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SEC's ESG, Climate Rules Stir Up Questions for Real Asset Managers

The proposed rules on ESG and climate risk disclosures are a double-edged sword to managers, with greater clarity on requirements but ample added challenges.

By Shayla Colon | March 1, 2023

Proposed **rules** that the **Securities Exchange Commission** is set to adopt early this year on climate risk and environmental, social and governance, or ESG, disclosures are already prompting real assets fund investors to push for additional reporting – and managers to assess the added risks they face.

While the rules, now in the final adoption stage, apply specifically to publicly traded companies and registered vehicles, their reach can extend to private funds in multiple ways. And real estate and infrastructure fund managers have already begun receiving deeper inquiries from limited partners, or LPs, about climate risk and ESG.

These rules could impact the private real estate and infrastructure asset classes particularly around reporting requirements, said **Dan Mistler**, head of ESG advisory at the **ACA Group**.

"The main challenge with the reporting for managers is data – getting reliable, timely data," Mistler said.

In some cases, private fund investors that utilize debt from publicly traded banks may have to report information under these rules sooner than others, he noted. That is why real estate and infrastructure are among the industries already pushing this kind of reporting up and down their supply chains, leading to a plethora of ways to get caught up in the requirements, he added.

The proposed **climate risk** disclosure rule would require companies to provide detailed reporting on how they manage and govern climate-related issues, in addition to how these changes have a material impact on their operations, assets and business. Similarly, the **ESG disclosure** proposal would obligate a registered fund manager to provide investors information on ESG factors considered, what ESG-focused funds it has and metrics related to achieving ESG goals, such as greenhouse gas emission targets.

The **ESG proposal** also would mandate including information relative to ESG strategies on fund prospectuses, annual reports and fund manager brochures. This rule would ensure that information is cited in Form ADVs even though many managers already do so, said **Vadim Avdeychik**, a partner at **Clifford Chance**.

Many managers have struggled to document metrics on climate risk and ESG due to a lack of data and standardized reporting.

Yet under the rules, publicly traded firms would have to report scope 1, 2 and 3 emissions if they are financially material to the business. Under **U.S. Environmental Protection Agency** definitions based on the Greenhouse Gas Protocol, scope 1 emissions are those directly produced by companies and their assets, while scope 2 emissions are indirectly created when companies purchase energy from utilities, such as electricity and heat. Scope 3 emissions result from external sources that are not directly in a company's value chain.

Reporting of scope 3 emissions has been a major point of contention around the proposed rules, leading to widespread pushback in thousands of comment letters submitted to the commission, many of which said there wasn't enough data available to quantify accurate results.

Pimco, for example, expressed general support for scope 3 emissions reporting but recommended that it only be required if those emissions are "material or if a company has publicized a GHG emissions reduction target or goal that encompasses Scope 3 emissions, including public climate-related commitments or pledges."

With similar reasoning, **Manulife Investment Management** suggested the SEC not mandate scope 3 reporting until at least three years after scope 1 and 2 emissions reporting is required.

As a result of the overwhelming industry opposition, it's likely that component won't make it into the final rule, Mistler noted. Even more challenging, however, is what investors may look for after such data becomes available.

"Even if you could wave a magic wand and solve the data problem, investors will begin to look to see that this information is being used in decision-making and operationalizing. That will be a much bigger challenge," Mistler said.

Another issue managers need to consider is how reporting climate and ESG data can open companies up to liability. Scrambling to solve the data problem will likely cause some managers to "make poor data decisions or not to conduct adequate diligence on data providers," thus leaving them exposed to more liability, he added.

While the proposed rules have several caveats allowing estimates to be used rather than definitive figures, making materially incorrect disclosures is a risk, according to **Jason Rozes**, a partner at **Dechert**, a law firm.

The proposed rules over time will also push managers to provide data they have long said isn't available. That landscape is changing each time more information is released, said **Amy Lynch**, president of **Frontline Compliance**. Moreover, the SEC rules give more structure around what managers can and can't do when presenting data, breaking it down by the different levels of fund investment, thus introducing loose standardization, she added.

While the proposed rules feature phase-in periods for compliance, many commenters have also taken issue with how short they are, pleading for more time before they become effective. For instance, some groups are requesting an amendment that provides a two or three-year phase-in to the climate risk disclosure rule as opposed to what is currently outlined.

There is also concern around the cost of tracking and reporting such data. Larger, sophisticated managers that have already been tracking this kind of data for some time may have an easier time than smaller outfits, Rozes explained.

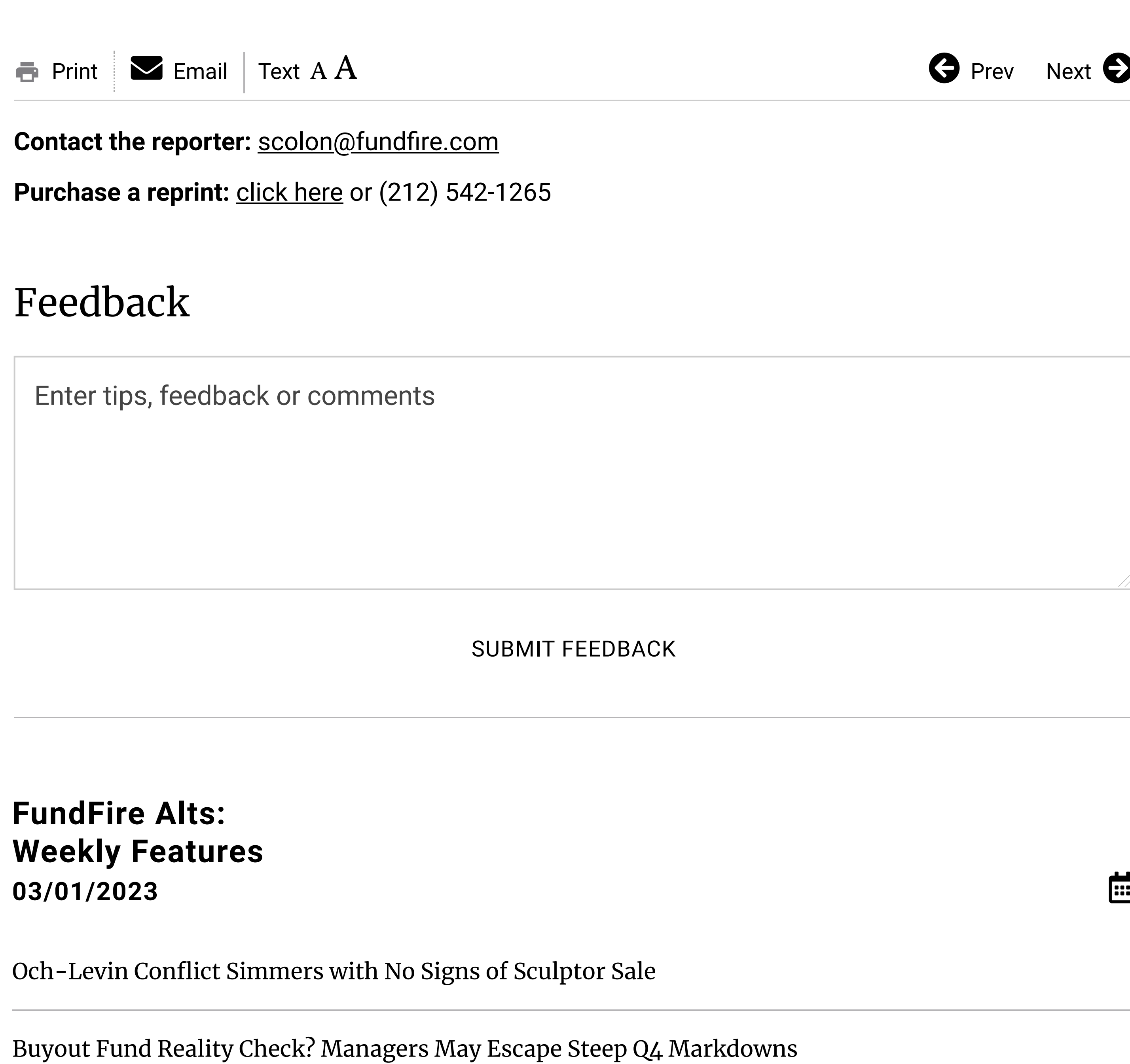
"The number one argument that the comment letters agree on is that this compliance will directly increase costs in the billions for companies," he said.

Adding regulatory layers at any time can have associated costs, such as hiring compliance officers or outsourcers, Avdeychik noted.

How managers approach the reporting requirements could determine winners and losers in these markets, as well as prompt lawsuits against the SEC, according to Rozes.

But given that private real estate managers are already facing due diligence questions over sustainability, whatever final rules emerge could offer them further guidance, he said.

"What the public companies are doing can definitely serve as a roadmap and a model for the private sector," Rozes said. "And I think in a good way because whether this rule gets passed, and whatever it looks like in the end, sustainability and ESG as an investment strategy isn't going away. Whether you're an investor in a public company or private fund investor in a real estate fund, having more disclosure of climate-related risks that are reliable [and] consistent is going to help people make more informed decisions."



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