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Heating Up: the SEC Rules on Climate Disclosure*

*** Placing the latest climate disclosure policy initiatives in context.**

by Isabel Verkes

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ESG Book substantiated its support for the SEC's proposed rule on Climate Disclosure in this formal comment, available on the SEC website. This article adds context to this proposal and ESG Book's position.

Introduction

"What gets measured gets managed." This quote by Peter Drucker also applies the other way around. Failing to measure corporate climate exposure and impact results in a lack of management, or even mismanagement in the face of climate risks and opportunities. Among the wide range of ESG topics that might be relevant information to investors, emissions can be seen as the 'clearest' data point to measure. Hence, it is emissions disclosure we must focus on to optimize our investment for positive (financial) impact, according to The Economist. Indeed, the recent Inflation Reduction Act in the US indicates a new momentum for the US pushing ahead on addressing climate change, with subsequent transition risks for companies.

Many financial market players have an interest in better climate-change information about companies, given that many financial institutions have bold ambitions regarding the decarbonization of financing activities. Take for example the 74 institutional investors with US$10.6 trillion in assets under management that joined the UN-convened Net-Zero Asset Owner Alliance, and thereby committing to transition investment portfolios to net-zero greenhouse gas emissions by 2050. As companies and investors are looking to manage their exposure to climate-related risks and opportunities, investor demand for information about companies' climate metrics is growing. All this accentuates that climate change-related data on companies can be financially material for investors.[1]

Failing to measure corporate climate exposure and impact results in a lack of management, or even mismanagement in the face of climate risks and opportunities.

The term "financial materiality" used in the SEC's proposed rule on climate disclosure, to be addressed in this paper, is consistent with the SEC's existing definition and Supreme Court precedent. An item is material "if there is substantial likelihood that a reasonable investor would consider it important when determining whether to buy or sell securities or how to vote".

The various ways to organize climate-related disclosure by companies

In the absence of regulatory requirements for companies to disclose emissions, a number of voluntary reporting initiatives emerged to guide companies and investors on the disclosure of emissions and other climate-relevant data such as physical risks (e.g. potential financial loss from floods) or decarbonization targets. Notable examples are the guidance by the Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD), CDP, and the International Sustainability Standards Board (ISSB) created by the International Financial Reporting Standards Foundation (IFRS). These initiatives are contributing to the ongoing development of increased transparency around climate change as a corporate and financial issue. However, the proliferation of - slightly diverging[2] - frameworks and standards for voluntary disclosure can lead to confusion among investors and corporates, and the risk of duplicating efforts by these standard-setting organizations. Indeed, consolidation efforts underlie the creation of the ISSB as a global standard-setter for sustainability disclosures for the financial markets, combining several initiatives. While this is a positive development, the voluntary nature of standard-setting organizations' guidance comes with a lack of authority and enforcement to truly hold companies accountable.

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The TCDF reporting framework was established in 2015 and guides companies' disclosure on their governance, strategy, risk management, and metrics and targets regarding climate change. The TCDF is a foundation for the recent work of the ISSB – where the ISSB adds granularity, as well as the CDP (formerly the Carbon Disclosure Project). The CDP provides a mechanism for reporting on environmental topics, also in line with the TCFD recommendations.

With the ongoing consolidation of climate-related reporting standards, what is next? Legislative action and regulatory enforcement - nationally and increasingly on a global level. That is with the eye to providing clarity to issuers, also by consolidating existing frameworks into regulation[3]. The European Union was one of the first movers. It released its action plan for financing sustainable growth in 2018 as the strategic foundation for its subsequent sustainable finance policies and regulations. The EU is doubling down on these efforts, and others are joining that party, with recent significant developments in climate disclosure around the world.

In Spring 2022, regulators in the European Union and the United States proposed climate-related disclosure rules, complemented by a new global climate disclosure proposal from the ISSB.

Proposal	What is it?	Why is it important?	Applicable to & when?
ISSB: Climate-related disclosures requirements draft	Standards to help voluntary adoption of climate-related disclosure rules by jurisdictions world-wide: the drafts of General Requirements for Disclosure of Sustainability-related Financial Information and Climate-related Disclosures.	Not mandatory, rather an attempt to align national jurisdictions and create more consistency in climate-related disclosure and enforcement thereof.	After consultation, planned release of guidelines by the end of 2022.
EU: ESRS	To help inform the implementation of the EU's Corporate Sustainability Reporting Directive (CSRD), the European Financial Reporting Advisory Group (EFRAG) released guidance on various sustainability-related disclosure requirements, including the European Sustainability Reporting Standards (ESRS). Considered the most normative proposal, compared to that of the SEC and the ISSB.	These standards focus less on investor protection, and more on the impact of environmental sustainability issues for corporates, with a double materiality lens. This implies taking into account how sustainability issues impact corporates financially (financial materiality), as well as the impact of the company on the climate and society.	Large companies in the EU, where two of these 3 conditions are met: - EUR 40m in net annual turnover - EUR 20m in assets - More than 250 employees Phasing in from 2023 until 2026, with the first reports around 2024.
U.S.: SEC Climate Disclosure draft	The SEC's proposed rule of 'Enhancement and Standardization of Climate-Related Disclosures for Investors' aims to ensure investors have the information they need to make sound decisions in the face of climate change.	Different from the EU's focus on issues, the SEC focus (as per its mandate) lies with investors. This emphasis on investor protection has the proposed rule focus on the disclosure of financial material information around climate change, including emissions, climate risks, and net zero targets.	All U.S. listed companies in the U.S., as well as foreign private issuers filing with the SEC. Like the EU, phasing in from 2023-2026 and with the first reports around 2024, if the rules are adopted by late 2022.

There has always been this difference between the US and most other economies regarding mandatory climate-related disclosure requirements in that the US SEC took a passive stance. This year, we see the US SEC's attention on climate disclosure is catching up, even if its focus is on investors rather than issues as in the EU. With the new SEC proposal on Climate Disclosure, US companies are, for the first time, required to provide detailed reporting of their emissions, climate-related risks, and decarbonization transition targets. The SEC's overarching objective is to provide investors with consistent, comparable, and reliable information on climate risks and greenhouse gas emissions.

Yet, there is still work to be done. The SEC staff will likely work on removing potential ambiguities from the rule. And, given that it's likely that some version of this rule passes, non-disclosing corporates are advised to start collecting the most fundamental climate metrics yesterday.

Looking closer at the US, a newcomer to corporate climate disclosure rules

The SEC proposal on climate disclosure passed with a 3-1 vote. In the words of the majority, the proposed rules are designed to "provide registrants with a more standardized framework to communicate their assessments of climate-related risks as well as the measures they are taking to address those risks." The sole Republican SEC Commissioner, Pierce, explained her vote against in a dissenting statement. In her words, the proposal "turns the disclosure regime on its head" and will harm investors, the economy and the SEC.

Following years of close interaction with investors and companies, ESG Book is supportive of the proposed climate disclosure rule, as we explain in ESG Book's formal response to the SEC's request for comments. Climate-related impacts or risks can materially affect a company's financial position and operations. Today's data availability is limited, which is a fundamental challenge to our apprehension of climate risks for corporates and financial institutions. By including well-structured climate-related information in financial statements, the SEC Climate Disclosure proposal promotes consistency in information across a company's reporting, by including climate as a material element of publicly accessible information. The best remedy to address failed risk management and greenwashing is a credible and commonly shared language of climate-related information. The more we practice and build on this language, the more it benefits investors and society alike.

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References

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3. See for example the US market regulator's motivation in the recently published SEC Proposed Rule on Climate Disclosure, p. 29.

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