

The Evolving Securities Legal Framework of ESG Issues

In brief

In 2021 and 2022, as the market continued to focus increasingly on environmental, social, and governance (ESG) issues, government financial regulators across many independent agencies strongly indicated that increased enforcement relating to ESG is on the horizon, while private plaintiffs filed novel securities class actions based on ESG issues.

Given the rapid development of legal ESG issues in the financial services industry, market participants must remain cognizant of the potential legal risks relating to ESG, and take adequate precautions to protect themselves against both government investigations and private civil litigation. This article analyzes the emerging framework of ESG regulation and litigation in order to advise market participants of the upcoming legal risks relating to ESG issues.

The SEC's Proposed Rule on Climate-Related Disclosures

Federal financial services regulators have made clear their intention to use their regulatory power to protect market participants from alleged abuses relating to ESG. Leading this charge is the Securities and Exchange Commission (SEC).

On 4 March 2021, then-acting SEC Chair, Allison Herren Lee was the first to act among federal regulators when she announced the creation of a new Climate and ESG Task Force in the SEC Division of Enforcement, with the stated purpose of developing "initiatives to proactively identify ESG-related misconduct."¹ In a public release, the SEC stated that the "initial focus [of the Task Force would] be to identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules."² For the rest of the 2021 calendar year, the SEC followed up the creation of the Task Force with numerous other actions signaling the importance of ESG enforcement.³

¹ US Securities and Exchange Commission, Press Release, "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues" (4 March 2021), https://www.sec.gov/news/press-release/2021-42?utm_medium=email&utm_source=govdelivery.

² *Id.*

³ The SEC made the following ESG-related announcements in 2021:

- On 15 March 2021, SEC Acting Chair Allison Herren Lee issued a statement titled, "Public Input Welcomed on Climate Change Discourse," requesting that the public provide input on the SEC's disclosure rules and guidance as they apply to climate change disclosures.
- On 11 June 2021, the SEC issued a press release announcing its "Annual Regulatory Agenda," which included notable proposed and final SEC rulemaking areas, such as "[d]isclosure relating to climate risk, human capital, including workforce diversity and corporate board diversity, and cybersecurity risk."
- On 6 August 2021, the SEC approved the Nasdaq Stock Market's proposal to amend its listing standards to encourage greater board diversity and to require board diversity disclosures for Nasdaq-listed companies.
- In September 2021, the SEC's Division of Corporate Finance issued comment letters regarding climate-related disclosures in companies' most recent Form 10-K filings.



Then, on 21 March 2022, the SEC approved a landmark proposed rule to require, for the first time, that public companies disclose climate-related information in their SEC filings. SEC Chair Gary Gensler stated that the climate disclosure proposal would "provide investors with consistent, comparable, and decision-useful information for making their investment decisions, and it would provide consistent and clear reporting obligations for issuers."⁴

The SEC's climate rule proposal broadly requires disclosure related to the following categories of information:

- **Climate-related risks and their impacts on strategy, business model, and outlook**
 - Public companies must disclose the climate-related risks reasonably likely to have a material impact on the company over the short, medium, and long-term.⁵
 - Companies must also disclose the actual and potential impacts of those risks on the company's strategy, business model, and outlook.⁶
- **Governance disclosure**
 - The proposal requires companies to describe the board's oversight of climate-related risks and management's role in assessing and managing climate-related risks.⁷
- **Risk management disclosure**
 - The proposal requires public companies to describe their processes for identifying, assessing, and managing climate-related risks.
 - If a company has adopted a transition plan to mitigate or adapt to climate-related risks, then the company must also describe that plan in detail, by including relevant targets and metrics, how physical and transition risks are managed, and actions taken and progress made towards the plan's targets or goals.⁸
- **Financial statement metrics**
 - The proposed rule requires that public companies disclose the financial impact, expenditures, and assumptions of climate-related events (severe weather events and other natural conditions and physical risks identified by the registrant) and transition activities (including transition risks identified by the company) on their consolidated financial statements. The rule would also require companies to disclose contextual information, assumptions, and inputs used to calculate each of these metrics.⁹
- **Greenhouse gas emissions**
 - The proposal would require all registrants to disclose Scope 1 and Scope 2 greenhouse gas emissions.
 - The proposal would also require the disclosure of Scope 3 emissions if they are material or if the company has a target or goal related to Scope 3.

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- On 3 November 2021, the SEC issued Staff Legal Bulletin No. 14L (CF) on Shareholder Proposals, which singled out as likely no longer excludable shareholder proposals "squarely raising human capital management issues with a broad societal impact" and proposals that "request[] companies adopt timeframes or targets to address climate change."

⁴ US Securities and Exchange Commission, Press Release, "SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors" (21 March 2022), <https://www.sec.gov/news/press-release/2022-46>.

⁵ Proposed new Item 1502(a) of Reg. S-K (proposed 17 CFR 229.1502(a)).

⁶ Proposed new Item 1502(b) of Reg. S-K (proposed 17 CFR 229.1502(b)).

⁷ Proposed new Item 1501 of Reg. S-K (proposed 17 CFR 229.1501).

⁸ Proposed new Item 1503(a) of Reg. S-K (proposed 17 CFR 229.1503).

⁹ See proposed 17 CFR 210.14-02.



- The various scopes of greenhouse gas (GHG) emissions are defined as follows:
 - **Scope 1:** Direct GHG emissions from operations owned or controlled by the company.
 - **Scope 2:** Indirect GHG emissions from the generation of purchased or acquired energy consumed by operations owned or controlled by the company.
 - **Scope 3:** All other indirect emissions not otherwise included in Scope 2 that occur in the upstream and downstream activities of a company's value chain.¹⁰
- **Attestation of GHG Scopes 1 and 2 emissions**
 - The proposal requires accelerated filers and large accelerated filers to submit a third-party attestation report covering the disclosure of its Scope 1 and Scope 2 emissions. GHG emissions attestations providers must meet certain minimum expertise qualifications and independence requirements.¹¹
- **Targets and goals disclosure**
 - Lastly, the proposal requires registrants to disclose whether it has set any climate-related targets or goals and, if so, how it intends to meet those targets and goals.¹²

If the SEC's proposal is approved, it would create a massive new regulatory regime of mandated climate disclosures—and associated legal risks—that companies must carefully manage.

SEC enforcement of ESG issues through existing mechanisms

Regardless of whether or not the climate proposal is approved, the SEC is expected to push on ESG issues through existing regulatory mechanisms, as demonstrated by the following recent actions taken by the agency:

- On 28 April 2022, the SEC charged Vale S.A. ("**Vale**"), a publicly traded Brazilian mining company, with making misstatements about its ESG disclosures prior to the January 2019 collapse of its Brumadinho dam, which killed 270 people and caused significant environmental and social harm. According to the SEC, Vale misrepresented that its dam adhered to the "strictest international practices" when Vale knew that it did not. The SEC's complaint charges Vale with violating Section 10(b) of the Securities and Exchange Act of 1934 ("**Exchange Act** ") and Rule 10b-5 thereunder, as well as Sections 13(a) of the Exchange Act.¹³
- On 23 May 2022, the SEC announced the settlement of charges against BNY Mellon Investment Adviser, Inc. ("**BNY Mellon**"), relating to its ESG assurances in violation of the Investment Advisers Act of 1940 and the Investment Company Act of 1940. The SEC alleged that BNY Mellon falsely stated it conducted an ESG review of all investments in certain mutual funds, when in reality the SEC found that many investments did not have an associated ESG review score at the time of investment. The SEC stated that "the Commission will hold investment advisers accountable when they do not accurately describe their incorporation of ESG factors into their investment selection process." Without admitting or denying the SEC's findings, BNY Mellon agreed to a cease-and-desist order, censure, and payment of a USD 1.5 million penalty.¹⁴

¹⁰ Proposed new Item 1504 of Reg. S-K (proposed 17 CFR 229.1504).

¹¹ Proposed new Item 1505 of Reg. S-K (proposed 17 CFR 229.1505).

¹² Proposed new Item 1506 of Reg. S-K. (proposed 17 CFR 229.1506).

¹³ US Securities and Exchange Commission, Press Release, "SEC Charges Brazilian Mining Company with Misleading Investors about Safety Prior to Deadly Dam Collapse" (28 April 2022), <https://www.sec.gov/news/press-release/2022-72>.

¹⁴ US Securities and Exchange Commission, Press Release, "SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations" (23 May 2022), <https://www.sec.gov/news/press-release/2022-86>.



- On 10 June 2022, the Wall Street Journal reported that the SEC was investigating Goldman Sachs Group Inc. for its management of ESG investment funds. It is still unclear whether the investigation will result in an enforcement action.¹⁵

Other financial regulatory agencies

Beyond the SEC, other financial regulatory agencies have clearly signaled to the market that they intend to step up ESG regulation and enforcement:

- Approximately two weeks after the SEC announced its creation of the Climate and ESG Task force, the Commodity Futures Trading Commission (CFTC) established its own Climate Risk Unit "to support the agency's mission by focusing on the role of derivatives in understanding, pricing, and addressing climate-related risk and transitioning to a low-carbon economy."¹⁶
- On 18 November 2021, the Financial Crimes Enforcement Network (FinCEN) issued a Notice calling the market's attention "to an upward trend in environmental crimes and associated illicit financial activity."¹⁷ FinCEN stated that it provided the Notice, in part, because of "environmental crimes' contribution to the climate crisis, including threatening ecosystems, decreasing biodiversity, and increasing carbon dioxide in the atmosphere."¹⁸ The Notice provided financial institutions with specific suspicious activity report filing instructions and highlighted the likelihood of illicit financial activity related to several types of economic crimes.
- On 16 December 2021, the Office of the Comptroller of the Currency (OCC) announced draft principles "designed to support the identification and management of climate-related financial risks with more than USD 100 billion in total consolidated assets,"¹⁹ and the OCC requested feedback from market participants on all aspects of the draft principles to inform future guidance on climate-related financial risk.
- On 11 January 2022, during his confirmation hearing before the Senate Banking Committee, Federal Reserve Chair Jerome Powell stated that the Federal Reserve was looking at "climate stress tests," and that he thought it was "very likely that climate stress scenarios, as we like to call them, will be a key tool going forward."²⁰
- On 7 February 2022, Acting Chairman Martin J. Gruenberg of the Federal Deposit Insurance Corporation (FDIC) released the FDIC's priorities for 2022, which included "[a]ddressing the financial risks that climate change poses to banking organizations and the financial system."²¹ In the release, the FDIC stated that it would "seek[] public comment on guidance designed to help banks prudently manage [climate] risks, establish[] an FDIC interdivisional, interdisciplinary working group on climate-related financial risks, and join[] the international Network of Central Banks and Supervisors for Greening the Financial System."²²

Private securities litigation

¹⁵ Dave Michaels, Wall Street Journal, "SEC Is Investigating Goldman Sachs Over ESG Funds" (10 June 2022), <https://www.wsj.com/articles/sec-is-investigating-goldman-sachs-over-esg-funds-sources-say-11654895917>.

¹⁶ US Commodity Futures Trading Commission, Press Release, "CFTC Acting Chairman Behnam Establishes New Climate Risk Unit" (17 March 2021), <https://www.cftc.gov/PressRoom/PressReleases/8368-21>.

¹⁷ FinCEN Notice, "FinCEN Calls Attention to Environmental Crimes and Related Financial Activity," 18 November 2021 (available at <https://www.fincen.gov/sites/default/files/2021-11/FinCEN%20Environmental%20Crimes%20Notice%20508%20FINAL.pdf>).

¹⁸ *Id.*

¹⁹ Office of the Comptroller of the Currency, Risk Management: Principles for Climate-Related Financial Risk Management for Large Banks; Request for Feedback (16 December 2021), <https://www.occ.gov/news-issuances/bulletins/2021/bulletin-2021-62.html>.

²⁰ Senate Banking Committee, Testimony of Jerome Powell, 11 January 2022 (available at <https://www.youtube.com/watch?v=OyxIn6cPGq4>).

²¹ Federal Deposit Insurance Corporation, Press Release, "Acting Chairman Martin J. Gruenberg Announces FDIC Priorities for 2022" (7 February 2022), <https://www.fdic.gov/news/press-releases/2022/pr22015.html>.

²² *Id.*



Private financial and securities litigation regarding ESG issues has continued as well, as the plaintiffs' bar has developed novel legal theories, and federal district courts have made dispositive rulings on major ESG-related lawsuits that have been pending.

The so-called "greenwashing" legal theory—whereby a company engages in advertising, promotional, or other disclosure campaigns that are designed to create the false impression that it or its products are more environmentally responsible or friendly than they really are—saw at least two new lawsuits based on violations of the securities laws:

- On 14 May 2021, a securities class action was filed against Danimer Scientific Inc. ("**Danimer**") on behalf of persons who allegedly purchased securities of Danimer and/or Live Oak Acquisition Corp. In an amended complaint filed on 19 January 2022, plaintiffs alleged that defendants "materially misrepresented the biodegradability" of their product by claiming that the product was 100% biodegradable in all environments, although that may not be true in common marine and soil environments like sealed landfills. Plaintiffs alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as Sections 14(a) and 20(a) of the Exchange Act and Sections 11, 12(a)(2), and 15 of the Securities Act of 1933 ("**Securities Act**").

This case is pending as *In re Danimer Scientific, Inc. Secs. Litig.*, No. 1:21-cv-02708 (E.D.N.Y.)

- On 26 July 2021, a securities class action was filed against Oatly Group AB ("**Oatly**") on behalf of persons who allegedly purchased Oatly's American Depositary Shares. In the consolidated amended complaint filed on 4 March 2022, plaintiffs alleged that Oatly "overstated its sustainability practices," as plaintiffs had received information regarding "very high concentrations" of "certain wastewater byproducts from Oatly's manufacturing facility in New Jersey, which were of significant concern to local regulators and required the installation of a new wastewater treatment facility." Plaintiffs alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as Section 20(a) of the Exchange Act and Sections 11, 12(a), and 15 of the Securities Act.

The case is pending as *Kai Jochims, et al v. Oatly Grp. AB, et al*, No. 1:21-cv-06360 (S.D.N.Y.).

While the plaintiffs' bar filed the new *Danimer* and *Oatly* matters, the federal courts issued major rulings on two ESG-related matters that had already been pending:

- On 19 March 2021, in *Ocegueda v. Zuckerberg*, No. 20-cv-04444, 2021 WL 1056611 (N.D. Cal. 19 Mar. 2021), the court dismissed plaintiffs' claims that Facebook's board of directors violated Section 14(a) of the Exchange Act and breached its fiduciary duties by issuing public statements promoting values of diversity while allegedly failing to include minority members on the board or protect against discriminatory advertising practices and alleged hate speech on the Facebook platform. Magistrate Judge Laurel Beeler held that plaintiffs did not plead a materially false statement because Facebook's commitment to diversity was vague and aspirational and therefore "non-actionable puffery." Notably, *Ocegueda* is the first time a court has granted a motion to dismiss claims alleging deficiencies in a company's compliance with policies relating to diversity, equity, and inclusion.
- On 30 September 2021, in *In Re: 3M Co. Sec. Litig.*, No. 20-cv-2488, 2021 WL 4482987 (D. Minn. 30 Sept. 2021), the court dismissed plaintiffs' claims against 3M for allegedly "issuing false and misleading statements to conceal the truth about the Company's exposure to legal liability" for manufacturing products containing per- and polyfluoroalkyl substances. Plaintiffs claimed, among other things, that 3M concealed and misrepresented evidence that the chemicals were toxic, and that its "omissions and misrepresentations" caused 3M's stock price to trade at "artificially inflated prices." Judge Nancy E. Brasel granted defendants' motion to dismiss, in part, on the grounds that plaintiffs' complaint did not meet the heightened pleading burden established by the Private Securities Litigation Reform Act by failing to specifically point to allegedly false statements. Rather, Judge Brasel ruled that the shareholders' allegations were "at least akin to the kitchen sink by alleging that entire swaths of 3M's SEC filings are false."

Conclusion

The securities legal framework with respect to ESG continues to evolve every day, and without close attention to these developments, market participants risk inadequate preparation for government investigations, enforcement actions, and private civil litigation. Given the increasing risk of investigations and lawsuits based on securities violations, market actors must carefully consider their public statements and SEC filings with respect to ESG claims, take affirmative steps to ensure the accuracy of such statements, and even potentially consider ESG-specific disclaimers. As the legal landscape continues to evolve, management should consult with counsel to gauge the



strength of current compliance programs and determine whether additional policies are needed to ensure ESG compliance going forward.

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