SEC Targets Greenwashing and Other Misleading ESG Claims

July 20, 2022

The Securities and Exchange Commission (*"SEC"* or the *"Commission"*) is taking significant steps to combat "greenwashing," which occurs when a company conveys false or misleading information to overstate its environmental or sustainability practices, as well as other activities the SEC perceives to be potentially misleading to investors with respect to a company's ESG efforts. Last year the SEC all but promised rulemaking and enforcement on ESG disclosures. The Commission delivered on this promise in the first part of 2022 and is likely to continue to do so into 2023.

ESG Proposed Rulemaking

In April 2022, the SEC proposed its first significant environmental disclosure rule. "The Enhancement and Standardization of Climate-Related Disclosures for Investors" proposes rule amendments under the Securities Act of 1933 and Securities Exchange Act of 1934 that would require registrants to include certain climate-related information in their registration statements, periodic reports, and audited financial statements. Generally, a registrant would be required to disclose any climate-related risks that are reasonably likely to have a material impact on the registrant's business, results of operations or financial condition, including disclosures regarding greenhouse gas (*"GHG"*) emissions and its strategy for managing those emissions. Notably, companies would be required to report their upstream and downstream (Scope 3) emissions only if such emissions are material or where the registrant set goals related to such emissions. Companies will have between one and three years to comply with the new requirements if they are finalized. Public comment on the proposal closed in June with over 10,000 comments submitted by interested parties.

Shortly thereafter, in May 2022, the SEC approved two proposals under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The first, entitled "Investment Company Names," seeks to improve and clarify the scope of the existing "Names Rule" by, among other items, mandating additional disclosure and reporting requirements on certain entities that purport to invest in assets with, *inter alia*, ESG characteristics. The Names Rule currently requires that registered investment companies whose names suggest a focus on a particular type of investment invest at least 80% of the value of their assets in those investments. If the proposed changes to the Names Rule are finalized, any registered investment company that has a name with terms indicating the fund's investment decisions incorporate one or more ESG factors (e.g., "socially responsible investing," "green," "ethical" or "impact") will be required to ensure that at least 80% of the value of its assets is invested in investments that are made in accordance with those ESG factors, with only limited periods of time and circumstances in which the fund may depart from its 80% policy . The SEC's second proposal, entitled "Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices," would require that certain advisers and funds that claim to follow ESG strategies provide specific information regarding their ESG investment practices in fund prospectuses, annual reports, and adviser brochures. For funds, the specific disclosures and level of detail required would be dependent on the extent to which a fund considers ESG factors in its investment process. Under this framework, the SEC proposes three categories of ESG funds, each varying levels of disclosure requirements: "Integration Funds" that consider one or more ESG factors alongside other, non-ESG factors in their investment process, but where ESG factors are not dispositive in the investment process; "ESG-Focused Funds" that consider one or more ESG factors as significant or primary factors in selecting investments or in engagement with portfolio companies; and "Impact Funds" that, as a subset of ESG-Focused Funds, seek to achieve one or more specific ESG impacts (e.g. affordable housing, environmental sustainability.) If the proposals are

finalized, certain of these funds will be required to disclose GHG emissions associated with their portfolio investments, the social or environmental impacts of investments, and/or information relating to ESG-related proxy voting and issuer engagement. The comment period on both proposals is still open.

Greenwashing Enforcement

The SEC has ramped up enforcement actions relating to greenwashing claims even in the absence of final rules. The SEC foreshadowed an intent to focus on greenwashing in the ESG market when it launched the Climate and ESG Task Force within its Division of Enforcement in March 2021. The Commission quickly thereafter published a risk alert summarizing observations from examinations of investment advisers and investment funds relating to claims about ESG investing. The SEC's Division of Examinations then announced that ESG investing would be included in its examination priorities for 2022.

In April 2022, the SEC brought its first ESG-related action against a Brazilian mining and metals company. The SEC charged the company with making misleading claims about the safety of its dams prior to the collapse of one such dam in Brazil in 2019. According to the SEC's complaint, the collapse of the dam killed 270 people and released over 12 million tons of toxic waste into the watershed of a nearby river. The SEC claimed that the mining company was aware of risks to the dam but that it nonetheless engaged in practices aimed at skirting its safety obligations and filed securities documents that contained false and misleading statements about the strength and resiliency of its dam in its ESG disclosures, including in the company's sustainability reports.

Shortly thereafter, the SEC brought an enforcement action against a mutual fund adviser alleging misstatements and omissions regarding the use of ESG criteria in the selection of investments for certain of its funds. Specifically, the SEC alleged that an affiliated sub-adviser represented that an ESG quality review was undertaken for all investments to identify ESG risks and opportunities and, as part of this review, a numerical ESG score was assigned to those investments. The SEC asserted that although the adviser represented to investors that the sub-adviser conducted ESG reviews for all investments, certain investments were selected that did not undergo an internal ESG review. The SEC also alleged that the adviser lacked internal policies and procedures reasonably designed to prevent inaccurate or incomplete ESG information from being disseminated.

Both of these cases have been settled.

What's Next

The SEC is reportedly actively investigating other ESG matters across the industry and more enforcement is likely. These matters are rife for enforcement particularly because ESG investing has seen significant growth in a short period of time with little oversight and no consistent standards.

Further, any final rule issued by the SEC on environmental disclosures will likely face legal challenges. Challengers could find support in the Supreme Court's recent decision in *West Virginia v. EPA*.

In *West Virginia v. EPA*, the Supreme Court ruled that the Environmental Protection Agency (*"EPA"*) did not have the authority to issue the 2015 Clean Power Plan (*"CPP"*) in the absence of clear Congressional authority. The CPP addressed carbon dioxide emissions from existing and new coal- and natural gas-fired power plants pursuant to Section 111 of the Clean Air Act (*"CAA"*). The EPA determined under the CPP that power plants would be subject to three "building blocks" for emission reductions. The first building block provided for "heat rate improvements" that would allow existing sources to burn coal more cleanly. The second and third building blocks involved "generation shifting" at the grid level – from coal-fired power plants to natural gas-fired plants and, eventually in building block three, to renewable energy sources. The Court found that the CPP would ultimately lead to a "sector-wide shift in electricity production from coal to natural gas and renewables," and that such "major questions" of economic and

political significance are left to Congress, not the EPA, to decide. The Court held that the EPA exceeded its authority under the CAA when it issued the CPP and that the CPP was therefore unlawful.

The Court's opinion in *West Virginia v. EPA* may be instructive as to how courts could view the SEC's disclosure rules, particularly to the extent that such rules do not necessarily pertain to materially misleading statements or omissions. The Clean Power Plan would have forced electric generation to shift from fossil-fuel-fired plants to renewable sources, such as wind and solar, over time. If challengers to any final ESG disclosure rule could successfully argue that the SEC's proposed rules were meant to create similar changes by shifting investments to greener companies, a court may find that such rules exceed the authority of the SEC. However, to the extent these rules apply to the provision of material information needed to inform investor decisions, a court could find that these rules fit squarely within the purview of the SEC. How this argument will play out in the courts remains to be seen.

For More Information

If you would like further information concerning the matters discussed in this article, please contact any member of the ESG Counsel and Sustainable Finance Group or the Investment Management Group, or the Chapman attorney with whom you regularly work.

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