



Professional Perspective

Green Bond Impact Reporting Under Securities Law

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Green Bond Impact Reporting Under Securities Law

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The rising volatility of financial markets since the beginning of the Covid-19 pandemic has prompted many investors to increase their focus on resilience, governance, and corporate leadership as they strive to understand which companies are best suited to withstand unpredictable disruptions.

This increase in focus has given further energy to financial markets' already accelerating interest in environmental, social, and governance and sustainability factors. Investors and commentators ask whether outperformance on ESG not only supports the non-financial case for being associated with a company, but can indicate lower risk in downside scenarios. This increased focus was demonstrated and articulated by a May 2020 recommendation for increased SEC guidance on ESG related disclosure by the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee. As a result, companies are facing extensive requests for disclosure and reporting on ESG and sustainability factors.

Many companies have asked whether disclosing metrics related to sustainability and ESG—including data on greenhouse gas emissions, water usage, and waste prevention—can increase securities litigation risk for issuers and underwriters. That question raises additional complexity when a company takes affirmative action to market a financial product as having green or sustainability characteristics, such as by issuing a green bond. This article addresses some of the key issues that companies face as they consider reporting on non-financial metrics in the context of a sustainable financing, and provides some best practices for issuers of sustainability-themed bonds to avoid litigation risk.

Increased Focus and Integration

In recent years, major investment managers have continued to integrate sustainability as a core component of portfolio management strategy across both green-focused and non-green-focused funds. Sustainability and ESG factors inform how these funds approach financial technology, risk management, and product selection. Often, funds are raised with specific ESG parameters or preferences and fund managers increasingly weight the attractiveness of investing in a company based on ESG metrics. Inflows into sustainable funds have increased rapidly as well: 2019 saw \$20.6 billion of total new assets in sustainability-themed mutual funds and ETFs, which nearly quadrupled 2018's previous record of \$5.5 billion.

The prominence of sustainability-themed securities such as green bonds has also skyrocketed. The first green bond was issued in 2007. In 2019, green bond issuances totaled over \$250 billion (across all currencies), far exceeding analysts' projections and yet still far below investor demand as the average offering was more than three times oversubscribed. Thanks partly to the EU's new green investments taxonomy, analysts expect even higher growth for green bond issuances in 2020.

Positive Impact Reporting

One of the more high-profile ways a company can respond to stakeholder demand for demonstrating an ESG strategy is by connecting its financings to its sustainability story, which it can accomplish by issuing a green bond.

Green bonds are fixed income debt obligations like any other, but in a green bond offering, the issuer connects the bond to environmental sustainability by including in its offering disclosure a "Green Bond Framework." The Green Bond Framework comprises several core components, including a statement that the issuer will allocate an amount equal to the net proceeds of the bond to a specified list of business activities ("eligible green projects") and a description of how the issuer will report to the market on its compliance with the framework. Reporting is generally provided at least annually, and focuses on how the proceeds were allocated, and to what types of business activities or projects.

Green bond issuers often include reporting on the positive environmental or social impact of the business activities receiving allocations ("positive impact reporting"). Positive impact reporting is recommended, but not required, by the authoritative industry guidelines for green bonds, the Green Bond Principles (non-binding process guidelines developed by a committee of issuers, investors, and underwriters). This type of reporting is helpful to asset managers that create portfolios based on positive impact, enabling them to report to their own stakeholders the cumulative impact of their holdings.

Positive impact reporting raises new questions in the context of a green bond issuance. In the past, companies have reported on corporate social responsibility or sustainability metrics in response to general stakeholder demand. Those metrics were not tied to specific financings or business activities, and were often aspirational and inchoate. In the green bond context, a closer nexus exists among the financing marketed as green, the business activities to which proceeds of that financing were allocated, and the associated positive impacts. Positive impacts are increasingly measurable and concrete, providing a more substantial basis for investor reliance.

Securities Law Considerations

For most green bond issuers, securities law risk arises primarily under an anti-fraud provision of U.S. federal securities law known as Rule 10b-5, which is promulgated under Section 10(b) of the Securities Exchange Act of 1934. Rule 10b-5 provides a cause of action against any person who, “in connection with the purchase or sale of any security” makes “any untrue statement of a material fact or omits to state a material fact.” Rule 10b-5 can be enforced either by the Securities and Exchange Commission or through private lawsuits and applies to both primary and secondary market transactions.

To sustain a 10b-5 claim, a plaintiff must establish each of the following: the plaintiff must be a purchaser or seller of the securities at issue; the misrepresentation or omission must be material, meaning a reasonable investor would consider it important in deciding whether to sell or purchase the security; the defendant must have acted with scienter, meaning a “mental state embracing intent to deceive, manipulate, or defraud”; the plaintiffs must have relied on the misstatement or omission in making the investment decision; the plaintiff must have suffered economic damages; and the plaintiffs must show that the alleged misrepresentation caused the economic loss claimed.

Although the below discussion focuses on securities litigation risk under Rule 10b-5, other provisions of U.S. federal securities laws—such as Sections 11 and 12 of the Securities Act of 1933, as amended (the Securities Act)—as well as state securities and consumer protection laws, remain sources of potential litigation risk for positive impact reporting.

Below are three key questions facing green bond issuers considering positive impact reporting.

Can issuers face securities litigation due to their positive impact reporting?

Issuers are well-advised to assume that positive impact reporting could potentially give rise to securities litigation, but any increase in risk should be manageable.

In general, securities fraud litigation can arise from any disclosure used “in connection with” the purchase or sale of a security, including a green bond. Positive impact reporting could be used in connection with the sale of a green bond if the issuer affirmatively markets their green bond using positive impact reporting, such as by including those metrics in its offering disclosure (which could trigger Section 11 exposure for offerings registered under the Securities Act).

Positive impact reporting could also be found to be used in connection with any other transactions involving the issuer's securities to the extent the reporting is publically disseminated (as most positive impact reporting is) and/or influences (or is intended to influence) the price of the issuer's already-issued securities (which could trigger exposure under Section 10(b) of the Securities Act). The nexus between the statement and the securities transaction generally drives whether the reliance element was satisfied.

Courts have found a sufficient nexus to exist based on, among other things, filings with the SEC, press releases, letters published in the financial press, investment research reports, and product advertisements. In light of this broad scope and the increasing relevance of positive impact reporting to investors, it is prudent to view this type of reporting as subject to the securities fraud laws.

Assuming that positive impact reporting is found to be used in connection with a securities transaction, any increase in risk can be managed in the same way companies routinely manage risks related to disclosing non-ESG operating metrics: by avoiding misleading disclosure, one of the necessary elements of a securities fraud claim. Misleading disclosure refers to a misrepresentation or failure to include information necessary to prevent the information presented from being misleading. Although issuers cannot necessarily control every element of a securities fraud claim (such as a plaintiff having incurred economic losses as a result of statements made in connection with a securities transaction), the clarity of their communication is within their control. Recommendations to ensure clarity are set forth below.

How can issuers manage the securities law risk arising from positive impact reporting?

To improve the likelihood that positive impact reporting is clearly communicated, issuers should:

Avoid factual errors. Apply similar rigor to obtaining and reflecting the underlying data on positive impact reporting as they would apply to other key performance indicators (such as financial results). This means having a clear process for measurement and subjecting the public disclosure of this data to sufficient backup controls. One component of this process should include confirming the positive impact data is consistent with publicly available data on relevant metrics, such as those reported on regulatory agency websites. For example, when reporting on greenhouse gas emissions, the issuer should confirm its disclosure is consistent with emissions reported to federal, state, and local environmental agencies pursuant to permit reporting requirements. Where appropriate, board or senior management committees and legal counsel should be involved.

Consider using well-established metrics. Such metrics may include the sector-specific core indicators proposed by the *Handbook of Harmonized Impact Reporting*, promulgated under the auspices of the Green Bond Principles, or those suggested by the Sustainability Accounting Standards Board or the Greenhouse Gas Reporting Program.

Describe the parameters of the metrics in sufficient detail.

- **Expected vs. historical impacts?** Many positive impact reports in the context of a green bond refer to the annualized positive impact that they expect based on a project or operating improvement being fully in place (i.e., run-rate), rather than the historically achieved positive impact. This approach is helpful to investors that seek to quantify their forward-looking impact, but issuers should take care to avoid giving the impression that projects under construction are completed. Issuers should also consider disclosing the material assumptions underlying any ex ante estimates (such as baseline years), as well as any ex post data they collect if it reveals material deviations.
- **Completed, funded, committed?** Issuers should make clear what triggered including a project's positive impact in their report. A project could be included when completion has occurred and operations have begun, the funds necessary to finance the project have been disbursed, or the funds have been committed or the final investment decision has been reached.
- **Full balance sheet or selected projects?** Positive impact reports tend to focus on specific projects being funded rather than the entirety of an issuer's operations. Issuers should take care not to imply that the positive impact report is an exhaustive picture of their impact on environmental- or sustainable-development-related factors, which green bond investors do not generally require. Issuers are well served by understanding any material ways in which their non-green bond business activities undercut their positive impacts and clearly describe the scope of their positive impact report to avoid misleading by omission.

Include forward-looking statement disclaimer and appropriate disclosure on risks. Issuers tend to avoid statements in their offering disclosure that predict future results, because if those predictions later prove to be incorrect, investors can easily demonstrate the inconsistency. Issuers may nevertheless choose to include such predictive statements in their positive impact reporting or elsewhere due to investor demand or for other reasons. To mitigate the securities law risk in doing so, issuers often rely on the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These provisions protect issuers for forward-looking statements that are identified as such and accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."

These cautionary statements should be specific, robust, and dynamic over time, rather than boilerplate. They should disclose reasons why projects may not be completed on schedule (or at all), or why projects may not yield the expected positive impacts. The same matters should be included in the "Risk Factors" section of the offering disclosure. It may also be helpful, to the extent possible, to couch these disclosures as statements of opinion, which are subject to greater protection as long as the issuer subjectively believes them to be true.

Reflect all appropriate internal input. Facilitate greater collaboration among various teams involved in producing, reviewing, and publishing positive impact reporting. When a company's finance, legal, and sustainability teams work together, for example, the accuracy and the integrity of the reporting is supported with more points of view and focus areas.

Can positive impact reporting be considered “material”?

Securities fraud liability not only requires misleading disclosure in connection with a securities transaction, but also that the subject of the misleading disclosure was material. A material misrepresentation or omission is one that a reasonable investor would be substantially likely to consider important when deciding whether to purchase or sell securities of an issuer. This inquiry is objective in that it is based not on whether an individual in fact considered disclosure to be important, but rather on how a “reasonable” investor would view the information. But this inquiry is also fact-specific, depending on the facts of each securities transaction and the misleading information.

Issuers are well advised to assume that a reasonable investor in a green bond would consider positive impact reporting to be important to their investment decision, although the question is far from settled. No law, regulation, or reported court decision directly addresses the importance of positive impact reporting to a reasonable investor in a green bond, and the general rule has been that issuers do not include such information in their disclosure.

Below are four considerations that may be relevant to courts confronting this question:

Positive impact reporting with a business impact. The greater the link between the relevant positive impact metric and traditional business metrics such as earnings or asset value, the more likely a reasonable investor would be to find that positive impact metric to be important. Under existing SEC guidance, information on environmental factors could be required under several mandatory disclosure line items, but only to the extent it meets the traditional reasonable investor standard. This includes where such factors are likely to lead to capital expenditure, litigation, and risks to earnings.

Extent of securities sold to “green” investors. Investors may argue that what is important to a reasonable investor in a green bond is different from what is important to a reasonable investor in a non-green security. For example, positive impact reporting may be vital to an asset manager with investment fund criteria that require green investments and who reports back to stakeholders on the positive impact of their investment. If a large proportion of a green bond issuance is purchased by green-focused investors, there is a stronger argument for concluding that positive impact reporting would be important to a reasonable investor in that issuance.

Prominence of “green” marketing. Investors may contend that issuers should not be permitted to market securities as having positive impact and then claim that positive impact reporting is not important to the reasonable investor in those securities. From this perspective, the greater prominence given to the positive impact reporting in marketing the bond, the more likely that information would be considered important to a reasonable investor.

Clarity and specificity. Statements of intent, aspirations, subjective assertions, and similar statements are less likely to be considered important to an investment decision than objective statistics or statements capable of being proven false.

An issuer should also be aware of the risk that an investor in other (non-green) securities may consider the positive impact reporting to be important to the extent those metrics are linked to traditional business metrics, because they may affect the company's ability to access financing in the future or for other reasons.

Conclusion

Companies developing and implementing their sustainability strategies will balance their desired outcomes—improved resilience, decreased risk, enhanced internal and external reputation—against the costs, which can include increased risk related to how they position their securities. Companies may benefit from using green bonds as part of their sustainability strategy and can use the above discussion to help minimize the risk from enhanced impact reporting accompanying their green bond.

Although such reporting is not risk-free, the risks are generally no greater than those arising from the company's ordinary course reporting of operating metrics. Just as with the company's ordinary course disclosure, a well-managed approach is likely to keep downside risk acceptably low for most green bond issuers.