END TO GREENWASHING: AN APPRAISAL OF THE EFFECT OF SEC PROPOSED CLIMATE- RISK DISCLOSURE RULES

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Abstract

The concept of Environmental, Social, and Governance (ESG) has emerged as a pivotal element in corporate law. Terms like "impact investing," "benefit corporation," and "greenwashing" have become commonplace. They emphasize the growing significance of ESG and the idea that investors prioritize the effects of their investments. While ESG concerns were once secondary considerations, recently, institutional investors have begun to assess business's ESG impact before making investment decisions. In response to the potential risks associated with greenwashing, many countries have initiated requirements for mandatory ESG risk disclosures. These regulations aim to enhance transparency in addressing climate risk and safeguard the interests of investors who rely on this information to make informed investment choices. It is against this backdrop that the Securities and Exchange Commission in the United States proposed mandatory climate-risk disclosures for public corporations. This paper endeavours to emphasize the importance of recent trends of mandatory ESG and climate-risk disclosure.

1.0 INTRODUCTION

The growing trend of ESG disclosures shows a shift from traditional business concept of financial value to a more impact driven investment model. According to the U.S. Securities and Exchange Commission ("SEC")'s Chairman Gary Gensler:

> "Today, investors increasingly want to understand the climate risks of the companies whose stock they own or

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> might buy. Large and small investors, representing literally tens of trillions of dollars, are looking for this information to determine whether to invest, sell, or make a voting decision one way or another".[1]

Similarly, BlackRock's Larry Fink in a letter urged companies to disclose how they are preparing for a "net zero world" where net greenhouse gas emissions are eliminated by 2050.[2] In 2021, Blackrock published guidance concerning its expectations with respect to climate-related disclosures, stating that "climate risk—physical and transition risk—presents one of the most significant systemic risk[s] to the long-term value of our clients' investments",[3] and true to its position, Blackrock voted for two shareholder proposals requiring Berkshire Hathaway Inc. to issue disclosures addressing how the company is managing climate risk, noting that the company "is not adapting to a world where environmental, social, governance (ESG) considerations are becoming much more material to performance".[4] With Bank of America Merrill Lynch predicting that up to $20 trillion could be invested in these types of funds over the next three decades,[5] it is not surprising to see that many corporations have started taking the path of voluntary ESG disclosures as a business and marketing strategy,[6] which have prompted many countries to require mandatory ESG and climate

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[1] Chair G. Gensler, "Climate and Global Financial Markets" available at https://www.sec.gov/news/speech/gensler-pri-2021-07-28 (accessed 16 December, 2022).

[2] SP Global, "Seven ESG Trends to Watch in 2021" available at https://www.spglobal.com/en/researchi-nsights/featured/special- editorial/seven-esg-trends-to-watch-in-2021 (accessed 16 December, 2022).

[3] BlackRock, "Our 2021 Stewardship Expectations" available at https://www.blackrock.com/corporate/literature/publication/our-2021-stewardship-expectations.pdf (accessed 17 December, 2022).

[4] Cadwalladers, "Investors and Regulators Turning up the Heat on Climate-Change Disclosures: Attempting to Make Sense of the State of Play in the US, EU, and UK" available at www.cadwalader.com (accessed December 19, 2022).

[5] Business Insider, "10 reasons to care about ESG investing" available at https://markets.businessinsider.com/news/stocks/10- reasons-to-care-about-esg-investing-bank-of-america (accessed 19 January, 2023).

[6] Exxon Mobil was first US oil super major to disclose greenhouse gas emissions data related to customer use of its petroleum products. The company said it will provide Scope 3 emissions data reports annually.

risk disclosures in order to drive transparency in addressing climate risk, and invariable protect investors from false disclosures.

Interestingly, several international and regional policy and regulatory initiatives are driving in the same direction. The IFRS Foundation's proposals around sustainability reporting, and the Network for Greening the Financial System represent an important international attempt to make progress on disclosure by coordinating best practice in the world of financial supervision of climate-related risks. On the other hand, the SEC proposal on mandatory climate-risk disclosure, the new sustainability disclosure requirements for market participants in the EU under the Sustainability Disclosures Regulation and the Taxonomy are aimed at providing legal framework for ESG reporting in the countries or regions where the rules apply, with a far-reaching effect for public corporations.

2.0 THE RISE OF VOLUNTARY CLIMATE-RISK/ESG DISCLOSURE AND THE FAUX PAS OF GREENWASHING

Globally, in the early 1990s, fewer than 20 publicly traded firms issued reports that included ESG data. By 2014, the number around the world providing some information on ESG issues had increased to nearly 6, 000.[7] In the United States, 83% of companies registered with the Securities and Exchange Commission (SEC) in 2017 disclosed some sustainability information in their regulatory filings8. Early firm-initiated disclosures of sustainability information tended to be reactive, with firms often disclosing in press releases or on company websites after high-profile scandals. These practices became recognized as industry best practices and served as guidelines. In response to the recent growth in demand for ESG information from investors, stakeholders, and regulators, firm ESG disclosures began being centralized in a single document: the ESG report. Yet the content in these reports varied widely by firm, by

[7] *Supra* note 4.
[8] *Ibid.*

industry, and over time, in part because ESG reports are not audited, mandated, or regulated in many jurisdictions, including the United States. This encouraged greenwashing and the inclusion of false and misleading statements in an attempt to sway investors.

Greenwashing [9] refers to the practice of falsely promoting an organization as environmentally friendly when in practice the organization may be causing more harm to the environment through its activities and business operations. [10] It could also be used to describe the practice of firms claiming to have strong ESG compliance when they do not.[11]

With the recent rise in ESG investments, [12] there has been a significant increase in the number of corporations involved in greenwashing. One example comes to mind. In 2015, Volkswagen launched a marketing campaign in which they portrayed their diesel engines as meeting or exceeding US and Californian emissions standards, offering impressive fuel efficiency and performance, and emphasizing their commitment to low emissions and environmentally friendly attributes. Ironically, the company had secretly implemented "defeat devices" software in these vehicles, which were specifically designed to manipulate emissions testing. These engines, equipped with the surreptitious software, emitted nitrogen oxide pollutants at

[9] The word greenwashing was first coined 1986, by prominent environmentalist Jay Westerveld when he observed vast amounts of waste that hotels produced and failed to undertake any sustainable measures to tackle it. However, the same hotels promoted the reuse of towels as part of their environmental strategy, which implied that reuse of towels was nothing but a cost saving measure.

[10] ActusESG, ESG Greenwashing: A not-so green business practice: available at ActusESG.com (accessed on December 19, 2022).

[11] Jason Holt, "INSIGHT: 'Green-Washing' Lessons for Financial Crime Compliance Programs", Bloomberg Law available at https://news.bloomberglaw.com/white-collar-and-criminal-law/insight-green-washing-lessons-for-financial-crime-compliance-program (accessed on December 17, 2022).

[12] According to Financial Times, Global ESG-linked funds took in nearly US $350 billion last year, compared with US $165 billion in 2019, according to data from Morningstar. Net assets held in UK-domiciled ESG funds went from US $39 billion at the beginning of 2017 to US $96 billion by the end of 2020, including active and passive funds.

levels up to 40 times higher than the permissible limits in the United States. Consequently, the scandal forced Volkswagen to initiate a global recall of millions of vehicles and incurred substantial financial losses.[13]

3.0 SEC MANDATORY CLIMATE AND ESG DISCLOSURE RULES

In a bid to stem the menace of false voluntary ESG disclosures, the SEC like its counterparts in other countries, has proposed rules to require mandatory climate-risk disclosures in periodic filings by public companies with reporting obligations pursuant to the Securities Exchange Act Section 13(a) or Section 15(d), and companies filing a Securities Act or Exchange Act registration statement (the "**Proposed Rules**"). The Proposed Rules would amend and create new sections within Regulations S-K and S-X that the SEC believes would provide more consistent, comparable, and reliable information for investors to evaluate climate-related risks to registrants. The SEC states that registrants should continue to evaluate the climate-related risks they face and assess whether disclosure related to those climate-related risks must be disclosed in the Description of Business, Risk Factors, Legal Proceedings, and MD&A as described in the SEC 2010 Guideline.[14] In summary, the Proposed Rules would require registrants to disclose certain climate- related information, covering numerous topics including but not limited to:

1. Strategy, Business Model, and Outlook: The proposed rule 1502(b) would cover the material impacts or potential impacts of climate-related risks on business strategy, outlook, or consolidated financial statements over short, medium, and long terms, including use of carbon offsets or renewable energy credits or certificates ("RECs") as part of business

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[13] Russell Hotte, "Volkswagen: The scandal explained" BBC NEWS available at https://www.bbc.com/news/business-34324772 (accessed September 8, 2023).

[14] Amy S Matsuo, "Climate Risk: SEC's Mandatory Climate Disclosures Proposal" available at https://advisory.kpmg.us/articles/2022/sec-mandatory-climate-disclosures-proposal-reg-alert-mar-2022 (accessed 16 December, 2022).

strategy to reduce climate-related risks.

It also requires disclosure on the maintenance of internal carbon price, or the estimated cost of carbon emissions, including the price in units of the registrant's reporting currency per metric ton of CO2, the total price, including change over time, if applicable. It will also cover the impacts of climate events (severe weather, natural conditions, or other identified physical risks) and transition activities (including identified transition risks) on consolidated financial statements and related expenditures, including estimates and assumptions[15]

2. Governance: the proposed rule 1501(a)(1) covers oversight and governance of climate- related risks by the board, and would assess whether the entire board, specific board members, or a board committee is responsible for the oversight of climate-related risks. The processes by which the board is informed about climate-related risks, and the frequency of its discussions on them, and how the board or board committee considers climate-related risks as part of its business strategy, risk management, and financial oversight. In addition, proposed rule 1501(b)(1) would cover management oversight of climate-related risks including whether certain management positions or committees are responsible for assessing and managing climate-related risks and, if so, to identify such positions or committees and disclose the relevant expertise, and the processes by which responsible managers or management committees are informed about and monitor climate-related risks.[16]
3. Risk Management: a key component of proposed rule 1503(a) covers the processes for identifying, assessing, and managing climate-related risks, and whether the processes are integrated into overall risk management or processes, including determining the relative significance of climate-related risks to other risks, consideration of existing or expected regulatory requirements or policies on climate-

[15]*Supra* note 14
[16] *Ibid*

related risks, consideration of shifts in customer or counterparty preferences, technological changes, or change in market prices in assessing transition risks, determining materiality of climate-related risks, and transition plans, or strategies and implementation plan to reduce climate-related risks, if the registrant has adopted a plan.[17]

4. Financial Statement Metrics: the proposed Rule 14-02 would require registrants to provide certain climate-related financial statement metrics and related disclosures in a note to their audited financial statements, including financial impact metrics, based on disclosures covered by proposed Item 1502(b) applied on a line-item basis, expenditure metrics, both positive and negative impacts associated with the events, activities, and risks in the proposed financial impact metrics. These metrics are separately aggregated for expenditures expensed and capitalized costs incurred during the fiscal year. Financial estimates and assumptions discussed in a qualitative narrative, covering whether financial statements were impacted by exposures to risks and uncertainties associated with climate-related risks and as part of the financial statements, these metrics and disclosures would be subject to external audits.
5. GHG Emissions Metrics Disclosures: The rule would require a disclosure of Scope 1 (direct) and Scope 2 (electricity indirect) greenhouse gas (GHG) emissions metrics, separately disclosed and presented by disaggregated constituent GHGs and in aggregate, as well as in absolute and intensity terms. If the registrant is an accelerated or large accelerated filer, an attestation report from an independent attestation service provider covering, at a minimum, Scopes 1 and 2 emissions disclosures would be required. Within one year of the compliance date for the disclosures, registrants would need to provide limited assurance, and within three years provide reasonable assurance. Scope 3 (other indirect) GHG emissions and intensity if material or the registrant has

[17] *Ibid.*

set a GHG emissions reduction target or goal including Scope 3 emissions.

4.0 EFFECT OF DISCLOSURE OR FAILURE TO DISCLOSE

Once the Proposed Rules become effective, a public corporation would be liable for securities fraud violation if it fails to disclose or makes a fraudulent disclosure pursuant to the ProposedRules.
The SEC Rule 10b-5[18] enables the SEC, or private plaintiffs to investigate and bring civil actions to enforce three types of securities fraud violations:

i. Those committed by employing any device, scheme, or artifice to defraud.
ii. Those committed by making a false statement or omitting information that wouldbe misleading to an investor.
iii. By engaging in fraudulent or deceitful conduct.[19]

A corporation who decides to toil the path of greenwashing in making its disclosure pursuant to the Proposed Rules would have the SEC or individual investors to contend with. I believe that an investor who relies on a corporation climate-risk disclosure made pursuant to the Proposed Rule would not have to contend with the roadblock of "materiality"[20]. It is my opinion that the controversial

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[18] Rule 10b-5 is the Securities and Exchange Commission's (SEC) main basis for investigating possible security fraud claims. Violations of the rule include executives making false statements to drive up share prices, a company hiding huge losses or low revenues with creative accounting practices, or actions taken to grant current shareholders a better return on their investments—as long as the deception remains undiscovered. These schemes typically require ongoing, misleading statements to perpetuate the fraud.
[19] David Lopez, Jared Gerber et al "The Materiality Debate and ESG Disclosure: Investors May Have the Last Word" available at https://corpgov.law.harvard.edu/2022/01/31/the-materiality-debate-and-esg-disclosure-investors-may-have-the-last- word/ (accessed December 17, 2022)
[20] Materiality is a litigated issues in securities cases. SEC regulations 405 define material information as information "to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered".

debate intensified over whether ESG information, should be considered "material" for the purposes of the securities laws such that disclosure of inaccurate or misleading ESG information could be a basis for liability would be settled in favour of an investor who relied on a corporation's climate risk statement to make an investment decision.[21]

Although an attempt to hold a corporation accountable for making false, albeit voluntary climate risk disclosures in the case of ***People* v *Exxon Mobil Corp***[22] was not successful, however the attitude of the court when it decided the matter points to the direction of "immateriality because there was no duty to disclose". The fact of the case is intriguing. On October 24, 2018, the Attorney General filed a lawsuit alleging that Exxon engaged in a long-standing fraudulent scheme to defraud investors concerning the company's management of the risks posed to its business by increasingly stringent climate change regulation, alleging that Exxon artificially inflated its share price by failing to disclose the proper costs of carbon emissions in its project calculations. While dismissing the case, the court noted the Office of the Attorney General failed to prove by a preponderance of the evidence that ExxonMobil made any material representations that would have been viewed by a reasonable investor as having significantly altered the 'total mix' of information made available.[23]

Considering the history of the Proposed Rules, and the heavy reliance investors now place on ESG disclosures before making investment decisions, I am of the view that a plaintiff would not have to bear the burden of materiality to succeed in a security fraud case, as it is certain that a statement disclosed pursuant to a disclosure obligation of the SEC would be considered material. In a seminal Supreme Court case on materiality, *Basic* v *Levinson*, [24] the court found that

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[21] In *TSC Industries, Inc.* v *Northway, Inc.*, 426 U.S. 438 (1976), the Supreme Court of the United States articulated the requirement of materiality in securities fraud cases.

[22] 2019 N.Y. Misc. LEXIS 6544.

[23] *People* v *Exxon Mobil Corp*., 2019 N.Y. Misc. LEXIS 6544.

[24] *Basic* v *Levinson* 485 U.S. 224.

preliminary merger negotiations may be material, affirming that materiality is to be gauged through the eyes of the reasonable investor. **In *Matrixx Initiatives, Inc.* v *Siracusano***,[25] the court was of the view that an omission is actionable under the securities laws when the corporation is subject to a duty to disclosethe omitted facts.

5.0 CONCLUSION

As the concept of ESG and climate-risk disclosure evolves from what used to be voluntary to mandatory as indicated by the Proposed Rules, board and management of public corporations should brace up for the challenges ahead, by setting up various internal processes to help evaluate their disclosures to ensure it is free from greenwashing. Disclosures should be accurate, and not an act of subterfuge. Once the Proposed Rules become effective, it would form part of the US Federal Securities Laws, giving room to investors who place high premium on ESG to sue and hold public corporations accountable for failure to disclosure or false disclosures.

[25] *Matrixx Initiatives, Inc.* v. *Siracusano* 563 U.S. 27, 44 (2011).