SEC's Proposed ESG Disclosure Rule: Why It Fails to Remedy the Underlying Challenges Facing ESG Investing Practices

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ABSTRACT

ESG issues and ESG funds have rapidly propelled themselves into the spotlight by amassing trillions of dollars, representing one in every three dollars currently invested. What was intended to be a new way to invest "morally" and "responsibly" has resulted in companies greenwashing, making bold and questionable ESG claims, and playing fast and loose with the current lack of ESG standards to gain the upper hand in receiving investments. Realizing the opportunity to capitalize on those who desire to support ESG initiatives, asset management firms began to charge higher fees for ESG funds while providing no clarity or insight into what their ESG investing practices consist of. This significant expansion in ESG investing has revealed the frail and problematic reality in which investors are left with no enforceable remedies when companies mislead investors about their business criteria and ESG investment practices.

This absence of enforceable action against those who advantageously, however legally, deceive investors led to the Securities and Exchange Commission's proposed amendments to the Rules to Regulate ESG Disclosures for Investment Advisers and Investment Companies. In an effort to minimize investment advisers and investment companies taking advantage of the current lack of ESG investing regulations, this Proposed Rule aims to standardize ESG disclosure requirements by requiring additional specific disclosures on ESG strategies in fund prospectuses, annual reports, adviser brochures, and introducing a standard table for ESG fund disclosure information that allows investors to compare ESG funds. While the Proposed Rule has the right aim of increasing and clarifying information available to investors by providing investors interested in ESG investing with key information that is material to their investment decisions, this Proposed Rule is a failed effort that

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will not achieve its idealistic dreams. The Proposed Rule faces an array of challenges including the inherently inconsistent, unreliable, and incomparable regime of ESG data currently out in the world, the lack of standardization and uniformity in ESG ranking practices, the obscure and vague definitions for critical terms in the Proposed Rule, and legal challenges underlying the ability of the Proposed Rule to survive in a court of law. Furthermore, the proposed disclosure requirements are so broad and imprecise that they not only fail to promote the transparency the rule aims to achieve, but the Proposed Rule exacerbates the very issues it seeks to remedy.

There is an irrefutable need to provide a mechanism of accountability and enforceability in ESG investing practices, however, this Proposed Rule is not the solution.

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I. Introduction

A. Background

ESGs are an increasingly important aspect of the corporate business structure in the United States and all over the world. As the world continues to face numerous challenges such as COVID-19

and human rights issues, investors and members of the corporate and non-corporate community push for companies to achieve more than just economic prosperity for shareholders.[1] This societal push asks for companies to not only be transparent in their environmental and social impacts, but to take active steps to implement policies managing environmental, social, and governance risks.[2] Larry Fink, CEO of BlackRock,[3] explained: "[t]o prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."[4] As the largest asset management companies in the world begin to aggregate and invest billions of dollars into ESG companies and funds, ESGs have propelled into the spotlight and become a major focal point for regulators.[5]

i. What are ESGs?

To analyze these non-economic risks and opportunities, the ESG framework was implemented to try to capture the relevant data relating to three important, non-economic pillars of corporate behavior and activity.[6] The "E" stands for environmental, the "S"

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[1] *See* Kyle Peterdy, *ESG Disclosure*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/esg/esg-disclosure/ [https://perma.cc/59JW-LRMM] (last visited Oct 10, 2022).
[2] *Id.*
[3] BlackRock is the world's largest asset management firm. *See BlackRock: Worldwide Leader in Asset and Risk Management*, BLACKROCK 1 (Feb. 2019), https://www.blackrock.com/corporate/literature/whitepaper/eng-blackrock-worldwide-leader-in-asset-and-risk-management.pdf [https://perma.cc/T55M-L377].
[4] Larry Fink, 2018 Letter to CEOs: A Sense of Purpose, BLACKROCK (2018), https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter [https://perma.cc/W9WE-L7PM].
[5] *See ESG Funds Draw SEC Scrutiny*, SUSTAINABLE INVESTING, https://sustainableinvest.com/esg-funds-draw-sec-scrutiny/ [https://perma.cc/JQ9F-8MNT] (last visited Sept. 18, 2023); Brook J. Detterman & Kirstin K. Gruver, *Regulators Ramp Up Scrutiny of ESG Funds*, NAT'L L. REV. (June 2, 2022), https://www.natlawreview.com/article/regulators-ramp-scrutiny-esg-funds [https://perma.cc/VK9Z-LCGM] (discussing SEC ESG task force charges against investment firms); Lananh Nguyen & Matthew Goldstein, *Goldman Sachs Is Being Investigated Over E.S.G. Funds*, N.Y. TIMES (June 12, 2022), https://www.nytimes.com/2022/06/12/business/sec-goldman-sachs-esg-funds.html [https://perma.cc/58ZD-MAFH].
[6] *ESG Investing and Analysis*, CFA INST., https://www.cfainstitute.org/en/rpc-overview/esg-investing [https://perma.cc/5MGG-GUB6] (last visited Oct. 6, 2023).

stands for social, and the "G" stands for governance.[7] These three pillars are analyzed as relevant non-economic aspects of an organization that may affect the long-term economic well-being of a company.[8]

The environmental segment of ESG focuses on the impact a corporation has on its surrounding environment and the world at-large.[9] These environmental consequences include a company's emissions such as greenhouse gas emissions, pollution rates such as air, water, and ground pollution, and use of natural resources such as water resources.[10] In addition to a company's emission and pollution data, other environmental factors that may be considered include a company's recycling activity or inactivity, a company's attempt at minimizing waste and maximizing the use of its materials, whether a company's materials are cycled back into the economy or end up in a landfill, a company's deforestation activities, and whether a company is promoting or depleting biodiversity.[11] The purpose of reporting environmental implications is to supply stakeholders with transparency and information on how an organization handles its environmental risks and opportunities.[12] All in all, the environmental pillar of ESGs evaluates the environmental consequences and impacts of an organization's practices and uses this information to classify how environmentally sustainable a corporation's composite behavior is to provide insight on what may be a long-term business advantage.[13]

In addition to the societal, political, and regulatory movements to become a more environmentally aware business world, there is also a demand for transparency and promotion of social equality, increased diversity, improved labor conditions, and awareness of human rights issues all over the world. Nowadays, most large corporations have extensive and complex business structures with multiple overseas supply chain partners that often

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[7] *#1 What is ESG?*, DELOITTE, https://www2.deloitte.com/ce/en/pages/global-business-services/articles/esg-explained-1-what-is-esg.html [https://perma.cc/TLR7-5DE4] (last visited Sept. 18, 2023).
[8] *Id.*
[9] *See id.*
[10] *See id.*
[11] *See id.*
[12] *See* Kyle Peterdy, *ESG (Environmental, Social and Governance)*, CORP. FIN. INST. (June 30, 2022), https://corporatefinanceinstitute.com/resources/esg/esg-environmental-social-governance/ [https://perma.cc/4CT5-EW6C].
[13] *See #1 What is ESG?*, *supra* note 7.

have lesser labor protections.[14] The social segment of ESG looks at social issues inherent in every corporation and aims to analyze how a company manages labor issues, human rights issues, and diversity and equity issues.

This social pillar examines a company's *internal* management of social issues such as diversity, equity, and inclusion ("DEI") initiatives within the company, fair work practices, fair wages, labor relations between management and employees, employee development, employee growth, health and safety records, and many other internal social factors in a company.[15] This pillar also examines a company's *external* management of social issues, such as how well a company's leadership manages relationships with stakeholders, its community, and the world around it.[16] Some of the factors analyzed when assessing a company's external social impacts include: whether a company generates positive or negative outcomes in their communities, whether a company takes accountability for their supply chain partners' health and safety standards, whether a company ensures the quality and safety of their products, whether a company is accountable in their product liability, and whether a company responds to the concerns of their customers and community.[17]

The goal of providing information on the practices of a corporation's social initiatives and behavior is to quantify how "socially responsible" an organization is when evaluating its internal metrics of relations with employees, its external metrics encompassing the social practices of other companies the organization chooses to engage with, and, most importantly, the overall social impact the organization has on its community and society as a whole.[18]

In order to achieve the aforementioned environmental and social goals, a corporation must operate in a functional manner. This leads us to the governance pillar of ESGs. It is exactly what it sounds

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[14] *See What is ESG Investing?*, ADEC INNOVATIONS, https://www.adecesg.com/resources/faq/what-is-esg-investing/ [https://perma.cc/ZW32-VZED] (last visited Sept. 27, 2023).

[15] Cole Horton, *Explainer: What is the 'S' in ESG Investing?*, REUTERS (July 19, 2022, 11:16AM), https://www.reuters.com/business/sustainable-business/what-is-s-esg-investing-2022-07-19/#:~:text=NEW%20YORK%2C%20July%2019%20(Reuters,for%20action%20on%20social%20inequality [https://perma.cc/Z5XB-ZZGH]; *#1 What is ESG?, supra* note 7.

[16] *See ESG (Environmental, Social and Governance)*, *supra* note 12.

[17] *See id.*; *#1 What is ESG?*, *supra* note 7.

[18] *See ESG (Environmental, Social and Governance)*, *supra* note 12.

like—how is a corporation governed? Corporate governance focuses on how an organization is led and managed.[19] Governance in the ESG context looks to whether a corporation promotes transparency and accountability in leadership.[20] History has shown that a weak corporate governance structure and poor management has led to devastating consequences that paved the way for some of the most significant financial damages investors have faced; therefore, stakeholders have increasingly emphasized the need for management and leadership to be transparent in their decisions so they can be held accountable.[21]

Ensuring transparency in issues such as shareholders' rights, board of directors' diversity, executive compensation, corporate behavior, and anti-competitive practices and corruption is critical to successful governance.[22] The goal of reporting on corporate governance is to guarantee transparency with important corporate issues to provide a system of checks and balances on the corporate decision-makers in power.[23] This pillar is a part of the ESG criteria because it is viewed as a requisite for the environmental and social pillars.[24] Stakeholders look for a healthy corporate governance structure to evaluate whether an organization can make progress in its goals, including environmental and social goals.[25]

These environmental, social, and governance issues are meant to provide insight on corporate behavior.[26] The purpose of measuring the risks and opportunities related to each pillar is to empower stakeholders to promote behaviors and activity that society encourages[27] while minimizing and preventing behavior it deems harmful.[28] ESG-supporting companies, agencies, politicians, and members of society hope that this will encourage stakeholders and

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[19] *See id.*

[20] *See id.*

[21] *See What is the "G" in ESG?*, S&P GLOBAL (Feb. 24, 2020), https://www.spglobal.com/en/research-insights/articles/what-is-the-g-in-esg [https://perma.cc/3CXR-SKDY].

[22] *See id.*

[23] *See id.*

[24] *See ESG (Environmental, Social, and Governance)*, *supra* note 12.

[25] *See id.*

[26] *See* Gary Brooks, *Part 3: How are SRI/ESG Strategies Implemented?*, MISSION WEALTH (Apr. 29, 2019), https://missionwealth.com/wp-content/uploads/2023/07/Part-3-How-are-SRI-ESG-strategies-implemented.pdf [https://perma.cc/DG7M-U4U8].

[27] *See* Natalie Runyon, *ESG is just business seen through a new lens of competitive risk analysis & opportunity*, Thomson Reuters (Mar. 3, 2023), https://www.thomsonreuters.com/en-us/posts/esg/competitive-risk-analysis/ [https://perma.cc/A86J-HPWW].

[28] *See ESG (Environmental, Social and Governance)*, *supra* note 12.

investors to engage with and reward companies that operate with "corporate sustainability" and "corporate social responsibility," which, in turn, will motivate companies to become more sustainable and responsible.[29] This ESG framework helps to inform stakeholders on how an organization manages its environmental, social, and governance risks and opportunities by attempting to quantify the degree to which the organization is operating in a "sustainable" manner.[30]

ii. ESG Materiality

ESGs seem to capture a wonderful ideal of motivating businesses to engage in environmentally and socially sustainable practices and transparent governance practices. The reality is that we live in a world with endless organizations ranging from niche businesses only selling dog food to all-encompassing industry giants owning hundreds of diverse businesses. This means that different organizations' attempts at successfully implementing policies to increase sustainability in the E and S pillars or transparency and accountability in the G pillar are not simple one-size-fits-all policies.[31]

Although many ESG issues arise in each and every organization, regardless of how different the nature of their business industry is, "[n]ot all ESG issues matter equally."[32] Materiality of ESG issues defines the most important industry-specific environmental, social, and governance concerns that a business faces and must focus on while separating these important issues from those that are not as relevant in each industry.[33] Materiality is defined by the Sustainability Accounting Standards Board ("SASB") as issues "that are reasonably likely to materially affect the financial condition, operating performance, or risk profile of a typical company within an industry—in other words, those topics for which investors would most benefit from consistent, comparable, reliable disclosure." [34] These material ESG issues

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[29] *See ESG (Environmental, Social and Governance)*, *supra* note 12.
[30] *See id.*
[31] Emily Steinbarth & Scott Bennett, *Materiality Matters: Targeting the ESG Issues that Impact Performance*, HARV. L.F. ON CORP. GOVERNANCE (May 10, 2018), https://corpgov.law.harvard.edu/2018/05/10/materiality-matters-targeting-the-esg-issues-that-impact-performance/ [https://perma.cc/TXH9-CWMD].
[32] *Id.*
[33] *See #1 What is ESG?*, *supra* note 7.
[34] Janine Guillot & Jeffrey Hales, *Materiality: The Word that Launched a Thousand Debates*, SUSTAINABILITY ACCT. STANDARDS BD. (May 13, 2021),

represent what "matters" to a particular sector from an ESG perspective.[35] The materiality of an ESG issue typically rests on what is considered "financially material" in that given industry, meaning issues that impact a company's financial performance and success.[36] Logically, industry leaders urge companies to focus on material ESG issues that directly affect their specific sector's type of business. Materiality can be understood by considering how inherent an issue is to an industry. Greenhouse gas emissions, for example, are more inherent, and thus more material, to the oil industry than the banking industry.[37]

iii. ESG Reporting & Ranking

The purpose of collecting ESG data and defining ESG materiality is to use this information to evaluate whether organizations are taking advantage of ESG opportunities and minimizing ESG risks to see if they will succeed in their ESG goals.[38] In order for ESG reports to be substantially useful, organizations must disclose ESG data. Otherwise, ESG data collection would be useless. For this reason, many ESG organizations provide internally gathered and publicly reported data on their organization's performance on ESG issues.[39] In certain instances, stock exchanges, regulatory bodies, and other government agencies mandate ESG-related reporting.[40]

These reports are published as part of an organization's ESG disclosure.[41] An organization's management team gathers data about their internal ESG issues and performance, and the management team then selects a reporting framework they believe provides the ESG information needed by their stakeholders.[42] When considering the needs of stakeholders such as investors and rating agencies, management teams must choose a reporting framework that their core audience is able to understand.[43] The ESG disclosures

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https://sasb.org/blog/materiality-the-word-that-launched-a-thousand-debates/ [https://perma.cc/4W9P-68TP].

[35] *#1 What is ESG?*, *supra* note 7.

[36] *Id.*

[37] *Id.*

[38] *ESG Disclosure*, *supra* note 1.

[39] *See #1 What is ESG?*, *supra* note 7.

[40] *ESG Disclosure*, *supra* note 1.

[41] *See id.*; *#1 What is ESG?, supra* note 7.

[42] *ESG Disclosure*, *supra* note 1.

[43] *Id.*

must be understood by stakeholders because they use this information to differentiate and compare organizations.[44]

ESG rating agencies aggregate these public ESG disclosures and reports to compare and rank organizations in each industry amongst their peers.[45] Although this practice of ranking organizations to provide stakeholders with valuable and streamlined information seems advantageous in theory, it is quite problematic in practice due to the broad discretion given to organizations and their management teams to choose and disclose which issues they view as "material," the numerous differences at the ESG data point level, the absence of a standard framework for ESG reporting and disclosures,[46] and the numerous different ESG rating agencies who all use their own proprietary methods to rate these organizations.[47] Furthermore, because rating agencies rely and base their rankings off of only voluntarily disclosed information, organizations sometimes engage in "greenwashing"[48] and provide misleading ESG data to boost their rankings.[49]

i. ESG Investing & Disclosures

ESG investing is a practice that focuses on investing in corporations with specific environmental, social, and/or governance initiatives that align with an investor's goals.[50] Rather than considering investment strategies that only focus on economics and desired rates of returns, ESG investments factor in strategies that aim to capture environmental, social, and/or governmental success.[51] The goal of ESG investing is to account for the non-financial risks of a company's daily activities and opt for those that

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[44] *See* Brian Tayan, *ESG Ratings: A Compass without Direction*, HARV. L. F. SCH. ON CORP. GOVERNANCE (Aug. 24, 2022), https://corpgov.law.harvard.edu/2022/08/24/esg-ratings-a-compass-without-direction/ [https://perma.cc/B2MM-SYJ2].
[45] *Id.*
[46] *#1 What is ESG?*, *supra* note 7.
[47] *See ESG Ratings: A Compass without Direction*, *supra* note 44.
[48] Corporate Finance Institute, *ESG Companies – Meet the Players*, YOUTUBE (Aug. 24, 2021), https://www.youtube.com/watch?v=e1z9K3Fzyu8&t=3s [https://perma.cc/7J28-ECXF] (discussing greenwashing as the practice of making generic and sometimes baseless or unsubstantiated claims about ESG initiatives which lack important details or measurements and/or omit specific implementation strategies).
[49] *See id.*; *see also ESG Ratings: A Compass without Direction*, *supra* note 44.
[50] *See What is ESG Investing?*, ADEC INNOVATIONS, https://www.adecesg.com/resources/faq/what-is-esg-investing/ [https://perma.cc/3VJ5-B84Y] (last visited Oct. 2, 2023).
[51] *See id.*

are more "sustainable" and "responsible" with their ESG decisions.[52]

ESG investment vehicles include green bonds,[53] mutual funds,[54] exchange-traded funds ("ETFs"),[55] index funds,[56] and other publicly traded instruments.[57] Each fund establishes their own ESG investment objectives and goals, and investors can look to these different objectives and goals when selecting from the wide variety of ESG funds they want to invest in.[58] While any fund that labels itself as an ESG fund has broad discretion in deciding how they weigh and apply the particular ESG factors they integrate in their investment decisions, the ESG considerations and investment strategies utilized by fund managers are vaguely disclosed in the fund's prospectus.[59] Most importantly, these funds that include

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[52] *See #1 What is ESG?*, *supra* note 7.

[53] Green bonds are a type of fixed-income investment tool that specifically targets raising money for climate and environmental projects. *See* Troy Segal, *Green Bond*, INVESTOPEDIA (Sept. 21, 2022), https://www.investopedia.com/terms/g/green-bond.asp [https://perma.cc/4XAJ-PXS9].

[54] Mutual funds pool money from many different investors and invests this money, on behalf of those investors, in stocks, bonds, and short-term debt. Investors who buy shares of mutual funds become proportional stockowners of the respective mutual fund and pay fees for the services mutual funds provide. *See Mutual Funds*, INVESTOR.GOV, U.S. SEC. AND EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/investment-products/mutual-funds-and-exchange-traded-1 (last visited Oct. 5, 2023).

[55] Exchange-traded funds (ETFs) are a type of pooled investment security that is similar to a mutual fund. ETFs track a particular index, sector, commodity, or other asset and can be purchased or sold on a stock exchange similar to a regular stock and unlike mutual funds. *See* James Chen, *What Is an Exchange-Traded Fund (ETF)?*, INVESTOPEDIA (Oct. 17, 2022), https://www.investopedia.com/terms/e/etf.asp [https://perma.cc/F9N4-HMY8].

[56] "An index fund is a type of mutual fund or exchange-traded fund with a portfolio constructed to match or track the components of a financial market index such as the S&P 500." Jason Fernando, *What Are Index Funds, and How Do They Work?*, INVESTOPEDIA (Oct. 17, 2022), https://www.investopedia.com/terms/i/indexfund.asp [https://perma.cc/CZK5-UN3T].

[57] *ESG (Environmental, Social & Governance)*, *supra* note 12.

[58] *See* Greg Iacurci, *What to Know about Adding a 'Green' Investment Fund to Your Portfolio, Now that Biden Signed Historic Climate Bill*, CNBC (Aug. 18, 2022, 11:39AM), https://www.cnbc.com/2022/08/18/how-to-buy-an-esg-fund-now-that-inflation-reduction-act-is-law.html [https://perma.cc/W8VC-U7DH].

[59] *See* Shane S. Dikolli, et. al., *Walk the Talk: ESG Mutual Fund Voting on Shareholder Proposals*, 27 REV. OF ACCT. STUD. 864, 864 (2022) (analyzing whether mutual fund managers' voting behaviors are consistent with their public commitments to the investment objectives stated in their mutual fund prospectus and finding that ESG funds are more likely to vote in support of environmental, social, and governance shareholder proposals).

"ESG" in their names often charge much higher fund fees and are more expensive than conventional funds.[60]

A. Why regulation is considered necessary: the lack of ESG disclosure rules in place now

Federal securities statutes and regulations prohibit issuing *materially* misleading proxy statements, prospectuses, and shareholder reports.[61] This is a critical element in ESG funds, because these funds must disclose material information regarding their investing strategies, risks, fees, and performance.[62] The problem, however, is that there currently is no set definition for materiality or set standard for ESG disclosures; therefore, organizations have the power to disclose whatever information they want and define material issues in almost any manner that pleases them. While most companies largely rely on the 2010 guidance of reporting ESG disclosures based on materiality,[63] this standard permits companies to self-define what they believe constitutes appropriate ESG disclosures.[64]

When the issue of materiality was evaluated in *TSC Industries, Inc. v. Northway, Inc.*, the Supreme Court held that "an omitted fact is 'material' if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[65] The Court further explained that this "does not require proof of a substantial likelihood that disclosure of the omitted fact would have

[60] *See* Rebecca Moore, *Morningstar Finds ESG Funds Are More Expensive Than Conventional Funds*, PLANADVISER (Oct. 26, 2021), https://www.planadviser.com/morningstar-finds-esg-funds-expensive-conventional-funds/ [https://perma.cc/4G3L-Z3ZK]; *see also* Emile Hallez, *Premium Fees and So-So Returns on Some 'ESG' Funds*, ESG Clarity (Oct. 25, 2022), https://esgclarity.com/premium-fees-and-so-so-returns-on-some-esg-funds/ [https://perma.cc/3SDD-ABEF].
[61] 17 C.F.R. § 240.14a-9 (2022).
[62] *See Fund Disclosures at a Glance*, U.S. SEC. AND EXCH. COMM'N, https://www.sec.gov/investment/fund-disclosure-at-a-glance [https://perma.cc/47PU-LWWG].
[63] 17 C.F.R. pts. 211, 231, 241 (2010).
[64] This standard is set forth in *TSC Industries, Inc. v. Northway, Inc.*, which "offers companies considerable discretion in determining what constitutes appropriate climate-related disclosure" and was affirmed a decade later in *Basic Inc. v. Levinson*. *What is the Proposed SEC Climate Disclosure Rule*, BLOOMBERG L. (Aug. 15, 2022), https://pro.bloomberglaw.com/brief/proposed-sec-climate-disclosure-rule/#:~:text=The%20SEC%20has%20proposed%20new,insights%2C%20in%20public%20disclosure%20filings [https://perma.cc/W6KT-4L2P]; *see* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976); Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988).
[65] TSC Indus., Inc. v. Northway, Inc., 426 U.S. at 449.

caused the reasonable investor to change his vote, but contemplates a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the reasonable shareholder's deliberation."[66] The Court held that this standard for materiality is consistent with *Mills v. Electric Auto-Lite Co.*,[67] and this definition and standard for materiality was affirmed twelve years later in *Basic Inc. v. Levinson*.[68]

Concerningly, this broad judicial definition of materiality leaves us with no definition or standard for materiality that ensures any overarching regime of accountability towards those who disclose ESG information and no protections for stakeholders who are misled. Furthermore, since there are no specific requirements regarding what a fund or adviser using any ESG strategy must include in its disclosure, companies, funds, and advisors have dangerously substantial discretion in determining what information they want to disclose and how they want to disclose it.[69]

ESG factors rely on inconsistent research that is too premature to produce scientific facts that can irrefutably support any ESG claims, because ESG materiality definitions, issues, reporting schemes, disclosures, and ranking agencies lack any sort of standardization or uniformity to make ESG factors scientifically supported.[70] While there are some specified ESG reporting requirements based on materiality, there is considerable skepticism in accepting ESG ratings and materiality measures in the same way

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[66] *Id*.
[67] *See* Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 384 (1970) (the general description of materiality as a requirement that "the defect have a significant propensity to affect the voting process"); *see also* TSC Indus., Inc. v. Northway, Inc., 426 U.S. at 449 (upholding this standard of materiality).
[68] *See* Basic Inc. v. Levinson, 485 U.S. at 251.
[69] *See* Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, Securities Act Release No. 11068, Exchange Act Release No. 46,868, Investment Company Act Release No. 34,594, 87 Fed. Reg. 36,654, 36,655, 36,658 (June 17, 2022) (to be codified at 17 C.F.R. § 279) [hereinafter Enhanced Disclosures by Certain Investment Advisers and Investment Companies]; *see, e.g.*, Pax World Mgmt. Corp., Investment Advisers Act Release No. 2761 SEC. & EXCH. COMM'N (July 30, 2008) (settled action) (alleging that despite investment restrictions disclosed in its prospectus, statement of additional information, and other published materials that it complied with certain socially responsible investing restrictions the fund purchased securities contrary to those representations and failed to follow its own policies and procedures requiring internal screening to ensure compliance with those restriction); *What is the Proposed SEC Climate Disclosure Rule*, *supra* note 64.
[70] *ESG Funds Draw SEC Scrutiny*, *supra* note 5.

financial reporting is accepted because ESG ratings and statements do not have the uniform standards that financial reports have developed over centuries of real-world data and statistics.[71] This concern was also voiced by the Securities and Exchange Commission ("SEC") Chairman, who confessed that many companies measure their climate risks with no overarching regime to ensure that the metrics are meaningful.[72]

Although ESGs were meant to be a step in the right direction towards environmental and social responsibility, many scholars, politicians, attorneys general, and the Chairman of the SEC have shared concerns that there is no common meaning of materiality and, therefore, no enforcement when companies mislead investors about their business criteria relating to ESGs.[73] Importantly, one of these notable critics is SEC Commissioner Hester Peirce.[74] The SEC expressed its concerns that sustainable investing using ESG ratings poses risks due to the lack of accountability and enforceability when companies mislead investors.[75]

In response to these concerns, the SEC created the Division of Enforcement's Climate and ESG Task Force, focused on investigating instances when companies mislead investors regarding ESG issues.[76] In the SEC's Statement of Basis and Purpose of the Proposed Rule, the SEC states:

> While the Commission has not generally prescribed specific disclosures for particular investment strategies, ESG strategies differ in certain respects that we believe necessitate specific requirements and mandatory content to assist investors in

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[71] *Id.*

[72] Andrew Ross Sorkin, et al., *The Pushback on E.S.G. Investing*, N.Y. TIMES (May 11, 2022), https://www.nytimes.com/2022/05/11/business/dealbook/esg-investing-pushback.html?login=email&auth=login-email [https://perma.cc/6GDW-9TZJ].

[73] *ESG Funds Draw SEC Scrutiny*, *supra* note 5.

[74] *Id.*

[75] Lananh Nguyen & Matthew Goldstein, *Goldman Sachs Is Being Investigated Over E.S.G. Funds*, N.Y. TIMES, (June 12, 2022), https://www.nytimes.com/2022/06/12/business/sec-goldman-sachs-esg-funds.html [https://perma.cc/U46N-WK6G].

[76] *Id.*; Brook J. Detterman & Kirstin K. Gruver, *Regulators Ramp Up Scrutiny of ESG Funds*, NAT'L L. REV. (June 2, 2022), https://www.natlawreview.com/article/regulators-ramp-scrutiny-esg-funds [perma.cc/3JKL-4NVH]; U.S. SEC. AND EXCH. COMM'N, *Enforcement Task Force Focused on Climate and ESG Issues*, https://www.sec.gov/spotlight/enforcement-task-force-focused-climate-esg-issues. [https://perma.cc/C2LX-4PS9] (last modified Apr. 11, 2023).

understanding the fundamental characteristics of an ESG fund or an adviser's ESG strategy in order to make a more informed investment decision. First, the variation discussed above concerning ESG investing, combined with the lack of a more specific disclosure framework, increases the risk of funds and advisers marketing or labelling themselves as "ESG," "green," or "sustainable" in an effort to attract investors or clients, when the ESG-related features of their investment strategies may be limited. Such exaggerations can impede informed decision-making as the labels may cause investors to believe they are investing in—and potentially are paying higher fees for—a "sustainable" strategy that may actually vary little from ones without such a label.[77]

Since ESG investing continues to rapidly grow and gain mass popularity, the SEC has recognized the necessity for some form of regulation to ensure accountability and honest practices when it comes to ESG data and reporting.[78] Dirty tactics in which investment companies and investment advisers misrepresent ESG information for their own advantageous purposes is precisely why the SEC is now taking regulatory action.[79] The proposed rules and regulatory action are a response to a complaint filed against an issuer for misleading investors in its ESG disclosure and a response to a settled enforcement action against a mutual fund adviser's misleading ESG disclosures.[80]

B. SEC Proposed ESG Disclosure Rule

In an attempt to standardize ESG disclosure requirements and discourage investment advisers and investment companies from playing fast and loose with the current lack of ESG standards, the SEC has proposed amendments to the Rules to Regulate ESG

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[77] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69 at 36,654; *see* Michael Wursthorn, *Tidal Wave of ESG Funds Brings Profit to Wall Street*, WALL STREET J. (Mar. 16, 2021), https://www.wsj.com/articles/tidal-wave-of-esg-funds-brings-profit-to-wallstreet-11615887004 [https://perma.cc/DMZ4-6LB3] (noting that ETFs with strategies that focus on socially responsible investments have significantly higher fees than "standard ETFs").

[78] *See* Maia Gez et al., *SEC Proposes Amendments to Rules to Regulate ESG Disclosures for Investment Advisers & Investment Companies*, WHITE & CASE (June 13, 2022), [https://perma.cc/W8U2-PLKL]; Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69 at 36,654.

[79] *SEC Proposes Amendments to Rules to Regulate ESG Disclosures for Investment Advisers & Investment Companies, supra* note 78.

[80] *Id*.

disclosures for Investment Advisers and Investment Companies.[81] On May 25, 2022, the SEC proposed these rule amendments with the goal of enhancing and standardizing disclosures pertaining to the ESG factors that investment advisers and funds consider.[82] The SEC states in the Proposed Rule that "[t]he proposed amendments to these forms and associated rules seek to facilitate and enhance disclosure of ESG issues to clients and shareholders, [and] are designed to create a consistent, comparable, and decision-useful regulatory framework for ESG advisory services and investment companies to inform and protect investors."[83] This Proposed Rule specifically impacts registered investment companies, investment funds, and investment advisers, identifying three specific categories of integration funds,[84] ESG-focused funds,[85] and impact funds.[86]

These proposed changes require additional specific disclosures on ESG strategies in fund prospectuses, annual reports, and adviser brochures, and it would introduce a standard table for ESG funds' disclosure information that allows investors to compare ESG funds quickly.[87] In order to combat the aforementioned ESG misrepresentations and greenwashing practices of exaggerated

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[81] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69 ("The [SEC] is proposing to amend rules and forms under both the Investment Advisers Act of 1940 ("Advisers Act") and the Investment Company Act of 1940 ("Investment Company Act") to require registered investment advisers, certain advisers that are exempt from registration, registered investment companies, and business development companies, to provide additional information regarding their [ESG] investment practices.").

[82] *Id.*; U.S. SEC. AND EXCH. COMM'N, ESG DISCLOSURES FOR INVESTMENT ADVISERS AND INVESTMENT COMPANIES FACT SHEET, U.S. SECURITIES AND EXCH. COMM'N, https://www.sec.gov/files/ia-6034-fact-sheet.pdf [https://perma.cc/89PC-HVQ8] (2022).

[83] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69.

[84] The SEC defines "Integration Fund" as "funds that integrate ESG factors alongside non-ESG factors in investment decisions." *See* ESG DISCLOSURES FOR INVESTMENT ADVISERS AND INVESTMENT COMPANIES FACT SHEET, *supra* note 82.

[85] The SEC defines "ESG Focused Funds" as "funds that employ several different ESG investment strategies as a significant or main consideration in selecting investments or in their engagement strategy with the companies in which they invest." *See* Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69.

[86] Impact Funds are a "subset of ESG focused funds that seek to achieve a particular ESG impact." ESG DISCLOSURES FOR INVESTMENT ADVISERS AND INVESTMENT COMPANIES FACT SHEET, *supra* note 82; *see also SEC Proposes Amendments to Rules to Regulate ESG Disclosures for Investment Advisers & Investment Companies, supra* note 78.

[87] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69.

claims about ESG strategies, the SEC is "proposing minimum disclosure requirements for any fund that markets itself as an ESG-Focused Fund, and requiring streamlined disclosure for Integration Funds that consider ESG factors as one of many factors in investment selections."[88] As part of this proposal, the SEC is amending Form N-CEN[89] to collect census-type information from these funds and the ESG-related service providers that these funds use.[90] The purpose of collecting census-type information in client-facing disclosures is to "provid[e] the Commission and investors with consistent, usable, and comparable data."[91]

These amendments to Form N-CEN also require a fund to disclose whether they follow any third-party ESG frameworks such as the Global Reporting Initiative,[92] the Sustainable Accounting Standards Board standards,[93] or the Principles for Responsible Investment.[94] The purpose for requiring funds to disclose third-party ESG frameworks they use is to "help the Commission, investors and other market participants to classify funds based on the ESG frameworks they follow in order to understand and assess trends in the market better."[95]

This proposal adds an additional question to the Form N-CEN under C.3(j) which asks questions tailored to ESG funds' strategies

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[88] *Id*.
[89] Form N-CEN uses a structured, XML-based data language. *See id.*
[90] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69.
[91] *Id*.
[92] GRI is a non-profit organization that creates standards to attempt to unify ESG reports and disclosures. *See About GRI*, GLOBAL REPORTING ORG., *About GRI*, https://www.globalreporting.org/about-gri/ [https://perma.cc/3JNM-VTYC] (last visited Sept. 24, 2023).
[93] The Sustainability Accounting Standards Board is a not-for-profit standards-setting organization that develops sustainability accounting standards with a mission "to establish and maintain industry-specific standards [across ESG topics] that assist companies in disclosing financially material, decision-useful sustainability information to investors." *See* SASB STANDARDS, *Governance Archive*, SASB STANDARDS https://www.sasb.org/about/governance-archive/ [https://perma.cc/D3JS-PHQ3] (last visited Sept. 24, 2023).
[94] The Principles for Responsible Investment (PRI) works "to promote sustainable investment through the incorporation of environmental, social and governance factors." *See About the PRI*, PRINCIPLES FOR RESPONSIBLE INVESTMENT *About the PRI*, https://www.unpri.org/about-us/about-the-pri [https://perma.cc/2E6B-KW7N] (last visited Sept. 25, 2023); Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69.
[95] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69 at 36,693.

and processes.[96] If a fund incorporates ESG factors, it "would then be required to report, among other things: (i) the type of ESG strategy it employs (*i.e.*, integration, focused, or impact); (ii) the ESG factor(s) it considers (*i.e.*, E, S, and/or G); and (iii) the method it uses to implement its ESG strategy."[97] In summary, these specific proposals in the Proposed Rule establish a reporting and disclosure requirement for ESG funds and advisers beyond that of what previously existed in the ESG world.

I. Issue

While the Proposed Rule is clear in what it aims to implement, there are many challenges preventing the rule from successfully achieving its purpose of protecting investors and providing clarity.[98] Although there are many pieces to this Proposed Rule, this paper focuses on the specific proposals that are at the core of the Proposed Rule, which does not create any meaningful change or value. The underlying issue in these proposals centers around the lack of any specified and enforceable definitions. Particularly, the absence of any definition of materiality and the absence of regulatory enforcement of ESG ranking agencies renders these enhanced ESG disclosures meaningless.

The Proposed Rule overlooks the fact that the true ambiguity in ESG investing lies in the way ranking agencies define materiality and provide rankings of ESGs. Currently, none of the ESG rating agencies have streamlined approaches or standardized materiality measures; this lack of uniformity allows ranking agencies to have complete discretion in saying what is or is not material and what, in their opinion, is necessary or unnecessary to consider and disclose for the purpose of their ESG rankings.[99] Unfortunately, the judicial interpretation of the critical term "material" also furthers this ambiguity and does not provide any legal remedy to clarify this problem.[100] Simply said, ESG rankings are all in the eye of the beholder, and the beholder is a number of ranking agencies that are extremely influential in how ESG funds and advisers invest.[101]

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[96] *Id*. at 36,692-3.

[97] *Id*.

[98] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69.

[99] *See* Kurt Wolfe, *Who Regulates the ESG Ratings Industry*, BLOOMBERG L. (Feb. 22, 2022, 4:00AM), https://news.bloomberglaw.com/esg/who-regulates-the-esg-ratings-industry [https://perma.cc/8WWD-ZK8J].

[100] *See supra* Part I. B.

[101] MSCI publishes ESG ratings on 8,500 companies and 14,000 issues, ranking industry leaders and laggards based on their ESG risk and opportunity management relative to their peers. These ranks range from leader who is "a

Because ESG funds, advisers' investing strategies, and considerations of ESG factors primarily rely on ranking agencies' conclusions of ESG companies, the ESG ranking agencies themselves must be regulated prior to regulating ESG funds and advisers in order for these amendments to result in any meaningful change.[102] Without standardizing the proprietary and differing methods in which ranking agencies consider material issues and provide ranking scores, requiring ESG funds and investment advisers to disclose their ESG strategies does not fulfill the purpose of the Proposed Rules to "provid[e] the Commission and investors with consistent, usable, and comparable data."[103]

II. Analysis:

A. Analyzing the SEC Proposal

All investment funds are required by the SEC to have a prospectus, which details the investment funds' objectives, strategies, performance, and any other "material" information

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company leading its industry in managing the most significant ESG risks and opportunities" at AAA or AA, to average meaning "a company with a mixed or unexceptional track record of managing the most significant ESG risks and opportunities relative to industry peers" at A, BBB, or BB, to laggard meaning "a company lagging its industry based on its high exposure and failure to manage significant ESG risks" at B or CCC. *See ESG Ratings: A Compass without Direction*, *supra* note 44; *ESG Ratings* MORGAN STANLEY CAP. INT'L., https://www.msci.com/our-solutions/esg-investing/esg-ratings [https://perma.cc/TBG6-XFX6] (last visited Sept. 22, 2023); *see also What is an MSCI ESG Rating?*, MORGAN STANLEY CAP. INT'L., https://www.msci.com/our-solutions/esg-investing/esg-ratings [https://perma.cc/TBG6-XFX6] (last visited Sept. 22, 2023).

[102] After Morningstar, a Chicago-based investment research and financial services firm that provides investment analysis, fund ratings, and other professional and investment services, published its ratings of mutual funds using the ESG scores of their portfolio firms, ESG firms rated in the top 10% attracted between $24 and $32 billion USD of capital inflows whereas funds rated in the bottom 10% experienced outflows between $12 and $15 billion. *See Walk the Talk: ESG Mutual Fund Voting on Shareholder Proposals*, *supra* note 59 (using data from Hartzmark and Sussman 2019 study); *see also* Samuel M. Hartzmark & Abigail B. Sussman, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, 74 J. OF FIN. 2789, 2831-32 (presenting evidence that investors value sustainability and evaluating U.S. mutual fund market outflows and inflows); *see also* James Chen, *Morningstar Inc.*, INVESTOPEDIA (last updated Mar. 10, 2022), https://www.investopedia.com/terms/m/morningstarinc.asp [https://perma.cc/GRA6-WUDU].

[103] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69 at 36,691-2.

regarding the fund.[104] Using the prospectus, investors can analyze whether the objectives, strategies, and performance of the fund aligns with their investment goals. These prospectuses are particularly important when it comes to ESG funds, because ESG funds, unlike other investment funds, specifically incorporate Environmental, Societal, or Governance issues. These are non-pecuniary factors that inevitably face challenges on how these factors are weighed against financial considerations and whether they meet the objectives of the investor.[105] Investors rely on these prospectuses to differentiate and find which ESG funds align with their preferences, therefore, there is an irrefutable need for ESG funds and advisers to produce prospectuses that meaningfully inform potential investors on how investment decisions will be made. Due to this need for clear and informative prospectuses, the SEC is amending rules to require enhanced disclosures in the prospectus, annual reports, and adviser brochures of ESG funds and investment advisers.[106]

However, these proposals for enhanced disclosures by ESG funds and investment advisers will not provide any clarity as to the actual ESG considerations they factor into their investment practices, because most ESG investment decisions are heavily influenced, if not dictated, by how ranking agencies rank ESG companies.[107] These ESG ranking agencies do the preliminary work in determining which companies "outperform" their industry peers, and ESG funds and advisers rely on this information when

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[104] Chris B. Murphy, *What is a Prospectus? Example, Uses, and How to Read it*, INVESTOPEDIA (July 18, 2023), https://www.investopedia.com/terms/p/prospectus.asp [https://perma.cc/T4SK-JTFM]; Shauna Carther Heyford, *Digging Deeper: The Mutual Fund Prospectus*, INVESTOPEDIA (Aug. 25, 2021), https://www.investopedia.com/articles/mutualfund/04/032404.asp [https://perma.cc/MF6W-7SK7].

[105] *See* Andrew Ross Sorkin, et al., *The Pushback on E.S.G. Investing*, N.Y. TIMES (May 11, 2022), https://www.nytimes.com/2022/05/11/business/dealbook/esg-investing-pushback.html?login=email&auth=login-email [https://perma.cc/LA39-KDLP] (highlighting calls from lawmakers, the SEC, and industry to cut back on ESG investing).

[106] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69.

[107] *See Walk the Talk: ESG Mutual Fund Voting on Shareholder Proposals*, *supra* note 59; *see also Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, *supra* note 102 at 2789 (presenting evidence that investors value sustainability and evaluating U.S. mutual fund market outflows and inflows).

determining which ESG companies to invest in.[108] The problem is that these ESG ranking agencies and ratings providers do not produce reliable assessments.[109] Without standardized requirements for ESG rating agencies, rating agencies and providers produce inconsistent and incomparable ESG data and ranks that are not proven to be financially supported, accurate, or meaningful.[110] Therefore, even if funds and advisers more specifically disclose exactly which ESG ranking agencies they look to and which factors from these agencies they consider and weigh more heavily, the Commission, investors, and other stakeholders still will not have the necessary information to understand whether funds and advisers' use and integration of this information is reliable and reflects the investors' desired impact of the fund.

This Proposed Rule does not prevent companies and ranking agencies from continuing to play fast and loose with their definitions of "materiality," selectively use ESG data, and make ambiguous claims of ESG opportunities and risks.[111] Since there are no meaningful standards imposed upon ESG companies and ranking agencies, there is no consequence to impose upon those who take advantage of this lack of standardization. Beginning with a company's ability to voluntarily disclose whatever ESG data they see fit and ending with the ranking agencies' practices of defining materiality not pursuant to any consistent definition, the information relied upon by funds and advisors may be wholly inconsistent data that possibly measures the wrong factors and results in a favorable rating for certain companies, while inaccurately reflecting the ESG risks and opportunities of other companies.[112]

What remains to be the most problematic issue central to rating agencies and ESG fund disclosures is the lack of an enforceable definition of materiality. The Supreme Court made clear that what is considered material is "inherently fact-specific,"[113] and

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[108] *See Walk the Talk: ESG Mutual Fund Voting on Shareholder Proposals*, *supra* note 59 (using data from the Hartzmark and Sussman 2019 study); *see also Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, supra note 102 at 2790 (analyzing the significant fund flows after Morningstar's 2016 introduction of sustainability ratings, which indicates that investors value sustainability through their allocation choices).
[109] *See* David F. Larcker et al., *ESG Ratings: A Compass without Direction* (Aug. 2, 2022) (working paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4179647 [https://perma.cc/W6BL-K5AV].
[110] *See Who Regulates the ESG Ratings Industry?, supra* note 99.
[111] *See id.*
[112] *See id.*
[113] *See* Basic Inc. v. Levinson, 485 U.S. at 236.

this standard is dangerously flexible. In short, those who are able to avoid this system by legally producing ESG disclosures that fall within this overly flexible definition will produce more favorable, but possibly inaccurate and misleading rankings. Those who achieve this will not face any regulatory action or legal consequences, lack any incentive to halt these practices, and may be rewarded with increased investment.[114]

Because companies, and possibly ranking agencies, can get away with playing fast and loose with the lack of regulations and standards and are using these opportunities to game the system, regulating ESG funds and advisers will never eliminate these issues. Furthermore, because not enough time has elapsed to prove that ESG rankings actually provide accurate measures of ESG risks, opportunities, and long-term economic effects, the SEC does not have enough data to ensure that claims on successful ESG investing are accurate.[115]

The question remains: how will requiring funds and advisers to enhance disclosures in their prospectuses and annual reports resolve any of these underlying issues? The answer is that it will not. The SEC's action to regulate funds and investment advisers prior to establishing any sort of definition of materiality for ESG ranking agencies, establishing what data is required to be disclosed by companies and included in ESG ranking agencies' ranking practices, and establishing a standardized and comparable method of producing reliable ESG rankings is ultimately just an illogical regulation, hastily proposed.

The proposed item of C.3(j) of Form N-CEN, which would ask varying questions tailored to different types of ESG funds' strategies and processes, faces several challenges that prevent the Proposed Rule from achieving its purpose of protecting investors and providing the Commission and investors with clarity. Funds that indicate that they incorporate ESG factors in their investment strategies would be required to report (i) the type of ESG strategy it employs, integration, focused, or impact; (ii) the E, S, and/or G factor(s) it considers; and (iii) the method it uses to implement its ESG strategy, tracking an index, applying an inclusionary or

[114] *See Walk the Talk: ESG Mutual Fund Voting on Shareholder Proposals, supra* note 59 at 865 (using data from Hartzmark and Sussman 2019 study); *see also Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, *supra* note 102 at 2789-99 (presenting evidence that investors value sustainability and evaluating U.S. mutual fund market outflows and inflows).
[115] *See Who Regulates the ESG Ratings Industry?, supra* note 99.

exclusionary screen, proxy voting, or engaging with issuers.[116] Specifically, Integration Funds would be "required to summarize in a few sentences how the fund incorporates ESG factors into its investment selection process and what ESG factors the fund considers."[117] Open-End Funds and Close-End Funds would be required to "provide the information on how the fund incorporates ESG factors into its investment selection process and what ESG factors the fund considers in the fund's prospectus."[118] ESG-Focused Funds would be required to "provide detailed disclosure including a standardized ESG strategy overview table… presented in a tabular format, in a standard order and consistent manner" and would be "required to provide more detailed information than integration funds… provid[ing] additional information about their strategies, including information about the impacts they seek to achieve and key metrics to assess their progress."[119] Finally, an Impact Fund would be "required to disclose how it measures progress on its objective."[120]

The purpose of Item C.3(j) of Form N-CEN asking these tailored questions to different types of funds is to "improve information available to investors by providing investors with an interest in ESG investing with *key information* that is *material* to their investment decisions."[121] Problematically, these vague requirements do not actually set forth any substantive requirements or transparency as to exactly what these funds must disclose. The requirement to "provide information on how the fund incorporates ESG factor into its investment selection process and what ESG factors the fund considers" in the fund's prospectus does not clearly and outwardly set forth what additional information is considered "*key information* that is *material* to investment decisions," and this leaves funds with the same power they previously had to issue vague prospectuses with baseless and unsubstantiated claims regarding ESG considerations. Ultimately, funds retain the broad discretion to include or omit what considerations they make and what investment strategies they employ without having any sort of system in place to ensure that they adhere to those strategies or face consequences

[116] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69 at 36,692.
[117] *Id.* at 36,708.
[118] *Id*.
[119] *ESG Disclosures for Investment Advisers and Investment Companies Fact Sheet, supra* note 82; *see also* Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69 at 36,708.
[120] *ESG Disclosures for Investment Advisers and Investment Companies Fact Sheet, supra* note 82.
[121] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69 at 36,655 (emphasis added).

when they do not follow those strategies. Investors are left unprotected because the vague and undefined standards leave the SEC and courts with no way to enforce or penalize disclosures that take advantage of the system's loopholes.

This Proposed Rule does not make funds and advisers accountable for failing to be diligent and clear in their prospectus, and funds and advisers can continue to take advantage of the lack of any specific requirements to disclose whatever they believe is "material" pursuant to their own view of materiality and not to any specified and actionable rule. Furthermore, funds and advisers can also continue to omit and hide investment strategies and practices that would not be supported by investors by claiming that it is *not* "key information that is material to investment decisions." Without any specific definitions or requirements for what is considered "key information" or "material," this Proposed Rule leaves open the enormous and powerful loophole of allowing funds and advisers to self-define these issues and escape any liability or regulatory enforcement.[122]

The challenge with the specific proposal to amend Form N-CEN to collect census-type information using structured data language from ESG funds is that it is an attempt to standardize data that is inherently dissimilar. Standardization and collection of census-type information is only useful if the data that is being collected is reliable and accurate. Structured data language based off of the currently available ESG data would produce an undependable and uninformative standardization because (i) the ESG data disclosed by every company is different; (ii) the definition of materiality amongst ESG companies and ESG ranking agencies are different; (iii) the rankings produced by ESG ranking agencies are all based off of different methods resulting in inconsistent rankings; and (iv) the comparison of this irreconcilable information is contrary to the fundamental concept of standardization because the metrics themselves are not comparable nor corroborated by any evidence.

To standardize data points that are faulty or inaccurate would result in standardized data language that is similarly fallible and unreliable. Since there is currently no standardization or uniformity in how ESG ranking agencies define material ESG issues they consider, how ESG ranking agencies use different ESG data points, and how their proprietary calculations work to produce ESG rankings, an attempt to use structured language data to collect census-type information is the equivalent of trying to standardize

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[122] *See generally* TSC Indus., Inc. v. Northway, Inc., 426 U.S. at 438; Basic Inc. v. Levinson, 485 U.S. at 224.

and compare apples to oranges. Amending Form N-CEN to collect this "census-type" information that is machine-readable is not a technical challenge, but this machine-readable information will not provide investors or the Commission with any sort of useful insight or clarity on whether ESG investment practices actually yield the societal and financial economic returns that investors seek when they invest in ESG funds. The requirement for ESG funds to "provide concise disclosure, in the same format and same location in the prospectus" does not "provide investors a clear, comparable, and succinct summary of the salient features of a fund's implementation of ESG factors,"[123] because requiring ambiguous, incomparable, and unclear ESG information to be in the same location does not provide investors with any relevant or reliable information on ESG investment practices.

The ramifications of adhering to these proposals under the structure currently in place is that funds and advisers will provide more information on which rating agencies they use, how they use the rankings, which ESG factors they consider in their investment practices, and what their strategy is when dealing with these ESG issues, but the reality is that all of that disclosed information will not provide investors or the Commission with any usable or comparable ESG information to support whether funds' and advisers' claims that ESG funds provides returns worthy of collecting higher fees is actually true. These proposed rules simply do not work with the current set of facts and fall apart in the real world where funds' and advisers' disclosure of ESG considerations is the very last step in this complicated and long process of analyzing ESG information.

B. Legal Challenge to the Proposed Rule

The Proposed Rule faces a possible legal challenge that may render the rule arbitrary and capricious if it is enacted. Under the Administrative Procedure Act ("APA"), a reviewing court shall "hold unlawful and set aside agency action, findings, and conclusions found to be arbitrary [or] capricious."[124] Under *Motor Vehicles Manufacturers Association of the United States v. State Farm Mutual Automobile Insurance Co.*, an agency must examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choices made.[125] Furthermore, the [Securities and Exchange]

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[123] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69 at 36,663-64.
[124] 5 U.S.C. § 706(2)(A).
[125] *See* Motor Vehicles Mfrs. Ass'n of U.S. v. State Farm Mut. Auto. Ins. 463 U.S. 29 (1983).

Commission has a unique statutory obligation to consider the effect of a new rule upon 'efficiency, competition, and capital formation'; its failure to apprise itself, and hence the public and the Congress, of the economic consequences of a proposed regulation makes promulgation of the rule arbitrary and capricious and not in accordance with law.[126]

Critically, the SEC also has a "statutory obligation to determine as best it can the economic implications of the rule."[127] In summary, the SEC cannot fail to justify the rule and has an obligation to show that the adopted rule does not have costs so great that any intended benefit is completely outweighed.[128]

If this rule is enacted and challenged, the SEC would struggle to prove that their economic evaluation, based upon sufficient empirical data, proves that the benefits of the rule outweigh the costs. The aforementioned challenges facing ESG data collection, disclosure, and comparability (or the lack thereof) put into question the ability of the SEC to enact a rule that is based upon sufficient empirical data. Not only is there a scarcity of empirical and comparable data when it comes to ESG data, but the available data is far from sufficient to show any sort of statistical significance. The data the SEC uses to justify the need for this rule is speculative, subjective, and unsupported by the principles of accounting and finance. In *Business Roundtable*, the court found that the SEC relied upon insufficient empirical data when it concluded that the rule at issue would improve board performance and increase shareholder value.[129] In this instance and similar to *Business Roundtable*,[130] a court is likely to find that the SEC's reliance here on questionable and inconsistent ESG data is also insufficient to conclude that the rule would "improve information available to investors by providing investors with an interest in ESG investing with *key information* that is *material* to their investment decisions."[131]

In addition to the challenge of proving that there is a sound empirical basis for the rule, the SEC would also struggle to prove

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[126] Bus. Roundtable v. S.E.C., 647 F.3d 1144, 1148 (D.C. Cir. 2011).
[127] Chamber of Com., v. S.E.C., 412 F.2d 133, 143 (D.C. Cir. 2005).
[128] *See* Bus. Roundtable v. S.E.C., 647 F.3d at 1148-49 (holding that the rule was arbitrary because the Commission failed to justify it and that "the Commission inconsistently and opportunistically framed the costs and benefits of the rule, failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgements; contradicted itself; and failed to respond to substantial problems raised by commenters").
[129] *Id*. at 1144.
[130] *Id*. at 1150.
[131] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69 at 36,655 (emphasis added).

that the possible meager benefits of the "heightened" disclosure requirements outweigh the significant reporting costs that would be imposed on funds and incurred by companies, and ultimately, investors. If the Proposed Rule is adopted, asset management firms will incur considerable compliance costs such as amending their codes, increased research and development costs, increased consulting fees, and possibly increasing wages and salaries to adhere to the rule. Consequentially, these costs would be passed on to stakeholders in the form of higher premiums and fees for ESG funds, and the costs would also be passed on to those who do not have an interest in ESG investments.

The court in *Business Roundtable* found that "[the Commission's conclusion] that [the rule] could create 'potential benefits of improved board and company performance and shareholder value' sufficient to 'justify [its] potential costs,'" was a failure to "adequately . . . assess [and justify] the economic effects of a new rule."[132] A court in this instance is likely to come to the same holding and find that the SEC's belief that this rule would provide investors "key information that is material to their investment decisions" does not justify the potential costs of imposing the rule and fails to adequately assess the economic effects of the new rule. Given how immense these compliance costs will be, the possibly non-existent benefits from the Proposed Rule are not likely to support the rule as one where the benefits outweigh its costs. A court is likely to find that this is an instance where the SEC indeed acted arbitrarily and capriciously in their failure to adequately assess, evaluate, and justify the costs imposed by the rule.

C. Proposed Solution

The SEC's Proposed Rule would not be able to achieve its intended purpose due to the multiple practical and legal challenges it faces in its current form. Until enough time passes for data to produce results that corroborate any meaningful and accurate disclosures, and until specific definitions and requirements are established for materiality, material information, and key information, this Proposed Rule is premature. For the Proposed Rule to succeed, it needs to be re-shaped and amended to include several rules that provide more transparency, ensure accuracy, and ensure accountability in the ESG reporting world.

First and foremost, the SEC needs to continuously collect ESG data and allow an adequate amount of time to pass in order to conduct necessary studies, evaluate whether the data is meaningful,

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[132] Bus. Roundtable v. S.E.C., 647 F.3d at 1148.

and create accurate calculations to quantify the data. Without any mechanism to ensure that ESG reports, disclosures, rankings, and resulting ESG investment practices are well-founded, reliable, substantiated, and standardized assessments, the Proposed Rule is torpedoed. Allowing sufficient time to pass to collect research that consistently proves or disproves whether ESG data and ratings are supported by statistically meaningful metrics is a requisite for ensuring that the ESG information that funds and advisers factor into ESG investment strategies is reliable, truthful, and supports the claims of promoting environmental sustainability and social responsibility while yielding economic returns that warrant higher fees.

Second, the SEC must add a section to the Proposed Rule that incorporates clear and comprehensive definitions for "materiality" of ESG issues. The most important action for the SEC to take at this stage is to define "materiality" of ESG issues, as this term is the determinative piece in organizations deciding what ESG data they will voluntarily disclose and the resulting factors ESG rating agencies consider in their ranking methodologies. This proposal includes adding a definition of "materiality" that also contains a section on the ESG issues the SEC considers to be material. This list of "material ESG issues" would be tailored to the largest business sectors and would require disclosure of ESG data for the issues listed as material in that industry.

Additionally, the SEC could seek out the help and expertise of other agencies in defining and specifying these "material" issues. For example, as part of this definition of "material issues," the SEC could solicit the expertise of the Environmental Protection Agency ("EPA") to create a list of what issues are considered "material environmental issues" for different types of business sectors. Using this list, the SEC could require that any organization dealing with or involved in the oil and gas industry or business-sector is required to disclose all data relating to their greenhouse gas emissions, natural resource depletion, and any other issues the EPA considers to be material for that business sector.

By providing a comprehensive definition of "materiality" and listing out "material issues" requiring ESG data disclosures in each major industry, the SEC would create a standardized and uniform guideline for organizations, ESG rating agencies and providers, ESG funds, and investment advisers to follow. Furthermore, this guideline would also act as a powerful and clear rule for investors and/or the SEC to bring an enforcement claim, for the Commission to recognize violations of these disclosure rules that are actionable

and limit such conduct, and for the courts to follow when evaluating cases claiming any violations of these rules.

Although defining and specifying materiality in different business contexts aims to remedy the underlying issues present in the current Proposed Rule, this proposal would also face its own challenges. The difficulties of this proposed solution include the challenge with defining "material," "materiality," and "key information" in different contexts. Since relevant facts inevitably vary in different situations, it is never possible for a regulation to cover every unique scenario. For example, the proposed solution of defining "materiality" and listing out "material issues" for each major business-sector would create a laundry list that would not accurately encompass issues that are material in some situations which are not material in others. This might create a separate loophole where organizations could avoid certain disclosures by claiming that their organization is not part of the business sector specifically categorized in the rule. Henceforth, they would not have to disclose information that is considered "material" for that business sector, and ESG rating agencies would not have to include those data points in their calculations. Additionally, ESG issues that may not be listed as material for a particular organization within an industry may be extremely important for that specific organization, but the organization would not be required to disclose ESG data relating to that issue because it is not listed as material for that business-sector.

Third, the SEC must add a set of regulations and uniform standards to the Proposed Rule that requires rating agencies and providers to incorporate all the "material" ESG issues defined by the SEC in their rating practices. Rather than allowing rating agencies to incorporate and weigh any array of data they personally see as "material" in their rankings, every rating agency would have to follow the "material issues" and definition of "materiality" defined by the SEC and would be mandated to factor in the corresponding ESG data each organization is required to produce. By requiring all ESG rating agencies to incorporate the data that is objectively considered by the SEC to be the most important, rating agencies would inevitably overlap in their methodologies and rankings would become more standardized, uniform, and comparable.

Fourth, after materiality is defined and rating agencies follow more consistent and standardized ranking methods, the SEC must specifically define and set standards for what is considered "key

information that is material for investment decisions."[133] This proposed solution elaborates on the Proposed Rule of requiring funds and advisers to produce enhanced prospectuses which "provide key information that is material for investment decisions"[134] by detailing and defining what that actually means. Rather than providing a vague standard that gives no guidance as to what is considered "key information" that is "material," listing out this information would establish a standard that funds and advisers must follow.

These proposed solutions to the Proposed Rule aim to add necessary elements that remedy the underlying issues by providing more transparency, thereby curtailing organizations, ranking agencies, funds, and advisers from playing fast and loose with the current lack of standards resulting from vague terms and promoting accountability in the entire chain of the ESG world. While this proposed solution to the Proposed Rule is far from perfect and would face its own array of challenges, it brings the Proposed Rule a few steps closer to possibly achieving its goals. These proposals aim to define currently undefined key concepts that sit at the heart of the uncertainty and obscurity of the Proposed Rule, clarify ESG data that organizations must disclose, standardize methods for ESG rating agencies ranking practices, and create a meaningful guide for investors, the SEC, and the courts to follow. These proposals provide the necessary foundation for the Proposed Rule to achieve its purpose of limiting problematic ESG disclosure practices and protecting and informing investors.

III. Conclusion

As ESG investing continues to grow in popularity and economic strength, there is an undeniable need for regulation. The SEC's Proposed Rule starts on the right path by requiring heightened disclosures regarding ESG investing to combat the commonly occurring and problematic practice of questionable ESG claims in investing practices.[135] However, the Proposed Rule fails to deal with the underlying issues that are at the core of problematic ESG investment practices. The Proposed Rule does not address the critical and thorny issue created by the absence of an enforceable definition or standard for materiality, which dictates what ESG data is required to be disclosed. The Proposed Rule does not create any standardization or uniformity for ESG data, ESG disclosures, ESG

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[133] Enhanced Disclosures by Certain Investment Advisers and Investment Companies, *supra* note 69 at 36,655.
[134] *Id.*
[135] *Id.*

reports, or for ESG ranking agencies. The Proposed Rule overlooks the fact that the true ambiguity in ESG investing lies in the way ranking agencies define materiality and provide rankings of ESGs. The Proposed Rule does indeed heighten disclosure requirements, however, it is pointless to increase the output of unsubstantiated and incomparable ESG information and data.

The Proposed Rule does not address an array of cardinal issues created by the current state of inherently inconsistent, unreliable, and problematic ESG information and data. These statistical obstacles not only render the Proposed Rule an ineffective means of achieving its ends, but they also create possible legal challenges of producing sufficient evidence to show that the Proposed Rule is not arbitrary or capricious. Instead of providing investors with clarity on key information and enforceable remedies when investors are misled, this Proposed Rule continues to exacerbate the very issues it seeks to remedy while imposing additional costs that will ultimately fall on investors. The methods proscribed in the Proposed Rule fail to reach its well-intentioned goal, leaving the aims of the Proposed Rule an idealistic dream that will not become an achievable reality.