2021 that "the Administration is committed to using the full power of the U.S. federal government to address climate change as part of the Build Back Better plan."[5] The recently confirmed Chairman of the SEC, Gary Gensler, has expressed openness to requiring companies to disclose more information about climate-related risks. In his

[4] https://assets.bbhub.io/company/sites/60/2020/09/2020-TCFD_Status-Report.pdf
[5] https://www.reuters.com/article/us-usa-treasury-yellen/yellen-vows-to-use-full-power-of-u-s-government-to-tackle-climate-change-idUSKBN2B902W

confirmation hearing, Gensler said, "There's tens of trillions of dollars of invested assets that are looking for more information about climate risk. I think then the SEC has a role to play to help bring some consistency and comparability to those guidelines."[6]

In addition to the direction communicated by Treasury and the SEC, financial regulators have started to act on the risks that climate change poses to the safety and soundness of the financial system. Last year, the Federal Reserve joined the Network of Central Banks and Supervisors for Greening the Financial System, an international group of financial regulators that facilitates the exchange of ideas, research, and best practices on the development of environment and climate risk management for the financial sector.[7] The Commodity Futures Trading Commission, an independent federal agency that regulates the derivatives market, announced in March 2021 the creation of a Climate Risk Unit to focus on the role of derivatives in understanding, pricing, and addressing climate-related risk and transitioning to a low-carbon economy.[8]

As this analysis was being drafted, media reports indicate that President Biden is preparing to issue an executive order to instruct federal agencies to take sweeping action to combat climate-related financial risk.[9] The draft order, titled "Climate-Related Financial Risk," envisions a government-wide strategy to measure, mitigate, and disclose climate risks facing federal agencies. Banking regulators may be asked to incorporate climate risk into their supervision of regulated entities. The SEC and Federal Reserve, however, are independent agencies and do not take direct orders from the White House. In the areas of securities law and bank supervision, the executive order may serve more as a way to communicate the President's expectations, rather than as enforceable obligations with which regulators must comply.

While the rhetoric and signals from the federal administration suggest forthcoming action, the timing and nature of such action is uncertain. Until enforceable rules are promulgated or new laws are enacted by Congress, these statements and working groups will do little to influence behavior in the economy. With a closely divided Congress, it is reasonable to expect that the executive branch will carry most of the responsibility in pushing any policy changes forward, potentially testing the boundaries of administrative authority on this issue.

5) SCOPE OF THIS BILL

This bill requires any company with annual revenues of at least $500 million, which is either organized under California law or licensed to operate in California, to file a report with the Secretary of State that discloses its climate-related financial risks in accordance with the recommendations described in Comment #3 above. These reports are required to be filed annually and must also include discussion of measures that companies will take to reduce and adapt to climate-related financial risk.

In drafting the bill, the author and sponsor confronted the tension and tradeoffs between sound legal standing and the desire to cover as many large companies as possible with the reporting requirement. This bill prioritizes the side of sound legal standing by making the reporting requirement applicable only to those companies organized under California law or

[6] https://www.wsj.com/articles/gary-gensler-is-confirmed-as-sec-chairman-by-senate-11618418366
[7] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20201215a.htm
[8] https://www.cftc.gov/PressRoom/PressReleases/8368-21
[9] https://www.politico.com/news/2021/04/15/biden-climate-risks-executive-order-481962

licensed to operate by the state. The effect of this decision leads to outcomes that weaken the intentions of the author. Over two-thirds of Fortune 500 corporations are incorporated in Delaware, and of the largest 30 companies headquartered in California only Apple, Cisco, and PG&E are also incorporated in the state. Notably, companies like Chevron, Uber, and Wells Fargo have no reporting requirements under this bill because each of those companies is incorporated in Delaware.

6) THIS BILL RELIES ON VOLUNTARY COMPLIANCE

This bill does not contain enforcement mechanisms that would incentivize compliance with the reporting requirement. A company that fails to provide its climate-related financial risk report faces no civil or criminal penalties, nor does this bill authorize any state regulator to take administrative action to punish a noncompliant company. Unless an enforcement mechanism is included in the bill, the Legislature must rely on businesses to voluntary comply with the reporting requirement.

The absence of enforcement mechanisms in this bill may be appropriate given the nature of the TCFD recommendations upon which this bill relies. When forming the TCFD, the Financial Stability Board emphasized that "any disclosure recommendations by the Task Force would be voluntary, would need to incorporate the principle of materiality, and would need to weigh the balance of costs and benefits." The TCFD recommendations, therefore, are not constructed as well-defined, legally enforceable requirements, but rather as guiding principles that help a company identify categories of information to disclose. Given the relatively new field of evaluating and disclosing climate-related risk, it may be appropriate to provide companies with flexibility in how they report such risk without fear of penalties for unintentionally withholding or imprecisely disclosing information that is later deemed to be material.

While the bill does not contain enforcement mechanisms for failure to file a report, the bill could impose liability on a company if a filed report is not in accordance with the TCFD recommendations. The bill requires that a company submit a statement to the Secretary of State affirming that the report follows the TCFD recommendations. If the report fails to comply with the TCFD recommendations, the company may be held liable for perjury. Because there is no express liability for failing to file a report altogether, a risk averse company may decide to avoid any chance of committing perjury related to an incomplete or inaccurate report by not filing a report in the first place.

7) ARGUMENTS IN SUPPORT

The Natural Resources Defense Council (NRDC) writes as sponsor of the bill:

> California's economy is increasingly vulnerable to the effects of climate change; from sea level rise impacting the coast, ongoing droughts affecting agriculture, fishing and critical ecosystems, and wildfires devastating entire communities. However, the financial and economic risks of climate change are not widely disclosed or evaluated to inform responsible investing and lending...
>
> Federal requirements could still be years away, and will not encompass the range of entities covered by SB 449, state-chartered banks, other state licensed financial institutions, and insurance companies which are not publicly traded. California

has an important opportunity to lead and set the standard for assessing climate-risk by passing SB 449.

8) ARGUMENTS IN OPPOSITION

A coalition of financial services companies and the California Chamber of Commerce write in opposition:

> The measure is premature given the amount of activity happening at the federal and international levels. Both the executive and legislative branches have served notice that changes will be happening soon. The Securities and Exchange Commission is already reviewing their guidance documents on the topic. There is a very real risk that compliance with SB 449 will not align with federal guidance. Given the global nature of climate change, every effort should be made to assess and mitigate climate risks nationally. To impose state requirements lessens the overall effectiveness and leads to a patchwork of disjointed mandates producing confusing, contradicting and misleading information not to mention duplicative, redundant and contradicting reporting requirements at many levels.

9) AMENDMENTS

a) Move the provisions of this bill into the Corporations Code

The April 13, 2021, version of the bill removes the responsibility of Department of Financial Protection and Innovation from receiving the reports. This version also removes definitions specific to financial services businesses and replaces those terms with a broad definition of "covered entities." Based on the new version of the bill, these provisions are better suited for the Corporations Code, which covers laws related to the formation of business entities and related reporting requirements of those business entities.

<u>Suggested amendment:</u>

Remove all provisions of the bill from the Financial Code and place them in the Corporations Code as a standalone title.

b) State that the affirmation is not filed under penalty of perjury

As discussed in Comment #6, the requirement for a covered entity to affirm to the Secretary of State that the report discloses climate-related risk in accordance with the TCFD recommendations implies that the statement is filed under penalty of perjury. In order to remove the disincentive to file a report at all, this bill should state that the affirmation is filed, *not under penalty of perjury*.

<u>Suggested amendment:</u>

On page 8, line 15, after "affirming" insert:

", not under penalty of perjury,"

10) DOUBLE REFERRAL

This bill is double-referred to the Committee on Environmental Quality.

11) PRIOR AND RELATED LEGISLATION

a) SB 260 (Wiener and Stern) of the current legislative session: Requires businesses with operations in California and annual revenue of at least $1 billion to publicly disclose their greenhouse gas emissions, as specified, and requires the Air Resources Board to develop and adopt rules requiring these business to set science-based emissions targets.

b) AB 766 (Gabriel and Bennett) of the current legislative session: Requires publicly traded corporations headquartered in California and with annual revenue of at least $100 million to disclose to the Air Resources Board and Secretary of State the potential financial impacts of and any risk management strategies relating to climate change, as specified.

LIST OF REGISTERED SUPPORT/OPPOSITION

Support

1000 Grandmothers for Future Generations
350 Butte County
350 Conejo / San Fernando Valley
350 Hawaii
350 New Orleans
350 PDX (Portland, OR)
350 Sacramento
350 Seattle
350 Silicon Valley
350 South Bay Los Angeles
350 Ventura County Climate Hub
Acterra: Action for a Healthy Planet
Alameda County Interfaith Climate Action Network
California Coalition for Clean Water & Reliability
California League of Conservation Voters
California Water Research
Carbon Accountable
Ceres
Civic Sundays
Climate First: Replacing Oil & Gas (CFROG)
Climate Protection and Recovery Fund
Conejo Climate Coalition
Divest NJ Coalition (New Jersey)
E2 (Environmental Entrepreneurs)
East Valley Indivisibles
Elders Climate Action, Norcal and Socal Chapters
Environmental Defense Fund, Incorporated
Extinction Rebellion SF Bay
Feel the Bern San Fernando Valley Democratic Club
Feminists in Action (formerly Indivisible CA 34 Womens)
Fossil Free California
Friends of Public Banking - Santa Rosa
Friends of The Climate Action Plan
Glendale Environmental Coalition

Indivisible Alta Pasadena
Indivisible CA Statestrong
Indivisible California Green Team
Indivisible Conejo
Indivisible Sacramento
Indivisible San Jose
Indivisible San Pedro
Indivisible Ventura
Lutheran Office of Public Policy - California
Mendocino Women's Political Coalition
Mothers Out Front California
Natural Resources Defense Council
New Mexico Climate Justice
Peninsula Interfaith Climate Action
San Francisco Bay Physicians for Social Responsibility
San Jose Community Energy Advocates
Santa Barbara County Action Network
Sierra Club California
Socal350 Climate Action
SolidarityINFOService
Stand.earth
The Climate Center
TIAA Divest! From Climate Destruction
Together We Will - San Jose
55 Individuals

Opposition

California Association of Realtors
California Bankers Association
California Building Industry Association (CBIA)
California Business Properties Association
California Chamber of Commerce
California Credit Union League
California Mortgage Association
California Mortgage Bankers Association
Western States Petroleum Association

Oppose Unless Amended

American Council of Life Insurers
American Property Casualty Insurance Association
Association of California Life and Health Insurance Companies
National Association of Mutual Insurance Companies
Pacific Association of Domestic Insurance Companies
Personal Insurance Federation of California

-- END --