ANTICIPATED SEC DISCLOSURES: WHAT THEY ARE, WHAT TO EXPECT, AND WHY THEY MATTER TO STATE ATTORNEYS GENERAL

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Background on ESG

Public investment professionals are tasked with helping retirement savings grow over time. Private investment professionals maximize returns in the long-term as well as the short-term, depending on their clients' preferences. In order to do this responsibly, public and private investors oftentimes want access to various data that helps them make informed decisions before buying or selling shares of a company.

Responding to recent investor demand for more transparent and accessible information regarding Environmental, Social, Governance (ESG), the Securities and Exchange Commission (SEC) proposed three new rules.[1] Two of these rules are specific to ESG funds and one of these rules is specific to climate-disclosures, but is largely viewed to be akin to the environmental aspect of ESG factors.

ESG criteria (also called ESG factors or ESG considerations) are evaluations used to analyze certain risks associated with the environment, governance practices, suppliers, workers, community, etc. An ESG fund, broadly speaking, is determined to be based largely or entirely on ESG factors. This distinction is important to understanding the various SEC rules this writing will discuss.

Rule #1: Understanding the SEC's "Company Names Rule"

What an investment fund is called should align with what it does practice—but that isn't always the case. To address this concern, the SEC finalized a new rule titled, "Investment Company Names" (the "Company Names Rule"). This new Company Names Rule requires 80 percent of a fund's assets be invested in assets that are consistent with its name in order to combat deceptive and misleading fund names. This would apply to, for example, a fund with the term "ESG" in its name that does not utilize any ESG factors in determining how assets are allocated.

Rule #2: Understanding the SEC's Proposed "ESG Disclosures Rule"

Investment funds and advisors are required by law to make disclosures to the SEC about their investment strategies. The problem is, if funds or advisors have an ESG investment strategy, there is no guidance or uniform rules for them to follow in their disclosure. To fix this, the SEC has proposed a rule, titled "Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices" (the "ESG Disclosure Rule"). The ESG Disclosure Rule would seek to "create a consistent, comparable, and decision-useful regulatory framework" for funds and advisors who utilize ESG strategies and would change ESG-specific disclosures from being voluntary to mandatory. The SEC noted in its request for comments that the lack of an explicit ESG disclosure framework makes it more likely for certain funds and advisors to market

themselves as "ESG," "green," or "sustainable" when they are not. This type of false marketing is often referred to as "greenwashing."

Rule #3: Understanding the SEC's Proposed "Climate Disclosure Rule"

The SEC's proposed climate disclosure rule, titled "The Enhancement and Standardization of Climate-Related Disclosures for Investors" (the "Climate Disclosure Rule") would require periodic reporting on certain climate-related information. While some entities may currently report voluntarily on climate-associated risks, the Climate Disclosure Rule would create a mandatory, consistent reporting process. For the environmentally conscious investor, this rule would provide more visibility into climate-related risks and opportunities. Further, it would bring much needed order and standardization to climate-related reporting to foster responsible investment decisions as opposed to decision making based on incomparable data. The proposed Climate Disclosure Rule totals 490 pages. In simple terms, if implemented, it would require certain companies to disclose whether climate-associated risks:

- Have a material impact,
- Are managed with the necessary governance protocols,
- Impact a business' strategy, outlook, or business model, and
- Impact line items in a business' financial statements (including financial estimates and any underlying assumptions used for financial statements).

Further, the Climate Disclosure Rule would require reporting on direct and indirect greenhouse gas emissions—which are differentiated into three categories: Scope 1, Scope 2, and Scope 3.

The United States has contemplated various iterations of an expanded and refined set of climate-related disclosures for nearly 50 years. The new Climate Disclosure Rule is a necessary step to bring the United States' reporting up-to-par with the times and the rest of the world. Europe, for example, enacted a related climate disclosure rule, called the "Corporate Sustainability Directive Requirement" (CSRD), with the first phase of implementation taking effect in January 2024. The European CSRD is considered even more expansive than the SEC climate disclosure rule.

Why These Rules Matter to State Attorneys General

State Attorneys General are the chief enforcers of consumer protection laws. They have highly sophisticated consumer protection lawyers dedicated to stopping false, deceptive, and/or misleading business practices—including greenwashing. The first of its kind greenwashing suit was led by former California Attorney General (now Vice President) Kamala Harris against three companies that misrepresented that their water bottles were biodegradable.

Some states' consumer protection laws, such as Tennessee, allow the attorney general to take action not only in business-to-consumer (B2C) cases, but also business-to-business (B2B) cases—which could be applied in instances where investment funds may be misleading institutional investors. Because of this expansive authority, state attorney general input on the SEC's proposed rules is particularly valuable.

State Attorney General Action Regarding SEC Rules

It is common for state attorneys general to weigh-in on the federal rulemaking process—as was the case with the proposed rules outlined above. For example, seven progressive attorneys general submitted comments supporting the proposed ESG Disclosure Rule and suggested clarifications to the rule, and 21 conservative attorneys general submitted comments opposing the proposed ESG Disclosure Rule, calling it an "illegal and misguided effort."

The SEC may incorporate certain changes to its proposed rules in light of the comments it received from state attorneys general and more than 10,000+ interest groups. Once the ESG Disclosure Rule and Climate Disclosure Rule are finalized, many anticipate that conservative attorneys general will initiate litigation in an attempt to forestall some or all of these rules from taking effect. Progressive attorneys general will have the opportunity to respond by filing a friend of the court brief supporting the necessary changes these rules seek to achieve. It is noteworthy that similar attempts by conservative attorneys general to forestall the Department of Labor's ESG rule failed in court.

While the current climate around ESG and responsible investing can seem highly polarized, it is important to take head to remarks from the SEC Chairman, Gary Gensler, who said—"There [has been] opposition to many disclosure requirements that have become so integral to our regime that it's hard to imagine investors making a decision without them." With time, the same will be true of ESG and climate disclosures that are a necessary and critical step towards ensuring a more transparent and sustainable future in business and investing.

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[1] The SEC is an independent federal agency that regulates capital markets and the investment industry.