

Risk and Opportunity: The Double-Edged Sword of ESG

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ESG has taken the world by storm. Environmental, Social and Governance initiatives have become a driving force among companies across industries aiming to attract business and enhance shareholder value. Until very recently, ESG value statements were largely unregulated. However, the Biden administration's "government-wide approach"¹ to climate issues has shifted the ESG landscape in two significant and related ways. First, ESG has moved from a voluntary mechanism of communicating your corporate values to shareholders towards a mandatory regime regulated by administrative agencies, with the advent of the SEC's proposed rules on climate change and NASDAQ's recently published board diversity requirements. Second, regulators are focused on the scope and quality of ESG disclosures which is subjecting companies to heightened scrutiny. Many of the values companies communicate to the public through these initiatives have historically been imprecise but are now being placed under a regulatory microscope. As a result, corporations' ESG initiatives can be both a market opportunity and a compliance risk. With this lens in mind, this Article provides three key ESG takeaways to consider in evaluating and developing a corporate ESG strategy:

- First, while some proposed ESG rules will apply to any public entity, if you are an Investment Advisor or Investment Company,² touting yourself as "ESG-focused" comes with additional strings attached—there may be unique disclosure requirements related to the environmental impact of your portfolio if the SEC's proposed rules go into effect. Consider these implications when evaluating your investment strategy.
- Second, while ESG can be a valuable tool for company issuers seeking to communicate their corporate values to the investing public, those issuers may soon be subject to a wide range of ESG disclosure requirements.³ As a result, ESG poses a great compliance risk, and ESG whistleblowers should be treated accordingly. Consider engaging outside counsel to review "greenwashing" claims and other ESG-related concerns reported internally, to avoid a claim of biased review.

¹ Executive Order on Tackling the Climate Crisis at Home and Abroad, The White House (Jan. 27, 2021), available at: <https://www.whitehouse.gov/briefing-room/presidential-actions/2021/01/27/executive-order-on-tackling-the-climate-crisis-at-home-and-abroad/>.

² See ESG Disclosures for Investment Advisors and Investment Companies, U.S. Securities and Exchange Commission, available at: <https://www.sec.gov/files/ia-6034-fact-sheet.pdf>.

³ See ESG Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors, U.S. Securities and Exchange Commission (Mar. 21, 2022), available at: <https://www.sec.gov/news/press-release/2022-46>.

- Third, for both company issuers and Investment Advisors and Investment Companies, consider assessing your organization's policies and procedures to ensure that your compliance guidelines are effective and capture the growing disclosure risks associated with ESG initiatives.

New Disclosure Rules

In March 2022, the SEC proposed a comprehensive set of new climate-related disclosure requirements for all public companies. For example, the proposed rule amendments would require public companies to provide certain climate-related financial data and greenhouse gas emissions information in their public filings. Companies would have to disclose emissions they are directly responsible for, as well as emissions from their supply chains and products. The proposed rule received a very large number of comments, which are currently under consideration. Final rules were originally anticipated in fall of 2022, but the SEC just recently re-opened a short comment period, which may result in final rules being released in 2023.⁴

The influx of ESG-focused investment has led the SEC to propose additional ESG-related disclosure rules and requirements for Investment Advisors and Funds in order to provide “consistent, comparable, and reliable” information to investors in the ESG space.⁵ Specifically, some funds that tout themselves as environmentally-focused may be subject to requirements unique to that investment strategy. For example, registered funds and business development companies may be required to disclose “information regarding the GHG emission associated with their portfolio,” which includes the methodologies and data sources used when considering those emissions metrics.⁶ Certain ESG-focused funds may be required to provide an ESG Strategy Overview Table to standardize the disclosure of ESG strategies employed by the fund.⁷ Likewise, Impact Funds may be required to disclose their mechanism for measuring their funds’ progress on ESG objectives.⁸ However, the SEC has excluded from these disclosure requirements those environmentally-focused funds that affirmatively state that they do not consider GHG emissions as part of their ESG strategy.⁹

As a result, while all public companies will be required to make ESG disclosures, Investment Advisors, Investment Companies, Impact funds or Integration funds with an ESG-focused investment strategy should take careful note of these forthcoming

⁴ See SEC Reopens Comment Periods for Several Rulemaking Releases Due to Technological Error in Receiving Certain Comments, U.S. Securities and Exchange Commission (Oct. 7, 2022), *available at*: https://www.sec.gov/news/press-release/2022-186?utm_medium=email&utm_source=govdelivery.

⁵ ESG Disclosures for Investment Advisors and Investment Companies, U.S. Securities and Exchange Commission, *available at*: <https://www.sec.gov/files/ia-6034-fact-sheet.pdf>.

⁶ *Id.* at 1-2.

⁷ See *id.* at 2.

⁸ See *id.*

⁹ See *id.*

additional requirements to ensure that they are in compliance with the disclosure obligations applicable to their business.

Understand ESG as a Compliance Risk

The development of these requirements, the growing emphasis on ESG investment and disclosures, along with the ambiguity surrounding ESG metrics creates the perfect storm for fraud risk, “greenwashing” claims, and ESG whistleblowers. To be sure, the increased focus on ESG issues provides an additional incentive for whistleblowing on these issues. One of the responsibilities of the Climate and ESG Task Force is to “evaluate and pursue tips, referrals, and whistleblower complaints on ESG-related issues.”¹⁰ Recent years have seen record-breaking payments from the SEC’s whistleblower program. Since its creation, the SEC has awarded more than \$1.1 billion in payments to whistleblowers.¹¹ In 2021, the SEC received the highest ever number of whistleblower tips, and made the highest number of awards in terms of both dollar value and the number of recipients.¹² In fact, there were more awards in 2021 than in all prior years combined.¹³ There have already been examples of whistleblower-prompted investigations related to ESG.

As we enter the next era of ESG, boards or other governing bodies, should be taking seriously concerns from executives and employees regarding their companies’ ESG practices and treat them sensitively, as they would complaints regarding accounting, securities, or other traditional compliance issues. When these concerns arise, consider whether independent review is advisable under the circumstances and how the review should be structured to maximize the possibility of a positive outcome from a legal, ethical, and public relations standpoint.

Consider the Effectiveness of Your Compliance Program

Given the growing interest in ESG among shareholders, companies are recognizing the long-term benefits of ESG programs. In light of the increased focus on ESG, companies should take a holistic approach when developing an ESG compliance program. The Department of Justice’s seminal guidance on the development of an effective compliance program provides a helpful framework for assessing the strength of your compliance program. The program should be well-designed, be applied earnestly and in good faith (*i.e.*, be adequately resourced and empowered to function effectively), and it should *work* in practice.¹⁴ Understanding a business and the ways in which ESG issues may arise

¹⁰ SEC Announces Enforcement Task Force Focused on Climate and ESG Issues, U.S. Securities and Exchange Commission (Mar. 4, 2021), *available at*: <https://www.sec.gov/news/press-release/2021-42>.

¹¹ See Whistleblower Program 2021 Annual Report to Congress, U. S. Securities and Exchange Commission, at 1, *available at*: https://www.sec.gov/files/2021_OW_AR_508.pdf.

¹² See *id.*

¹³ See *id.*

¹⁴ See U.S. Department of Justice, Evaluation of Corporate Compliance Programs (Updated June 2020), *available at*: <https://www.justice.gov/criminal-fraud/page/file/937501/download>.

operationally is a critical first step to developing an effective program. Likewise, the program should be designed not only to detect wrongdoing but also prevent it. This may mean developing internal controls and periodic risk assessments specific to ESG metrics and disclosures and ensuring a leadership team has the requisite expertise to assess the accuracy and completeness of the company's ESG statements. This is equally true in the investment funds context. Last year, the SEC Division of Examinations issued a risk alert discussing examples of potentially misleading statements related to ESG in its examinations of investment advisers, registered investment companies, and private funds engaged in ESG investing. For example, the Staff observed "a lack of policies and procedures related to ESG investing; policies and procedures that did not appear to be reasonably designed to prevent violations of law, or that were not implemented; documentation of ESG-related investment decisions that was weak or unclear; and compliance programs that did not appear to be reasonably designed to guard against inaccurate ESG-related disclosures and marketing materials."¹⁵

Put simply, do not rely on existing compliance frameworks to capture ESG risks – consider updating your program to provide for specific training, policies, and procedures specific to these budding issues, and plan for stress-testing those policies to confirm they are being implemented and that they work as intended.

¹⁵ The Division of Examinations' Review of ESG Investing, U.S. Securities and Exchange Commission (April 9, 2021), *available at*: <https://www.sec.gov/files/esg-risk-alert.pdf>.



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