SEC's Climate Rules Promote Compliance, Not Real Change

By **Nir Kossovsky and Denise Williamee** (April 27, 2022)

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Compliance with the U.S. Securities and Exchange Commission's proposed new rules requiring corporate disclosures of activities and risks associated with climate change will be performative. These rules will fail at their primary purpose: giving investors or stakeholders actionable information.

Destined to be audited, analyzed and wordsmithed by teams of accountants and lawyers, the disclosures will likely lack qualitative insights and perspective from company leadership.

Revealing commentary investors value — what SEC Commissioner Hester Peirce described last month as a "picture of the company's present and prospective performance through managers' own eyes" — will be expunged.

Not universally, though, we hope. There are at least a few companies engaged with environmental, social and governance issues that see these rules as an opportunity to distance themselves from even potential allegations of greenwashing.

They aim to take an extra step in validating their verdant ESG and reputation risk management processes — complying with the rules while communicating their bona fides publicly, using outside, third-party authentication like financial instruments and insurance. This type of transparency gives shareholders actionable intelligence for investment and voting decisions — and it has for years.

Our firm recently released a study that found companies with ESG and reputational risk protection strategies have seen their stock prices rise 5% above the market within two weeks of a reputational challenge. And that premium is almost double for companies that have publicly shared and validated those strategies.[1]

We also found that stock prices of firms that managed, validated and publicized ESG and reputation risk management strategies on average gained 9.3% over the subsequent seven months after a potentially damaging reputational event. Meanwhile, firms in which such processes were assumed by shareholders to be in place gained 4.3%.

By and large, firms will probably just focus on compliance, and not upgrade their ESG or reputation risk management operations. That's a mistake.

We found in our study that companies that failed to institute, validate and communicate risk management strategies, and were challenged, lost 13.2% of their stock value over those seven-month periods — and they underperformed their peers by an average of 23.3%.

Some argue that the new rules will keep firms from making exaggerated ESG claims. They give shareholders the right to sue under securities law for alleged greenwashing.

But investors do not need these proposed rules to hold boards or management accountable. Current SEC rules already require companies to disclose all environmental stewardship, social justice and dutiful governance risks that may be material to a business's prospects.

And courts have already ruled that other statements, in nonregulated channels such as corporate social responsibility reports, corporate mission statements and credos, may also be material, if investors had reason to believe they could rely on them.

Shareholders sued Wells Fargo in Hefler v. Wells Fargo & Co., in the U.S. District Court for the Northern District of California, for a stock price drop following an ethics scandal, arguing they were misled by the CEO's public statements about ethics, greater accountability and transparency within the company. The case settled in May 2018 for $480 million.

In the U.S. District Court for the Southern District of New York, on March 26, 2020, Signet Jewelers settled In re: Signet Jewelers Limited Securities Litigation, a shareholder case of sexual harassment in the face of an explicit code of conduct promising no harassment. The price tag: $240 million.

The real problem is that the rules legitimize ESG ratings. These third-party substitutes for managerial messaging vary widely from rater to rater, often using questionable criteria or reaching questionable conclusions.

The SEC's Peirce disparaged them, in remarks to the American Enterprise Institute in 2019, as "labeling based on incomplete information, public shaming, and shunning wrapped in moral rhetoric preached with cold-hearted, self-righteous oblivion to the consequences, which ultimately fall on real people."

Whatever data these rating firms and fund managers use, the purported benefits in equity returns, predicting corporate behavior, or even advancing the disclosure goals of activists are all running up against evidence to the contrary. Consider Unilever PLC, an early ESG enthusiast, which saw its ESG rating jump from A (average) to AA (leader) after it promised to increase social impact by, for example, providing products with less salt or fat.

"Unilever has had almost 5 years of near-zero returns," reported an investor letter. One of Unilever's top shareholders quipped that "a company which feels it has to define the purpose of Hellmann's mayonnaise has, in our view, clearly lost the plot." Ominously, in late January 2022, activist investor Nelson Peltz disclosed a stake in the company.

Elevating these disparate and unreliable ESG metrics to an authority level exceeding both their accuracy and precision will have all sorts of perverse effects. They undoubtedly will complicate executive compensation — increasingly being tied to ESG activity — as well as misdirecting investor capital and undercutting the global effort to materially address climate change.

The new SEC rules are flawed, and the promises made in connection with them are misleading. Nevertheless, they create an opportunity companies should embrace.

This entails overseeing ESG risk management as mission critical — which includes implementing strategies that utilize the full risk management mix of processes, controls, insurances and disclosures to deliver the optimal ESG package.

Firms whose sophisticated leadership seize the opportunity to upgrade their enterprise reputation risk governance processes and disclose the effort will enhance shareholder wealth. That's something every investor can appreciate that compliance alone with the new SEC rules will not accomplish.

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[1] https://www.prweb.com/releases/companies_that_ward_off_esg_and_reputation_crises_see_value_surge/prweb18540811.htm.