Environmental, social and governance investments (ESG): Regulating greenwashing

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ABSTRACT

This paper delves into the legal and ethical dilemmas surrounding Environmental, Social, and Governance (ESG) investing in the United States, with a particular focus on the "E" in ESG, or the environmental risks associated with such investments. While some companies genuinely embrace ESG values and integrate them into their brand, others use ESG marketing techniques to boost sales without actually implementing these values. This raises concerns about how consumers and retail investors can verify a company's commitment to environmentally friendly, socially just, and ethical governance practices. Additionally, the paper examines how the U.S. government regulates the unscrupulous use of ESG by companies seeking to attract investors. The concept of greenwashing is introduced, along with a discussion of its ethical implications and potential legal repercussions. The author analyzes the nature of legal remedies available to those who invest in a corporation based on its purported environmental ethics, only to discover that these claims were false.

Keywords: Business Law, Commercial Law, Security Exchange Commission, Stock Market, Environmental, Social and Governance Investments, ESG, Greenwashing, Marketing, Retail Investor

INTRODUCTION

The increase in shareholder litigation regarding ESG or sustainable claims made by corporations is rapidly increasing over the last several years. This trend has led federal agencies to consider updating regulations to require climate disclosures and to enhance enforcement against misleading green-related claims made by companies seeking to lure investors. This paper concerns the legal and ethical issues surrounding Environmental, Social, and Governance (hereinafter, ESG) investing in the United States (U.S.). Each ESG category merits discussion, hence this paper will focus on the “E” in ESG. Many companies genuinely embrace ESG values and strive to incorporate them in their brand. Yet, some companies have used “ESG” marketing and brand techniques to sell more products and services without actually incorporating ESG values. How does the consumer or retail investor know whether the company is actually engaged in practices that are environmentally friendly, socially just, or invested in ethical governance practices? Further, how does the U.S. government regulate the unscrupulous use of ESG branding by companies trying to attract investors? This paper explores recent shareholder litigation, and the actions of government agencies trying to stay ahead of companies that exploit environmentally conscious investors.

RESEARCH METHODS

Research for this paper draws from primary and secondary sources, to include court documents, federal administrative actions, Nasdaq, Securities and Exchange Commission documents, as well as journal articles, and news sources.

INVESTORS

Retail Investors

A retail investor is a non-institutional investor. For example, individuals who participate in the stock market by trading through a brokerage account such as Robinhood, Fidelity, Ameritrade, or E*Trade, to name only a few brokerage firms that offer individual investors a trading platform. Retail investing has grown since the rise of the internet because of increased access to markets with the use of computers and apps. In some ways, retail investors have disrupted the market. The non-institutional investor is generally a non-professional investor who invests in the market using his or her own money. The retail investor can invest passively, where stock, options, bonds, ETF’s ("exchange-traded funds" are funds that can be traded or held for investment which generally include a bundle of specified assets relating to a certain industry, or other theme) or mutual funds may be purchased and held for years or decades. Retail investors can also actively execute trades where trades of the same security occur on the same day. The Financial Industry Regulatory Authority (FINRA), a non-profit, Congress approved organization that establishes and enforces rules for brokers and dealers, defines a pattern day trader as a customer executing “…four or more day trades within five business days” (FINRA Rule 4210

Margin Requirements, 2022, 4210(f)(8)(B)(i)). Day trading is "the purchasing and selling or the selling and purchasing of the same security on the same day in a margin account except for positions held overnight" (FINRA Rule 4210 Margin Requirements, 2022, 4210(f)(8)(B)(i)). U.S. brokerage firms, per FINRA rules, require day-traders to maintain $25,000 balance in the brokerage account and qualify for a margin account (FINRA Rule, 4210 Margin Requirements, 2022). The FINRA rules inadvertenlty regulate retail investors who are day traders.

In recent years, there has been a notable increase in retail investors participating in financial markets, as indicated by research conducted by FINRA. These investors may exhibit greater diversity, are younger, and have relatively lower levels of wealth compared to previous years (Lush, et al, 2021). Data shows retail traders are people who trade "at human speed" and their trade activity varies from passive to active. Conversely, institutional traders implement algorithms. (Mackintosh, 2020)

Institutional Investors: Mutual Funds, Hedge Funds, Pensions

Institutional investors are paid to invest and maximize client or participant funds. They have access to large pools of money to make larger trades, which can reap higher returns, and higher losses. They can employ complex strategies and tools such as sophisticated software and algorithms. The institutional trader must be licensed by the appropriate governing body to trade or invest on behalf of clients.

Mutual funds are regulated by the Securities Exchange Commission (SEC) under the Securities Act 1933 and Investment Company Act 1940. Mutual fund managers are tasked with growing funds, and investors may generally sell or buy mutual fund securities throughout the year. Conversely, hedge fund managers work with accredited investors and are regulated by SEC's Regulation D of the 1933 Act. An accredited investor is defined by a list of categories where the accredited investor demonstrates traits such as investment savvy and minimum assets (17 CFR 230.501). Accredited investors can include banks, savings and loan institutions, wealthy individuals, and individuals with professional certification (Regulations, CFR § 230.501 Definitions Regulation D.

Institutions or individuals with a proven financial background manage hedge funds. Some funds may require SEC registration, for example, funds with over $100 million in assets. Hedge funds may impose limitations on when an investor can make a withdrawal. Investing with a hedge fund can be risky, much like any other form of investment. For instance, hedge fund Long Term Capital Management (LTCM) suffered a loss of $3.6 billion in 1998, and other banks bailed them out to prevent significant market harm. The leaders of LTCM were esteemed economic experts, including Nobel laureate prize winners for research in financial economics, Robert Merton and Myron Scholes, former vice-chairman of the U.S. Federal Reserve, David Mullins, and a former Solomon Brothers trader, John Meriwether. Books have been written about the LCTM failure, but an important lesson is, "Theory does not always translate into reality, and academics rarely perform as well as professional practitioners" (Slome, np, para. 21, 2016).

Private pensions in the U.S. are regulated by the federal government, regulatory bodies, or state regulations. State insurance departments may have jurisdiction to regulate some private pension plans. The Employee Retirement Income Security Act (ERISA) is the primary federal law governing private pension plans. ERISA sets minimum standards for the management and operation of private-sector pension plans, and the Department of Labor (DOL) is responsible for enforcing ERISA regulations. The Internal Revenue Service (IRS) establishes rules the tax treatment rules for pension plans.

Private pension plans are required to file periodic reports and disclosures with regulatory bodies, which are available to the public. These reports require information about the financial condition of the plan, investment strategy, and performance of investments.

ESG Securities Regulations and Investors

In June of 2022, the SEC proposed rules to create a disclosure framework for ESGs and to regulate the use of words referencing "ESG" in investment firm names. One proposed rule seeks to standardize ESG disclosures in a framework that consistently considers and applies ESG factors throughout the investment engagement. Preventing greenwashing by investment funds forms the basis of the other proposed rule. Greenwashing is a term often used to identify investments or products that have exaggerated ESG factors. This will serve to combat fund managers and issuers from misleading investors by required that funds maintain strategies suggested in fund names (Better Markets, 2023, 40-41).

In response to investors seeking to analyze investment decisions assessing climate risk, in April 2022, the SEC proposed a rule requiring companies to include climate-change risk data and information in their disclosures (Better Markets, 2023, 41).

Some research that shows retail investors may be motivated to transact in ESG securities due to pecuniary rather than non-pecuniary interests. For example, data shows that ESG-related news influenced retail traders to transact in a company or ESG security likely for pecuniary reasons rather ESG values (Li, Watts, & Zhu 2023).

Not all retail traders are day traders in search of the next stock market catalyst. Many, are young college graduates, beginning their careers, and want to invest for long term growth, and in a way that makes them feel good about their contributions to the planet, social causes, and ethical governance, and they believe that pecuniary gain is consistent with ESG securities.

Research shows that there is a causal relationship between investors valuing sustainability and investing in companies that also prioritize sustainability. These findings indicate that over the studied timeline, funds with high (Morningstar) globe* ratings experienced a "$24 billion increase in fund flows while those with the lowest globe ratings face a more than $12 billion reduction" (Hartzmark & Sussman, 2019, 2831-2832). (*A globe rating is used by Morningstar to rate ESG risk of a company from, negligible (5 globes), low (4 globes), medium (3 globes), high (2 globes), and severe (1 globe), (Morningstar Research, 2021, p. 2).

Retail investors might be apprehensive about the insufficient transparency and uniformity in measuring the worth of ESG securities. While some investors prioritize environmental impact over short-term financial gain, they may want to first evaluate the level of risk involved. Or, an investor could have multiple ESG securities to choose from and desires the one that provides the most potential for financial gain over the long run. However, they may not have enough information to determine which ESG-friendly security is the most advantageous due to marketing tactics that include greenwashing.

Fund performance issues may result from fund managers prioritizing stakeholder over shareholder concerns (Peirce H. M., 2023; Peirce H. M., 2021). Some Fund managers may be more concerned about stakeholder ESG objectives than shareholder standards, "the stakeholder focus becomes an excuse to explain away poor earnings performance while providing no way to measure whether stakeholders are actually receiving value" (Flugum & Souther, 2023). Two-thirds of investment firms surveyed by IQ-EQ responded that fear of greenwashing inhibited their ESG investments (IQ-EQ, 2023). The fear of being wrong about ESG factors, and an apprehension of not clearly understanding the metrics was a key concern, along with fear of damaging their firms reputation if they inartfully applied ESG factors and were then accused of greenwashing. This could explain why some fund managers are reluctant to work more closely with shareholders desiring ESG guidance. The IQ-EQ report indicated that a major contributing factor in the survey results is a lack of clear guidelines from regulators (IQ-EQ, 2023) .

Conversely, SEC commissioner, Hester M. Peirce has consistently argued that more ESG regulations, or global ESG regulations will not help investors, nor will more financial sector regulation help to reduce carbon emissions. She argues that mandated ESG security regulation will excacerbate the confusion, and that we have sufficient laws in place now to address greenwashing in the financial sector. She claims that the morass of varying metrics, are complex, sometimes contradictory, and make it difficult to create standardized metrics for non-financial factors (Peirce, 2023). During her 2023 speech, *Tow Truck Taxonomies*, made from Stockholm, Sweden, Peirce voiced her concern that the excitement surrounding ESG investing may spark a "green bubble," where investors are too enthusiastic about pecuniary returns from ESG investments, which could inflate ESG-related security valuations (Peirce H. M., 2023).

In Peirce's 2021 speech in Wash., D.C., *Chocolate-Covered Cicadas*, the Commissioner discussed the topic of the SEC mandating climate change disclosures. There, Peirce referenced a public comment written by Peter Germain, Chief Counsel for Federated Hermes, Inc. (a global investment firm). The comment appeared to share Peirce's concern that mandating climate change disclosures of non-material information would confuse retail investors who already sift through a lot of information (Peirce, 2021, fn 21). Germain wrote, "We caution against a rulemaking that would mandate disclosure of non-material climate change-related disclosures because such information is not decision-useful to investors. In our experience, non-material information does not improve due diligence; on the contrary, it raises costs by imposing greater demands on the time needed to review the information disclosed . . . [and] is not helpful to . . . smaller or retail investors who may not have the ability to effectively digest or compare a large number of disclosures quickly" (Germain P., 2021, pgs. 4-5).

According to some researchers, securities labeled as ESG and companies that promote their ESG funds do not perform well financially or in terms of ESG performance. Some investors may be willing to sacrifice some financial performance for non-pecuniary value provided by ESG investing. But, retail investors who are willing to sacrifice for an ESG fund, may not be so willing when the ESG factors themselves perform more poorly than non-ESG portfolios (Bhagat, 2022). A study performed by London School of Economics and Colombia University researchers, "compared the ESG record of U.S. companies in 147 ESG fund portfolios and that of U.S. companies in 2,428 non-ESG portfolios" (Bhagat, 2022, p. 3) and discovered that the companies with ESG fund portfolios demonstrated a "worse compliance record for both labor and environmental rules" (Bhagat, 2022, p. 3).

Other studies claim that some ESG funds outperform the market, "… a growing number of studies prove the payoff from focusing on long-term value and ESG" (Polman & Winston, 2022, p. 2). Polman and Winston's study claim that one firm "created a list of companies prioritizing stakeholders (not just shareholders) that they call the Just 100. This group has outperformed the market" (Polman & Winston, 2022, 2). There is a lot of excitement in the market regarding the future of ESG funds, such as, "multi-trillion-dollar markets in clean energy, electric and autonomous vehicles, plant-based proteins, precision agriculture, AI-driven efficiency technologies, and much more" (Polman & Winston, 2022, p. 2). Data also shows a growing number of millenials and people under 30 are interested in ESG investments (Hickey, 2021).

GOVERNMENT REGULATIONS OF INVESTMENTS

Asset managers in the U.S. are regulated or operate under policies established or enforced by many agencies and laws such as, the Investment Advisers Act of 1940 (the "Advisers Act"), the Securities Exchange Commission, the Federal Reserve, Federal Trade Commission, Financial Industry Regulatory Authority ("FINRA"), Department of Labor, Office of the Comptroller of the Currency ("OCC"), the National Futures Association ("NFA"), Department of Justice, Commodity Futures Trading Commission ("CFTC), state laws, and international laws and regulations. A publicly traded company is also regulated by federal, state and international regulations. For example, Charles Schwab Corporation, Vanguard, Fidelity, and so on are in the business of asset management and may hold shares of Apple stock or Tesla stock (publicly traded companies) in their investment offerings. These regulations are largely to protect consumers, such as a retail investor, or an employee's pension, or other consumer or customer investment.

The Employee Retirement Income Security Act (ERISA) protects private pension plans from misuse and mismanagement. The Employee Benefits Security Administration of the Labor Department, the Internal Revenue Service of the Treasury Department, and the Pension Benefit Guaranty Corporation administer ERISA and enforce the associated laws. ERISA aims to safeguard retirement savings and stipulates that parties responsible for managing those savings must act in the best interests of the plan participants, which requires transparency, accountability, guaranteeing that participants can access their information (ERISA, 1974).

In 2020, the Department of Labor (DOL) adopted an ERISA related rule that critics argued deterred pension fund managers or fiduciaries from considering ESG funds in 401(k) plans (Department of Labor, 2020). In 2022, the DOL revised portions of the 2020 rule, in part, to allow a plan's fiduciary discretion to consider ESG factors, "…a fiduciary's duty of prudence must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis and that such factors may include the economic effects of climate change and other ESG considerations on the particular investment or investment course of action" (ERISA Fact Sheet, 2022, p. 4).

Pension funds or plans represent diverse policies and regulations regarding ESG investments. For example, in some states regulations have been implemented that ban (or will ban) state government pension investments in large fossil fuel companies. For example, "Maine enacted legislation prohibiting investment by the Maine Public Employees Retirement System in the 200 largest publicly traded fossil fuel companies, as determined by the carbon in their reserves" (Lichtenstein, Littenberg, Haas, & Reinstein, 2022, p. 1). The Maine law also requires divesture from the companies before 2026. Other states have recently proposed similar legislation for managing their public employees' retirement pensions, including New Jersey, Hawaii, Massachusetts and California (Lichtenstein, Littenberg, Haas, & Reinstein, 2022).

Conversely, some states, such as Florida, have gone in an entirely different direction by installing regulations that ban government pension plan managers from considering ESG investments. Louisiana has a policy to divest Blackrock investments (one of the largest asset managers in the world), from state public pensions due to Blackrock's enthusiasm for ESG securities (Lichtenstein, Littenberg, Haas, & Reinstein, 2022, p. 8). Blackrock considers the divergent views regarding ESG funds to be a risk to its own business, and as such reported the risk in its 10K Filing with the SEC on February, 24, 2023 (Blackrock, 2023, p. 28 & p. 31).

FINRA's 2023 Examination and Risk Monitoring Program Report includes updates to its Communications section due to concerns about firms making unsupported or inconsistent ESG claims. These claims include absent ESG-related risk disclosures and misleading ESG rankings or unsubstantiated claims made to investors or prospective investors (FINRA, Report on FINRA's Examination and Risk Monitoring Program, 2023, p. 42).

To mitigate the problems, FINRA further seeks to require financial firms to enhance communication when promoting ESG claims. For example, FINRA guides companies to establish well-planned protocols for promoting ESG factors through transparent communication and ensuring that ESG claims are in line with relevant offering documents. Further, communication should strike a balance by emphasizing the risks associated with ESG funds, such as the possibility that ESG strategies may not yield favorable investment performance, the fund's ESG strategy may not be successful, and the fund may miss out on profitable market opportunities due to adherence to ESG motivated strategies or mandates (FINRA, Report on FINRA's Examination and Risk Monitoring Program, 2023).

ESG RATINGS, FRAMEWORK AND CONTENT

There is no shortage of interest in ESG investments. Many institutions have evaluated ESG investment products in different ways, and some have failed to accurately assess and report their own ESG factors to investors and the SEC. The growing concern led the SEC's Division of Examination to publish a Risk Alert on April 9, 2021 (Securities Exchange Commission, 2021).

The table (Appendix) lays out general categories commonly associated with ESG content. Organizations and rating firms may add content and more granular data for each content area and assign varying weight to content. USSIF reported in 2023 that money managers and institutional investors consider ESG categories to include Climate Change, Military/Weapons, Tobacco, Fossil Fuel Divestment, Anti-Corruption, Board Issues, Conflicts, and Agricultural concerns (see USSIF, Executive Summary of 2022 Report on US Sustainable Investing Trends, pgs. 4-5). The proportion of shareholder proposals on social and environmental issues that receive high levels of support has been trending upward (USSIF, 2022, p. 7).

The number of ESG rating agencies is increasing, examples such as, Sustainalytics, RepRisk, Institutional Shareholder Services (ISS) Environmental and Social QualityScore, and MSCI, which is widely recognized as the most established (Weinreb, 2020).

There is a range of ESG frameworks employed worldwide, each complex and continuously evolving. A few prominent frameworks include the Global Reporting Initiative (GRI), which involved the collaboration of Bob Massie, Allen White, the United Nations Environment Program (UNEP), as well as the U.S. Environmental Protection Agency and General Motors during initial discussions. There is the Carbon Disclosure Project (CDP) led by Paul Dickinson, the Sustainability Accounting Standards Board (SASB) founded by Jean Rogers, and the Taskforce on Climate-related Financial Disclosures (TCFD) established by Michael Bloomberg (Weinreb, 2020).

Numerous organizations have developed ESG metrics to aid in the evaluation of companies' ESG efforts, and businesses have incorporated ESG frameworks into their strategic plans. However, retail investors may lack access to or the ability to discern the transparency of a company or investment firm in their utilization of such metrics and frameworks. A poor ESG rating by a rating firm can be the basis for a court filing. In the German case, *ISRA Vision v ISS ESG,* Munich Regional Court *(AZ: 39O8981 / 19)* (2020) case before the Regional Court of Munich, the court heard a dispute between an ESG rating agency and a company being rated. The court determined that ISS ESG's unfavorable ESG rating of Isra Vision was based on fundamental misunderstandings regarding the nature of the company's business, leading to an injunction against ISS ESG preventing the publication of the rating (Bullock & Cockfield, 2022).

There are private data collection companies that gather and report on data regarding ESG performance indicators. While some of the data sets and summaries of the reports are free, some require a substantial fee to access more ESG details. Retail investors may not have funds to enjoy nuanced ESG data and reports to inform investment decisions, and are left to rely on publicly available corporate and bank disclosures. Yet, the non-accredited or non-institutional investor cannot always rely on ESG disclosures from companies or investment brokers.

GOVERNMENT REGULATION OF ESG INVESTMENTS AND PRODUCTS

U.S. government agencies and state governments regulate and enforce ESG investments to protect investors, consumers, government interests, and competition. This can occur where a corporation uses “green” or ESG branding to market products or services, yet the product or service is not what it is purported to be. The government can also enforce laws against a company where there are material omissions about products or services upon which a reasonable consumer would not have discovered. How does this impact a retail investor? The retail investor may find that a certain publicly traded company that markets its product or service by making green claims is also a good investment. But, if the company can market without substantiating its environmental marketing claims, then the investor lacks information to make a good investment decision.

The U.S. Securities and Exchange Commission may bring claims against individuals and companies for misleading investors under Section 10(b) and Rule 10b-5 of the Securities Exchange Act. A corporation will face charges by the SEC if it makes an untrue statement of a material fact or omits a material fact that is necessary to avoid misleading investors. To survive a motion to dismiss under Section 10(b) and Rule 10b-5, a plaintiff must plead the following elements: a material misrepresentation or omission, with scienter, connection to purchase or the sale of security, must be reliance, demonstrate economic loss, and the loss is connected to the material misrepresentation or omission (*Kleinman v. Elan Corp*., 2013, p. 152; *Dura Pharms., Inc. v. Broudo*, 2005, pgs 341-342). To successfully show that defendant's claims were false or misleading under the Securities Act the plaintiff must show that the statements are more than expressions of optimism by the corporation or corporate officers (*In re Nokia Oyi*, 2006, p. 397). Even "misguided optimism is not a cause of action, and does not support an inference of fraud (Shields v. Citytrust Bancorp, Inc., 1994, 1129) as corporate officials are "not required to take a gloomy, fearful or defeatist view of the future" (*Shields v. Citytrust Bancorp, Inc*., 1994, pgs.1129-1130).

Goldman Sachs, one of the largest investment banks in the world, was found responsible by the SEC for not following its own ESG policies, processes, and procedures in managing several of its ESG investment products. Goldman Sachs was ordered to pay a penalty of $4 mil to the SEC.

"From April 2017 to February 2020 ("Relevant Period"), GSAM failed to adopt and implement policies and procedures reasonably designed to prevent violations of the federal securities laws concerning the investment process GSAM's Fundamental Equity group ("GSAM FE") utilized while advising an ESG (environmental, social and governance) separately managed account ("SMA") strategy and two ESG mutual funds – respectively, the US Equity ESG Strategy ("ESG SMA Strategy"), Goldman Sachs International Equity ESG Fund ("International ESG Fund"), and Goldman Sachs ESG Emerging Markets Equity Fund ("EM ESG Fund") (collectively "ESG Investment Products")" (In the Matter of Goldman Sachs Asset Management, L.P., 2022, p. 2).

BNY Mellon Investment Advisor, Inc. (BNYMIA) a wholly owned subsidiary of The Bank of New York Mellon Corporation settled with the SEC in May 2022 for "making material misstatements and omissions made by registered investment adviser BNYMIA concerning the consideration of Environmental, Social, and Governance ("ESG") principles to make investment decisions for certain mutual funds advised by BNYMIA (the "Overlay Funds")" (BNY Mellon Investment Adviser, Inc., 2022, p. 2).

BNYMIA suggested that ESG quality reviews were prepared for certain fund investments, but they were not, which the SEC characterized as misleading. For example, "… out of 185 investments made by one Overlay Fund between January 1, 2019 and March 31, 2021, 67 did not have an ESG quality review score as of the time of investment (or, in the case of corporate bonds, within 30 days after purchase, consistent with the Sub-Adviser's policy), amounting to nearly 25 percent of the fund's net assets as of March 31, 2021" (BNY Mellon Investment Adviser, Inc., 2022, p. 4).

Compass Minerals International, came under the SEC's purview in September 2022 regarding inaccuracies in environmental reporting. The SEC settled with Compass and ordered it to pay $12 mil in penalties. "Compass's management and then Board of Directors learned that a chemical plant its subsidiary owned in Brazil had been discharging mercury above permitted levels on certain occasions, some of which reached near the Botafogo River, and covering up the misconduct by inaccurately reporting the amount of mercury to the environmental authorities" (Compass Minerals International, Inc., 2022, p. 3, para. 6). Subsequently, the SEC found that "Compass did not adequately assess the probability" (Compass Minerals International, SEC Order, para 42, p. 11) of a number of risks occurring as a result of the high levels of mercury. The SEC also found that Compass Minerals should have included financial data and impacts regarding the risks in its reporting documents (Compass Minerals International, Inc., 2022).

Another publicly traded corporation, Vale, S.A. one of the world's largest iron ore producers, was charged by the SEC with misleading investors by not accurately reporting its safety and sustainability data (Securities Exchange Commission v. Vale S.A., 2022). The SEC filed its complaint in 2022 after a dam collapsed in Brazil killing over 250 people. Vale, S.A. had previously filed sustainability documents claiming that the dam was in compliance with its safety disclosures, yet the SEC charged that it had actually not been in compliance for years (Securities Exchange Commission v. Vale S.A., 2022). Vale, S.A. settled with the SEC for $55.9 million in late March 2023. Associate Director of the SEC's Division of Enforcement, Mark Cave, stated the settlement will "demonstrate that public companies can and should be held accountable for material misrepresentations in their ESG-related disclosures, just as they would for any other material misrepresentations" (SEC Press Release, 2023, p. 1, para. 2).

Retail investors who are eager to find investments that contribute toward environmental, social or governance values may be vulnerable to greenwashing from corporations or fund manager. It can take years for a regulator to bring a complaint for greenwashing against a company, often after the company or firm has been misleading investors for years. The retail investor may be initially drawn to the firm's sustainability or ESG-related claims and therefore invest their savings in securities offered by a company or firm, only to discover much later that they were duped. Retail investors have little likelihood of finding a satisfying remedy against a company that has engaged in years of greenwashing to lure investors, even though shareholder class action lawsuits, private lawsuits, or seeking assistance through the SEC or FINRA are options (Securities Exchange Commission, Investor Bulletin: How Victims of Securities Law Violations May Recover Money, 2018); (FINRA, nd). Litigation is costly, time-consuming, and risky. But, sometimes, it is the only option to recover investments that were lost due to the asset manager or corporation's unlawful conduct.

The SEC is ramping up its enforcement against companies that falsely signal that they are complaint with ESG measures that they have established for themselves. The SEC has also proposed a rule to enhance ESG reporting and disclosures to investors. The SEC's rule would make ESG disclosures more organized, available and detailed for the investor, while holding advisors and asset managers accountable for exaggerating its ESG products or funds (Securities Exchange Commission, Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, 2022). The SEC has also proposed a rule requiring publicly traded corporations to reveal climate change data (Securities Exchange Commission, The Enhancement and Standardization of Climate-Related Disclosures for Investors, 2022).

The Federal Trade Commission (FTC) also regulates publicly traded corporations that make material misleading claims to consumers about their products or services that are deemed unfair or misleading (15 U.S.C. § 45(a)).

The FTC, like the SEC, has studied companies that make ‘green’ claims that are not substantiated. In 2012, the FTC enacted Green Guides for companies to reference when marketing environmental claims (Federal Trade Commission, Federal Registrar Green Guides, 2012). The FTC has recently reviewed whether and how to modify or amend the Guide for Environmental Marketing Claims (Federal Trade Commission, FTC Seeks Public Comment on Potential Updates to its ‘Green Guides’ for the Use of Environmental Marketing Claims, 2022).

The FTC reviews and enforces corporate promises to consumers by bringing actions against companies for deceptive and/or unfair business practices under Section 5 of the FTC Act. The FTC applies a 3-part test to determine whether a company’s practice is unfair.
For the unfairness prong, the FTC looks for: 1) substantial injury to consumers; 2) whether the harm caused to consumers is outweighed by a benefit (a balancing test); and, whether the consumer acted reasonably. The FTC regulates the “deceptive” prong of Section 5 by considering three factors: 1) whether a company’s representation, omission or practice misleads consumers; 2) whether the consumer acted reasonably; and, 3) whether the representation, omission or practice is material (See, Section 5(a) of the FTC Act, 15 U.S.C. § 45(a)).

Walmart, Inc., and Kohl’s, Inc., both publicly traded corporations (publicly traded as WMT and KSS respectively), were sued by the U.S. on behalf of the FTC for marketing false ‘green’ claims about their products. Walmart made claims that towels, sheets and blankets were 100% Bamboo; some products were marketed for babies. Walmart advertised nursing bras, pillows and comforters as containing Bamboo fabric (U.S.A. v. Walmart, Inc., 2022, pages 3-9). Walmart marketed and sold what it touted as a “Serenity Organic Self-Cooling Luxury Bamboo Comforter” (U.S.A. v. Walmart, Inc., 2022, p. 10) making claims that, “Our Serenity Bamboo Comforter will appeal to your sense of luxury and your desire to help the planet” (U.S.A. v. Walmart, Inc., 2022, p.10). The FTC claimed that the aforementioned fabrics were actually rayon, and not bamboo.

Similarly, Kohl’s falsely advertised and marketed relevant products as green and eco-friendly, boasting, “Going green has never been so sumptuous . . . this sheet set keeps you cozy while suiting your eco-friendly taste” (U.S.A. v. Kohl's Inc. F/K/A Kohl's Department Stores Inc., 2022, pgs. 15-16). Another product was advertised as “Bambu Serenity bamboo mattress pad will appeal to your sense of luxury and your desire to help the planet” (U.S.A. v. Kohl's Inc. F/K/A Kohl's Department Stores Inc., 2022, p. 16). Like the products in the Walmart case, the Kohl’s products were also simply rayon.

Rayon is actually a generic title for cellulose, which may or may not originally include bamboo, cotton and other fibers as a source.   According to findings by the court in the Kohl’s and Walmart cases, “Regardless of the source of the cellulose, the manufacturing process involves the use of hazardous chemicals, and the resulting fiber is rayon and not cotton, wood, or bamboo fiber. See generally 40 C.F.R. Part 63, Subpart UUUU (“National Emission Standards for Hazardous Air Pollutants for Cellulose Products Manufacturing”). “[H]azardous air pollutants (HAP) emitted from cellulose products manufacturing operations” include carbon disulfide, carbonyl sulfide, ethylene oxide, methanol, methyl chloride, propylene oxide, and toluene” (U.S.A. v. Walmart, Inc., 2022, p. 12); (U.S.A. v. Kohl's Inc. F/K/A Kohl's Department Stores Inc., 2022, p. 18).

In both complaints, facts stated that from at least 2015 both companies knew that to market rayon as having green, or eco-friendly attributes without evidence, was unlawful, yet both companies continued their respective greenwashing marketing by exaggerating or falsely claiming the environmental and sustainable attributes of their products (U.S.A. v. Walmart, Inc., 2022, p. 15); (U.S.A. v. Kohl's Inc. F/K/A Kohl's Department Stores Inc., 2022, p. 21). The FTC claims that penalties imposed against Walmart and Kohl’s were the “largest ever civil penalty” for bogus bamboo marketing. Yet, the award, $2.5 million to be paid by Kohl’s and $3 million to be paid by Walmart, do not appear unreasonable given that the companies have profited off of the greenwashing tactics for many years (Federal Trade Commission, FTC Uses Penalty Offense Authority to Seek Largest-Ever Civil Penalty for Bogus Bamboo Marketing from Kohl’s and Walmart, 2022).

The Court further ordered both companies to cease making unsubstantiated claims that their products are made of bamboo, cease violating FTC’s Textile Act concerning deceptive advertisements about products, and to cease marketing products as being free of “harmful chemicals, using non-toxic materials, or in a way that is safe for the environment or non-polluting, or has any other environmental benefits” (Federal Trade Commission, FTC Uses Penalty Offense Authority to Seek Largest-Ever Civil Penalty for Bogus Bamboo Marketing from Kohl’s and Walmart, 2022, np, para. 6) regarding bamboo, unless otherwise substantiated (U.S. Department of Justice, 2022).

STATE INITIATED COURT CASES

Oil companies, such as Exxon Mobile Corp., (publicly traded as XOM) have recently seen complaints filed against them from across the country. They are largely accused of greenwashing, by spending big bucks on advertising, such as claiming a dedication to the environment, while not following through to the satisfaction of the complainants. One commonly sought remedy is for the courts to impose an injunction against the greenwashing (Kim, 2021). An injunction, in this scenario, is where the court orders a party in a lawsuit to cease activity or actions. A few of the court cases have included state Attorney Generals filing lawsuits against oil companies on behalf of consumers and investors.

About 20 lawsuits have been filed against Exxon Mobile and other oil producing companies by cities, states, and municipalities (Drugmand, 2022). For example, in Massachusetts, the state has alleged that ExxonMobil violated the Massachusetts Consumer Protection Act, G.L. c. 93A, by deceiving investors and consumers due to misleading claims about its commitment to the environment (*Commonwealth v. Exxon Mobil Corp*., 2019). Connecticut and the District of Columbia also filed lawsuits against Exxon Mobile alleging the use of deceitful practices related to environmental claims and practices (*Connecticut v. Exxon Mobil Corp*., 2020; *District of Columbia v. Exxon Mobil Corp*., 2020). All three plaintiffs sought injunctions against Exxon to prevent it from using greenwashing campaigns.

In the *New York v. Exxon Mobil Corp*., Case No. 452044/2018 (N.Y. Sup. Ct.) Justice Ostrager ruled in favor of Exxon claiming that New York's Attorney General (AG) "failed to establish by a preponderance of the evidence that ExxonMobil either violated the Martin Act or Executive Law 63(12) in connection with its public disclosures concerning how ExxonMobil accounted for past, present and future climate change risks" (*New York v. Exxon Mobil Corp*., 2019, p. 1). The New York AG failed to show that alleged misrepresentations were not material to a reasonable investor (*New York v. Exxon Mobil Corp*., 2019). Following Exxon's win, a spokesperson for the company said, "Lawsuits that waste millions of dollars of taxpayer money do nothing to advance meaningful actions that reduce the risks of climate change" (Wamsley, 2019, para 10).

Despite the mounting environmental litigation against the oil industry, and the growing accusations against Exxon for greenwashing, the company has been quite profitable. In 2022, Exxon reported "its highest profit in 152 years" (Crowley, 2022, p. 1). Therefore, for Exxon (XOM) shareholders, retail investors included, Exxon was a good financial investment (Crowley, 2022) for many who held through 2022.

Automaker Volkswagen (VW) was at the center of a high-profile greenwashing case that resulted in federal and state litigation in the U.S. The company infamously misled investors and consumers for years by cheating on emissions tests through the deceitful installation of software that reduced nitrogen oxide emissions during testing but returned to higher emissions during regular driving. This brazen emissions cheating scandal drew global attention and led to action from various U.S. regulators, including the Federal Trade Commission, the Department of Justice, and individual U.S. states. Volkswagen settled with these entities and with vehicle owners and California for approximately $14.7 billion (Shepardson, 2016).

Lawsuits across Europe and in the U.S. have continued against VW for its deceit well after the above 2016 settlement. The SEC, for instance, filed a complaint against the automaker in 2019, on behalf of investors in the U.S. who had been misled. The SEC noted that VW and its CEO relied heavily on U.S. investors to finance its company's growth. Yet, U.S. investors were duped into thinking that VW operated with clean diesel engines and that their product was better superior for the environment than other vehicles. In reality, the company's vehicles were polluting up to 40 times more than the legal limit in the U.S., and VW executives "lied to U.S. investors, who then paid artificially inflated prices for VW's bonds and ABS. These investors did not know that VW was lying to consumers to fool them into buying its "clean diesel" cars and lying to government authorities in order to sell cars in the U.S. that did not comply with U.S. emission standards. The entire time, Winterkorn and other senior officials at VW knew the truth: VW's "clean diesel" engine was a sham" (United States Securities and Exchange *Commission v. Volkswagen Aktiengesellschaft, Martin Winterkorn, et al*, 2019, p. 4, para. 12).

ESG-RELATED SHAREHOLDER LITIGATION ON THE RISE

Above, we reviewed ESG-related investment lawsuits and actions filed by federal agencies, and state governments. Ways that investors can make a difference is to press companies to implement and follow ESG promises with proxy shareholder proposals, and shareholder filing securities related lawsuits. Recently, the SEC made it easier for shareholders to include ESG-related shareholder proposals in annual meetings (Williams-Alvarez, 2022, p. 2). Shareholders can vote by proxy for shareholder proposals, in addition to other slated agenda items such as electing Board of Directors. Shareholders submitted a proposal to Chevron Corp. (CVX), which showed up as a proxy statement in April 2022, where shareholders requested the company to issue a "report on its methane emissions" (Williams-Alvarez, 2022, p.3). Subsequently Chevron management agreed to work on the issue after "98% of shareholders" voted in favor of the proposal (Williams-Alvarez, 2022, p. 4). During the 2023 proxy season, a rise in pro-ESG and anti-ESG stockholder proxy statements was reported by Cydney Posner for Cooley PubCo. (2023).

Judge Kathaleen S. McCormick, presiding over a 2021 Delaware shareholder lawsuit, discussed shareholder activism noting that, "ESG activism" has come to the fore, and stockholders have begun pressuring corporations to adopt or modify policies to accomplish environmental, social, and governance goals (*In re Williams Cos. Stockholder Litig*., 2021, p. 63, fn 305; Simmons, 2019,1289-1290; and, Strine, Jr., 2019, 19-29) .

A derivative shareholder lawsuit is where shareholders collectively sue the board, or the corporation (where their shares are held) for claims essentially alleging that the board or corporation have caused harm to the corporation, hence to investors. Private lawsuits such as derivative shareholder lawsuits may operate to either enforce ESG-related claims made by corporations, or remedy harm to shareholders resulting from alleged greenwashing. For example, shareholders sued Danimer Scientific, Inc. (publicly traded as DNMR) alleging harm to investors under the Securities Exchange Act from the company's greenwashing (*Rosencrants v. Danimer Scientific, Inc. et al.*, 2021; and, *Perri, Derivatively on Behalf of Danimer Scientific, Inc. v. Croskrey, et al*; *and Danimer Scientifc, Inc. a Delaware Corporation*, 2021 (hereinafter, *Perri v. Croskrey*, et al.).

In the *Danimer* case, shareholders sued corporate officers and the corporation alleging that defendant's made false or exaggerated claims about the biodegradability of its product, Nodax. Plaintiff's pointed to misleading claims in SEC filings, in the news, and during other public appearances such as an investor meeting (*Perri v. Croskrey*, et al., 2021, pgs 8-9). The complaint stated, "the key to Nodax's success was the investing public's confidence in its superior biodegradability, as compared to other plastics available in the market" (*Perri v. Croskrey*, et al., 2021, p. 8, para 29). Shareholders specifically alleged that Danimer, through its board members and executives, "overstated Nodax's biodegradability, particularly in oceans and landfills and failed to properly disclose environmental compliance issues; and (iv) as a result, the Company's public statements were materially false and misleading at all relevant times" (*Perri v. Croskrey*, et al., 2021, p. 3, para. 7). Plaintiff argued that the defendant's misleading claims concerning the biodegradability of Nodax were motivated to inflate the price of Danimer's stock (*Perri v. Croskrey*, et al., 2021, p. 6, para. 26). In fact, the day after the Wall Street Journal published an article questioning claims about Nodax's biodegradeability (Chaudhuri, 2021; Perri

v. Croskrey, et al., 2021, p. 12, para 44) Danimer's (DNMR) stock fell "12.89%" (*Perri v. Croskrey*, et al., 2021, p. 13, para 48).

According to recent SEC filings the above lawsuit is still pending (Danimer Scientific, 2023, 10-Q Statement, p. 19), but it has not slowed Danimer's push to promote its ESG image. In April, 2023, the company's Nodax product received favorable reviews in the EU for its biodegradable properties, and it was reported that Stephen Croskrey, still CEO and chairman of Danimer Scientific, had the opportunity to kick off 'Earth Week' by ringing the "closing bell at the New York Stock Exchange" on April 17, 2023 (Renolayan , 2023, np, para. 6). The company appears to be making efforts to continue its manufacturing of sustainable options for packaging despite its litigation woes. But, from a retail shareholder perspective, the stock (DNMR) has fallen from $66.30 on February 10, 2021 to closing at $2.93 on May 12, 2023 (NASDAQ, 2023a). However the Danimer shareholder lawsuit case is ultimately resolved, it presents an example of investors losing money on their investments in a company touting its environmentally friendly product when others fairly or not, rebut the claims of the company.

Another matter, one which was settled by the SEC, *U.S. v. Nikola Corporation* (2021) involved ex-CEO of Nikola, Trevor Milton, making numerous exaggerated or false and misleading statements on his social media accounts, pod casts, and other media regarding Nikola electric vehicles. The SEC settled the case for $125 million against Nikola for violations of Section 10(b) of the Exchange Act and Rule 10b-5, Section 17(a) of the Securities Act, and Rule 13a-15(a) under the Exchange Act (*In the Matter of Nikola Corporation*, 2021). The SEC filed a separate case against Milton, alleging, in part, that Milton targeted retail investors:

"Milton tracked the daily number of new Robinhood users who held Nikola stock. On June 8, 2020, Milton shared a tweet with a senior Nikola executive reflecting that over 36,000 new Robinhood users became Nikola stockholders that day." The senior executive responded, in part, by expressing his amazement at how many calls he received "from retail investors today that have no clue about Nikola, other than their friends told them to buy. A lot of hype out there with retail investors," to which Milton replied: "That's how you build a foundation. Love it." (*U.S. Securities and Exchange Commission v. Milton*, 2021, p. 14, para. 43)

U.S. prosecutors brought a separate, but related, criminal indictment against Milton based in part on the same facts as noted above, including Milton's false publicly-made statements that his company launched the first fully functioning zero-emission semi-truck in 2016 (*U.S. v. Milton*, 2021, p. 14). These false claims are evidence of greenwashing, and demonstrate intent to lure investors with deceit. Milton was convicted by a jury in October, 2022 on one charge of securities fraud and two charges of wire fraud (Adler, 2022). His sentencing is scheduled for later in 2023 (Adler, 2023).

The NKLA stock was purchased by shareholders in the $90 range in June 2020, yet today (April 28, 2023) is sold for less than $1. For those retail investors who fell for the initial misleading statements about the company and held the stock hoping for their investment to increase, they now own NKLA for a tremendous loss (NASDAQ, 2023b).

Another corporation, the focus of, *In re Oatly Group AB Securities Litigation*, found itself at the wrong end of a class action lawsuit where shareholders alleged that the company manipulated investors by failing to disclose issues with obtaining rapeseed oil, a key ingredient to the oat mil products produced by Oatly. The class action alleged that shareholders were harmed by paying "artificially inflated prices for Oatly" stock due to the misleading claims (*In re Oatly Group AB Sec. Litig*., 2022).

The consistency of informed investing may be improved by the proposed SEC rule amendments which will require climate-related information disclosures in a registrant's 10-K report. Disclosures may broadly include how a registrant governs and reports climate-related risks, emissions, metrics, and goals or targets (Securities Exchange Commission, The Enhancement and Standardization of Climate-Related Disclosures for Investors, 2022). The SEC's Proposed Rule purposes that mandatory disclosure of environmental information in finance sectors will be more readily available to investors, enabling investors to make informed decisions regarding climate-based risk in their financial portfolios. The SEC is clear that the initial cost for corporate compliance with the SEC Proposed Rule will be expensive for some companies, but claim that over time the costs will decrease.

The SEC Proposed Rule includes possible negative impact to markets and registrants if mandatory climate-risk disclosures are implemented, such as a downward impact on markets that are suddenly required to report climate based risks. For example, food related stocks or commodities may not currently reflect drought risk; the stock may be presently valued without the risk of drought, hence overvalued. If investors become aware (informed by SEC mandatory climate-risk disclosures) that the risk of drought is now incorporated into the value of the stock, the stock, or commodity, may decrease in value (Securities Exchange Commission, SEC Climate-Related Disclosures, 2022a, 392-396; Hong, Li, & Xu, 2019) Equity-based valuation of financial investments may not currently incorporate climate-based risks, which lead to inefficiencies in financial markets. Hence, some investments may be undervalued and some overvalued due to investors not having access to climate-based risk (SEC Proposed Rule, pages 392-396; Krueger, Sautner, & Starks, 2020).

The moral hazard in investing for a variety of stakeholders is evident from retail investor, pension retirement fund accounts, to the insurance company that ultimately pays the bill for the wrongdoing of a financial or corporate entity. The retail investor is fraught with asymmetrical information. For example, if a stock appears to have a given value, but the value does not reflect hidden, undisclosed climate-based risks, the stock may be, unbeknownst to the investor, overvalued. Of course, investing is a risky endeavor. Prices of stocks, ETFs, or commodities are subject to a variety of catalysts, some temporary, and some more long-lasting. Diversifying a portfolio is a way to absorb risk. But, regulations can minimize the knowledge gap to some extent by mandating disclosures regarding future ESG-related claims. A class action law suit may be too late to effectively signal information to the investor, as the harm has allegedly already occurred. Of course, regulations do not always stop brazen violations, for example Volkswagen lied and cheated its way around emission regulations. Post-harm penalty and enforcement of a regulation violation should be extensive enough to deter future violations.

In summary, greenwashing in the financial sector is increasing particularly as investors seek more ESG options. Yet, investors may have little or significant market knowledge and access to software and investment tools needed to discern ESG claims. Some investors may trade stock or engage in option trading throughout the day, while some take a long-term approach, and many investors opt to let institutions take care of investing for them. Some states, hedge funds, and pension plans welcome ESG or ESG related investments, while other institutions and state pension plans opt for pecuniary gains over ESG metrics. Some companies genuinely embrace ESG values and strive to create products, services and investments that further ESG criteria, whereas some companies exploit the attractiveness of the ESG branding, and exaggerate their company's adoption of social, governance and environmentally friendly practice leaving the retail investors vulnerable.

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APPENDIX

Environmental	**Social**	**Governance**
Deforestation	Advancement for Employees	Diversity of Board/DEI
Climate Change Risks	Customer Care/Cybersecurity	Political Contributions
Air/Water Pollution	Human Rights	Board Compensation
Waste Management	Employee Wages and Benefits Employee Rights	Managing Class Action Lawsuits
Water Usage	Employee/Management/DEI*	Proxy Statements
Fossil Fuel Divestment Issues	Treatment of Stakeholders	Shareholder Issues
Green Energy Initiatives	Marketing Campaigns/DEI	Accounting/Auditing
Carbon Emissions	Salaries/Wages and Promotion	Internal Corruption/Fraud
Endangered Species	Hiring Practices/	Ethical Practices
Green Construction/Tech	Fair Labor Practices	Marketing/Greenwashing

Table (Sample content often referenced in ESG categories with expected overlap between categories.) *Diversity, Equity, and Inclusion