
ESG Risks for Financial Institutions Operating in the United States: What to Expect in 2022 - Jones Day

In Short

The Background: Demand for ESG-aligned companies and investment products are likely to continue to accelerate transformation of the investing landscape in 2022.

The Issues: Although investor demand for ESG-related transactions continues to grow, these opportunities, along with the markets' and regulators' focus on ESG-related issues, can create significant legal uncertainty and risk for financial institutions. The conflict in Ukraine has only further complicated these considerations, although the direction and scope of its impact on ESG considerations is very much an open question.

Looking Ahead: The prominence of ESG-related issues in both the financial markets and the public discourse will present opportunities, but also create significant risks, for financial institutions in 2022, which may be magnified in light of the current broader geopolitical context.

ESG considerations will continue to play an ever-increasing role in financial markets in 2022. ESG-related transactions will continue to present significant opportunities for financial institutions as they respond to and support the needs of the market. However, these opportunities, along with the markets' and regulators' focus on other ESG-related issues, can create significant risk. ESG-focused concerns for financial institutions generally arise in two broad contexts: (i) disclosure-related risks and (ii) conduct-related risks.

This Commentary updates our prior observations concerning potential litigation and regulatory risks for financial institutions, including risks posed by governmental and private actors. We will provide additional updates, including as the impacts of the conflict in Ukraine continue to take shape.

Increased Engagement from Regulators

Last year saw frequent engagement by financial regulators focused on ESG issues, including following President Biden's May 2021 Executive Order directing multiple federal agencies to assess climate-finance risks. The Executive Order singled out financial institutions, noting: "The failure of financial institutions to appropriately and adequately account for and measure [climate-related financial risks] threatens the competitiveness of U.S. companies and markets … and the ability of U.S. financial institutions to serve communities."

This trend likely will continue in 2022 with regulators, led in some respects most visibly by the SEC, poised to enact new reporting requirements focused on climate risk and other ESG themes. SEC Chair Gary Gensler has made clear that a new climate risk disclosure rule likely is forthcoming. Reports indicate that a proposed rule could be issued as early as March 21, 2022, and we will provide further updates as appropriate in the coming days. In the meantime, the Climate and ESG Task Force created by the SEC in 2021 continues its work on ESG-related enforcement initiatives, which can proceed even in the absence of any new formal rulemaking process. These developments are of particular significance to financial institutions both in connection with their preparation of disclosures concerning their own corporate activities as well as any disclosures they may be required to make concerning lending or investing activity.

Other financial regulators are similarly expected to place greater emphasis and focus on climate change and broader ESG issues in the coming months. And, in November 2021, the Acting Comptroller of the Currency urged large bank boards to consider five climate change-related questions to “help put into motion the concrete steps that banks need to prudently manage climate risk.” The Consumer Financial Protection Bureau has also announced that it will take action focused on racial equity, suggesting that it could even look beyond fair-lending violations in charging unlawful discrimination. Market participants await further announcements from the Department of Labor regarding the October 2021 proposals regarding the extent to which investment manager fiduciaries may consider sustainability factors when assessing investment opportunities.

Although it remains to be seen what the ultimate regulatory framework and reporting requirements for financial institutions will look like and how they will operate in practice, the question of regulatory reporting and disclosures on ESG-alignment is no longer one of “if,” as opposed to “when” and “how.”

Increased Engagement by NGOs

Financial institutions’ ESG-alignment and mitigation of related risks will also likely continue to be a major focal point for non-governmental organizations (“NGOs”) and other private stakeholders, including in light of the broader geopolitical context involving the conflict in Ukraine and the increased focus on world energy markets. Financial institutions must balance pressure from NGOs to reduce financing activities of so-called “fossil fuel” companies with the practical reality that such companies outside of Russia will need increased financing to meet the global demand for energy.

In 2021, numerous NGOs scrutinized companies’ net-zero commitments and other climate-related statements both inside and outside of the courtroom, and that trend is expected to continue. In December 2021, for instance, the Sierra Club and Center for American Progress jointly issued a report noting that “the U.S. financial sector has not yet responded in a manner that suggests an understanding of either the scale of the crisis or the sector’s role in causing it.” That report is just one of several issued in 2021 that critically examine the role financial institutions can and should play in climate change. And these efforts are attracting the attention of lawmakers. For example, Representative Katie Porter (CA), teaming up with “Stop the Money Pipeline,” a coalition of environmental groups targeting asset managers and banks with net zero pledges, asserted that: “Banks have bankrolled the climate crisis … And they continue to do it today.”

NGOs are also actively considering litigation theories or other public pressure tactics against multinational companies in connection with the conflict in Ukraine. For example, the French affiliates of Friends of the Earth and Greenpeace are reported to have sent a letter to a major French energy company requesting it to end business activities connected to the Russian energy market that may “contribute to the commission of serious violations of human rights.”

It is likely that financial institutions and large, multinational organizations will continue to be a primary target of NGOs and other activist organizations pursuing traditional litigation proceedings and less-traditional dispute resolution mechanisms to advance their agendas. The majority of this litigation activity has thus far proceeded outside of the United States, with NGOs and other organizations pursuing companies and financial institutions that they believe are not sufficiently aligned with ESG objectives. In 2021, for example, five NGOs brought a complaint to the SEC alleging misstatements by the Japan International Cooperation Agency regarding “coal-free” bonds, the proceeds of which allegedly could flow to coal-fired power stations in Bangladesh.

More may be on the way. Indeed, the lead lawyer for Milieudefensie, the Dutch wing of the environmental organization Friends of the Earth, which obtained a ruling against Shell in the Netherlands requiring emissions reductions by 2030 (the ruling is on appeal), recently stated: "I think that the next step is to start also litigating against financial institutions who make these emissions and fossil fuel projects possible."

The Materiality Debate Continues

One area that should continue to receive attention is the ongoing debate surrounding what types of ESG information are actually "material" to investment decisions. In securities litigation, where large financial institutions are likely to remain attractive targets in light of the scope of their operations and perceived "deep pockets," liability can turn on the specificity and materiality of the alleged misstatement. Typically, if a statement is deemed vague or aspirational, then courts have found that it cannot have been material to a reasonable investor, and is therefore not actionable. On the other hand, if the statement is concrete enough and would alter the total mix of information that an investor would consider in making an investment decision, then it can potentially support a claim for securities fraud.

Notably, on June 21, 2021, the U.S. Supreme Court issued its decision in Goldman Sachs v. Arkansas Teacher Retirement System, holding that, at the class certification stage, a court may consider whether a company's alleged misstatements were too generic to have impacted its stock price. In advance of the ruling, amicus briefs filed in support of the plaintiff investors argued that generic statements regarding ESG may be material to investment decisions because "investors now incorporate information about a company's ESG performance into their decision-making." As more companies tout their ESG commitments in public disclosures—and as more investors claim to consider such factors when making investment decisions—legal arguments around materiality of these statements should be monitored.

The Debate Over Who Should Police ESG—From Environmental Issues to Human Trafficking

A financial institution's role as a financer, investor, or financial intermediary for a transaction that has ESG-related goals can create the risk of an expectation that a financial institution is responsible for policing those goals, even if that expectation is unreasonable, unwarranted, or unsupported by the transaction documents. Private citizens already have brought claims against banks as financers of third-party projects with negative environmental consequences. A group of residents of Flint, Michigan, for example, sued the underwriters of a municipal water development bond offering, alleging that they knew that the project would cause water contamination in violation of an asserted duty of care owed by the banks to those affected.

Private financial institutions face growing scrutiny in connection with their financing activities in collaboration with international development banks. At least one plaintiffs' lawyer has suggested that banks are a potential target for claims asserting that they have ignored human trafficking-related violations by their customers and derived benefits from facilitating illicit conduct by these customers. Similar claims may also give rise to follow-on shareholder class action cases in the United States and abroad asserting violations of securities laws and/or shareholder derivative claims. As described above, NGOs have already emerged as a formidable constituency seeking to use litigation as a tool to move financial institutions toward a role in policing ESG.

Politicization of ESG: Backlash and the Catch-22 for Financial Institutions

We also continue to monitor efforts by some parties to challenge existing and proposed ESG-related government action, and the partisan nature of these issues. Some state attorneys general may be poised to challenge through litigation various efforts contemplated at the federal level to advance climate and other ESG initiatives, and some have committed to doing so. For example, West Virginia Attorney General Patrick Morrisey sent a letter to the SEC in 2021 describing potential new regulations requiring ESG-related disclosures as unconstitutional. Similarly, in May 2021, the West Virginia treasurer, on behalf of the treasurers of 15 states, wrote to federal Climate Envoy John Kerry to express concern that the Biden administration is reportedly "pressuring U.S. banks and financial intuitions to refuse to lend to or invest in" fossil fuel companies. Separately, in a recent op-ed published in The Wall Street Journal, Arizona Attorney General Mark Brnovich, who is a candidate in the Republican primary for Arizona's U.S. Senate election to be held this November, argued that coordinated efforts to divest from conventional energy resources may amount to an antitrust violation that he and other state attorneys general might pursue.

In 2021, Texas took the lead by enacting two laws targeting financial institutions and other companies that were perceived to economically "boycott" oil and gas businesses. One of the new Texas laws prohibits state pension fund investment in companies deemed by the state comptroller to be boycotting oil and gas companies. Other resource-rich states have passed or are considering similar legislation. Texas has subsequently required financial institutions to submit "anti-boycott" certifications as prerequisites to engage in underwriting of municipal debt offerings.

In West Virginia, the state legislature recently passed a bill, expected to be signed into law by the governor, that would allow the state treasurer to refuse to enter into or remain in banking contracts with financial institutions that take any action "intended to penalize, inflict economic harm on, or limit commercial relations with a company" because the company engages in fossil fuel-based energy activity. In Kentucky, legislation that would require the state treasurer to maintain a list of financial companies engaged in energy company "boycotts" has passed the Senate and awaits input from the House. Under the proposed legislation, the treasurer's list would be shared with state government entities making investments of more than $1 million annually, which then would be required to cease business with the listed firms.

Highlighting the tensions financial institutions will continue to face in this politically fraught area, recent media reports indicated that the SEC's Fort Worth regional office has opened a preliminary investigation that may be targeting financial institutions that made certifications in connection with the Texas statute. The investigation may involve comparing the certifications against the companies' climate disclosures, emphasizing the challenges to financial institutions trying to navigate in this area. In addition, in June 2021, Maine passed legislation requiring its pension funds to divest from fossil fuels by 2026.

Conclusion

As ESG considerations continue to drive transformative change in the financial markets, they present significant opportunities for financial institutions to support market needs in green finance and elsewhere. The prominence of these issues in industry and in public and political discourse, including in light of the conflict in Ukraine and its impact on world energy markets, however, will continue to bring sustained scrutiny from public and private parties, including regulators, market participants, and NGOs. We will provide updates concerning these issues as they continue to unfold.

Three Key Takeaways

1. Regulators, including the SEC and OCC, are poised to enact new reporting requirements focused on climate risk, among other ESG themes, in the coming months. An increase in enforcement

actions is also likely to follow.

2. Financial institutions' ESG-alignment and mitigation of related risks will likely continue to be a major focal point for NGOs and other private stakeholders with increased vigor, given the broader focus on world energy markets in light of the current geopolitical crisis.
3. As more companies tout their ESG commitments in public disclosures—and as more investors claim to consider such factors when making investment decisions—legal arguments around materiality of these statements should be closely monitored.

Jones Day – Jayant W. Tambe, Lizanne Thomas, Mahesh V. Parlikad, Howard F. Sidman, Joseph B. Sconyers and Lauri W. Sawyer

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