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Alerts

ESG at the SEC… Leading or Lagging?

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ESG Business Insights

The fall has seen some significant developments regarding the legal frameworks around Environmental, Social, and Governance (ESG) in the United States. Overall, these developments may raise the question of whether the Securities and Exchange Commission (SEC) is leading or lagging in addressing ESG, especially given that its proposed emissions and climate risk disclosure rules have been pending for over a year.

This much seems true: businesses who have had their sights trained only on the finalization of those SEC rules may find all too soon that the shape of doing business is changing rapidly and markedly, and they would do well to ensure they are ready to meet it even while those SEC rules remain in flux. The SEC's pending rules aside, U.S. requirements that businesses make ESG-related disclosures are firming up, and scrutiny of how businesses do so is increasing.

Attention on ESG-Related Attributes is on the Rise

There are reams of legislative and regulatory frameworks in the U.S. addressing matters of both environmental and social concern. The challenge might be identifying a legal regime that does not address one or both in some measure.

But, in referring to ESG legal frameworks, the narrower sets do one of two things:

1. First, they require businesses to make some disclosure about environmental or social issues.
2. Alternatively, they address how a business does that, including, for example, what terminology it uses.

As to that latter category, attention to the environmental attributes businesses assign to products, packages, and services has increased for some time.

The Federal Trade Commission (FTC) first promulgated its Green Guides in 1992. Revised most recently in 2012, the Green Guides were, and remain, aimed at preventing unfair or deceptive environmental marketing claims, applying to "claims about the environmental attributes of a product, package, or service in connection with the marketing, offering for sale, or sale of such item or service to individuals." 16 C.F.R. § 260.1(c).

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The Green Guides have been the subject of some attention since December 2022, when the FTC announced it was seeking public comment on updates and changes to the guides based on increasing consumer interest in environmentally friendly products.

As Bureau of Consumer Protection Director Samuel Levine put it:

> "Consumers are increasingly conscious of how the products they buy affect the environment and depend on marketers' environmental claims to be truthful. We look forward to this review process and will make any updates necessary to ensure the Green Guides provide current, accurate information about consumer perception of environmental benefit claims. This will help marketers make truthful claims and consumers find the products they seek."

California already has its own "Truth in Labeling for Recyclable Materials," which it implemented in 2012.

California's rule significantly narrowed the types of items labeled as "recyclable," requiring criteria to be met to use the chasing arrows or any other indicator of recyclability on products and packaging.

Not unlike the FTC's stated aims for updates and changes to the Green Guides, CalRecycle has described the aim behind California's amendments to its rules as twofold—namely, to "[h]elp vendors and consumers make informed decisions about products," and "[p]rovide an objective basis for holding manufacturers, distributors, and retailers responsible for misleading consumers about whether products get recycled."

SEC Steps in With Amendments to the Names Rule and Dima Action

But, the FTC's Green Guides and California's Truth in Labeling rules are just the beginning. Lawmaker and regulator attention is fast extending beyond the kind of products picked up off grocery or drugstore shelves. With increasing frequency, that attention extends to products offered in the financial services sector. That is precisely where the SEC has stepped in to shore up its posture about ESG and its implications for businesses.

This fall, the SEC took such a definitive step when it finalized amendments to what has been called its Names Rule. The Names Rule requires funds whose names suggest a focus on particular investments, industries, or geographical regions to invest at least 80 percent of their fund assets in the type of investment, industry, or geographic region suggested by the fund name.

The amendments, first proposed in 2022, expand the rule such that it now extends to any fund name with terms suggesting environmental or social characteristics such as "growth," "value," "sustainable," or "socially responsible."

The SEC's finalization of these amendments to its Names Rule before its long-awaited and much-discussed emissions and climate-risk disclosure rules surprised some. But, that move does appear consistent with other recent actions by the SEC zeroing in on what entities are doing—and calling—ESG.

Also, just this fall, two enforcement actions came to a head before the SEC. The SEC had brought charges against DWS Investment Management Americans Inc., a subsidiary of Deutsche Bank AG, in those two actions—one action aimed at DIMA's failure to develop a mutual fund Anti-Money Laundering program and the other action aimed at misstatements regarding DIMA's ESG investment processes. DIMA resolved both actions for $25 million in penalties.

As to the ESG-related charges, the SEC's press release aptly summarized its own order: "DIMA had made materially misleading statements about its controls for incorporating ESG factors into research and investment recommendations for ESG integrated products, including certain actively managed mutual funds and separately managed accounts."

Sanjay Wadhwa, head of the SEC Climate and ESG Task Force established in 2021, added: "Whether advertising how they incorporate ESG factors into investment recommendations or making any other representation that is material to investors, investment advisers must ensure that their actions conform to their words."

In combination, the SEC's finalization of the amendments to its Names Rule and its order in the DIMA matter suggest that the SEC is focused on what businesses say and ensuring that what they say lines up with what they do. Other enforcement actions by the SEC in the last year or more also indicate as much.

In April 2022, the SEC charged Brazilian mining company Vale S.A. with making false and misleading ESG-related disclosures about the safety of dams before one major dam collapsed in 2019. Those charges were resolved for $55.9 million this year.

Questions arose this fall as to the SEC's attention on ESG when it released its 2024 Examination Priorities, and the list did not include reference to ESG—at least not expressly. Instead, the agency relayed that it will be focused on issues like information security, operational resiliency, and emerging fintech and anti-money laundering protocols.

But, all those issues are within the broader penumbra of ESG as they go directly to risk and, even more specifically, governance issues. Furthermore, the SEC's preceding record for this year and this fall would suggest it is not easing up on ESG-related scrutiny overall, even if it will prioritize specific examination areas it perceives as needing extra attention and/or development.

Last, on this front, it is worth noting that the range of SEC authority extends further than some businesses realize. Contrary to what may be popular belief, the risk of SEC attention and enforcement is not limited to publicly held businesses.

The SEC also regulates the offer and sale of securities, even by private businesses. If the SEC continues to tune into what businesses say about ESG, it may look for avenues to ensure private businesses also conform to their words.

The SEC's recent moves might be perceived as part of a burgeoning swell favoring attention on ESG-related representations. Taking those, together with the developing FTC Green Guides and like efforts at the state level, such as in California, there certainly looks to be heightened U.S. lawmaker and regulator scrutiny regarding the terminology businesses use in taking on ESG. And, importantly, this is the case regardless of whether and how long it may be before the SEC's emissions and climate-risk disclosure rules are finalized.

SEC’s Disclosure Rules Hang in the Balance

As to those emissions and climate-risk disclosure requirements, the SEC proposed those in March 2022. Entitled the "Enhancement and Standardization of Climate-Related Disclosures for Investors," the proposed rules would require publicly held businesses to make certain specified emissions and climate-related disclosures.

Specifically, the proposed rules would require businesses to disclose their direct greenhouse gas emissions (referred to as "Scope 1"), their greenhouse gas emissions related to the energy and electricity they purchase (referred to as "Scope 2"), and (most controversially) greenhouse gas emissions across their upstream and downstream value chain (referred to as "Scope 3").

One key distinction between Scope 3 and the others is that Scope 3 need only be reported where the emissions are material. There are also included exceptions for smaller businesses. Importantly, however, Scope 3 upstream activities include purchased goods and services, capital goods, waste generated from operations, and employee business travel and commuting. Scope 3 downstream activities are, in turn, the transportation and distribution of products, a third party's use of those products, and its investments. In a word, where required, Scope 3 covers the gamut.

Separate from emissions disclosures, the SEC's proposal also requires companies to describe their board's oversight of climate-related risks, including the names of board members and committees responsible for climate oversight, the process by which the board is informed about climate risks, and the frequency of discussion on such matters. Additionally, boards must identify members with experience in climate-related risks and describe the nature of their expertise.

Critics of the SEC's proposal have contended the rules go far beyond investor disclosure issues with which the SEC is charged and that, instead, the rules are designed to advance environmental and social agendas. Many expect the rules to face legal challenges, including whether they are beyond the SEC's rule-making authority. Furthermore, even if the rules

do pass into effect, many suspect that will be without the Scope 3 requirement included.

As intimated, Scope 3 reaches a stunningly wide range of indirect emissions sources, and many have contended that a mandate requiring capture of that data—much less accurate capture of that data—is unworkable, if not draconian. Opposition to the Scope 3 provisions of the SEC's rules has come even from those advocating for the rules overall.

When and if the SEC rules come online, approximately 12,000 businesses registered with the SEC will be expected to comply. Implementation of the SEC rules was scheduled to begin in 2024. But, the debate around the rules has been so vociferous, and the volume of public comments on the rules themselves was so enormous that the SEC had to set aside that original timeline.

So, for now, the SEC's rules remain pending, with expected release in October of this year also having passed, and with all looking ahead to the significant implication those rules will have for businesses in the event they are implemented.

Other Regulators Move Ahead With Climate-Risk Guidelines

It is worth noting that the SEC's proposed rules are very much in keeping with the tone of the Biden administration's approach to climate risk.

On May 20, 2021, President Biden signed a sweeping Executive Order directing all federal agencies to analyze and mitigate climate change's risks to homeowners, consumers, businesses and workers, and the U.S. financial system. And, since then, federal regulators have fallen in line—indeed tipping their hands that they will be looking to businesses to relay where they are on climate risk and related factors.

This is reflected in the bevy of climate-related financial risk management principles for large financial institutions proposed by the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve—all throughout late 2021 and through 2022.

The OCC principles were designed for banks with more than $100 billion in consolidated assets. However, acknowledging that "[a]ll banks, regardless of size, may have material exposures to climate-related financial risks," the OCC outlined those risks and how the principles were intended to address them:

> "Weaknesses in how banks identify, measure, monitor, and control the potential physical and transition risks associated with a changing climate could adversely affect banks' safety and soundness. Banks will likely be affected by both the physical and transition risks associated with climate change (referred to in the principles as climate-related financial risks).
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> Physical risks refer to the harm to people and property arising from acute, climate-related events, such as hurricanes, wildfires, floods, and heatwaves, and chronic shifts in climate, including higher average temperatures, changes in precipitation patterns, sea level rise, and ocean acidification. Transition risks refer to stresses to certain banks or sectors arising from the shifts in policy, consumer and business sentiment, or technologies associated with the changes necessary to limit climate change.
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> While many banks already consider these risks, the principles support banks' efforts to focus on key aspects of climate-related financial risk management, allowing bank boards of directors and management to identify risks and develop and implement appropriate strategies to mitigate those risks."

The FDIC's stated basis for and description of its proposed principles echoed that of the OCC. And the Federal Reserve's principles were self-described as "substantially similar" to those of the OCC and FDIC.

The proposed federal principles were finalized just this fall, indicating that the finalized guidance is mainly similar to the earlier proposed versions.

Also, in addition to its proposed principles, the Federal Reserve launched a Pilot Climate Scenario Analysis Exercise. It began working with six large U.S. banks to measure climate-related financial risks.

These examples emerged at the federal level. But, there has also been a trickledown effect to U.S. states along these lines. For example, the New York Department of Financial Services issued guidance on managing climate crises specific to banks and insurance companies, which guidance aims to align with federal regulators' efforts.

And the National Association of Insurance Commissioners announced in April 2022 that it had approved an updated "Climate Risk Disclosure Survey" outlining the climate-related information insurers would be required to publicly report. In fact, it was expected that state insurance regulators would implement those requirements in 14 states and the District of Columbia—a large footprint.

California Scoops the SEC

Plenty has come into place during the debate over the SEC rules and the protracted delay in finalizing them. In fact, California may just have scooped the SEC, jumping ahead with its own emissions and climate-related risk disclosure rules. Furthermore, if California's forging ahead of the SEC was not enough in and of itself, it has done so with a Scope 3 requirement included in its emissions rule and without exception.

Two rules are coming online in California—California's SB 253 and SB 261, signed by Governor Newsom this fall.

SB 253 addresses emissions. At the signing, Governor Newsom indicated concerns about the implementation deadlines for the law. But, as passed, the law directs the California Air Resources Board to issue regulations mandating greenhouse gas emission disclosures by the end of 2024, with reporting requirements to kick in later in 2026.

Those disclosure requirements will extend to anyone meeting the definition of a "reporting entity" under the law, which means:

- a partnership, corporation, limited liability company, or other business entity formed under the laws of California, the laws of any other state of the U.S. or the District of Columbia, or under an act of the Congress of the U.S.;
- with total annual revenues over $1 billion; and
- that does business in California.

As intimated, California's law mirrors the pending SEC rules. Scope 1 emissions are defined as "all direct greenhouse gas emissions that stem from sources that a reporting entity owns or directly controls, regardless of location, including, but not limited to, fuel combustion activities."

Scope 2 emissions are defined as "indirect greenhouse gas emissions from consumed electricity, steam, heating, or cooling purchased or acquired by a reporting entity, regardless of location."

Scope 3 emissions include "indirect upstream and downstream greenhouse gas emissions, other than scope two emissions, from sources that the reporting entity does not own or directly control," which may include "purchased goods and services, business travel, employee commutes, and process and use of sold products"—again, the gamut.

Also of note are the directives the law gives on required disclosures concerning conformance with the Greenhouse Gas Protocol developed by the World Resources Institute and the World Business Council for Sustainable Development, as well as independent third-party assurances.

Finally, failure to comply with the reporting requirements and timely file the required annual report could result in administrative penalties of up to $500,000 per reporting year.

Given the reach of California's emissions disclosure requirements, the implications are significant. California is an enormous market where most major businesses operate and will qualify as reporting entities under the law. And, importantly, as intimated, there is no distinction in SB 253 between private and publicly held businesses as is inherent in the SEC proposal. Even with its $1 billion threshold requirement, SB 253 is expected to apply to approximately 5,000 companies.

Moreover, the law will undoubtedly have a ripple effect even for businesses that do not qualify as reporting entities. Given the across-the-board inclusion of Scope 3 emissions, every one of the estimated 5,000 companies obligated to report will presumably need to reach into its value and supply chains for emissions data such that the businesses along those value and supply chains will need to collect it.

On top of all that, SB 261 has a lower revenue threshold of $500,000, which is expected to apply even further than SB 253—to as many as 10,000 companies.

Like SB 253, at signing, Governor Newsom expressed concerns about implementation deadlines for the law, but as passed, those 10,000 companies will be required to deliver biennial climate risk reports to the California Air Resources Board, with the first report due by January 1, 2026.

The law defines "climate-related financial risk" as "material risk of harm to immediate and long-term financial outcomes due to physical and transition risks, including, but not limited to, risks to corporate operations, provision of goods and services, supply chains, employee health and safety, capital and financial investments, institutional investments, financial standing of loan recipients and borrowers, shareholder value, consumer demand, and financial markets and economic health."

Reports addressing these risks must be prepared in keeping with the Task Force on Climate-related Financial Disclosures, and the administrative penalties for failure to comply of up to $50,000 per year are also contemplated.

The Wait May Be Up

Since their proposal in 2022, the SEC's proposed emissions and climate-risk disclosure rules have been some of the most discussed—and most debated—among emerging ESG frameworks.

But, while those remain pending, plenty else has already come online in the United States, including the bevy of principles for climate-related financial risk management for large financial institutions adopted by the OCC, the FDIC, and the Federal Reserve, the New York State Department of Financial Services' (NYDFS) guidance on managing climate crisis specific to banks and insurance companies; and, even more recently, California's implementation of its very own emissions and climate-related disclosure requirements for entities doing business in California. This is to name a few. Furthermore, that is just in the first category of ESG frameworks enumerated.

Significant developments in the second category have also been—from those addressing consumer products (such as the FTC's Green Guides and California's Truth in Labeling provisions) to the SEC's finalization of its Names Rule and its order in the DIMA matter.

Taking all that together suggests that the realm of ESG frameworks—both those mandating that businesses say certain things and those regulating how they do so—are firming up even while the SEC's proposed disclosure rules remain pending. For those pondering whether the SEC is leading or lagging in addressing ESG and even waiting on the finalization of the SEC rules as a signal as to the trajectory of ESG legal frameworks, a word of advice: The wait may be up.