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Financial Services

SEC Enhancement and Standardization of Climate-related Disclosures: Summary Explainer

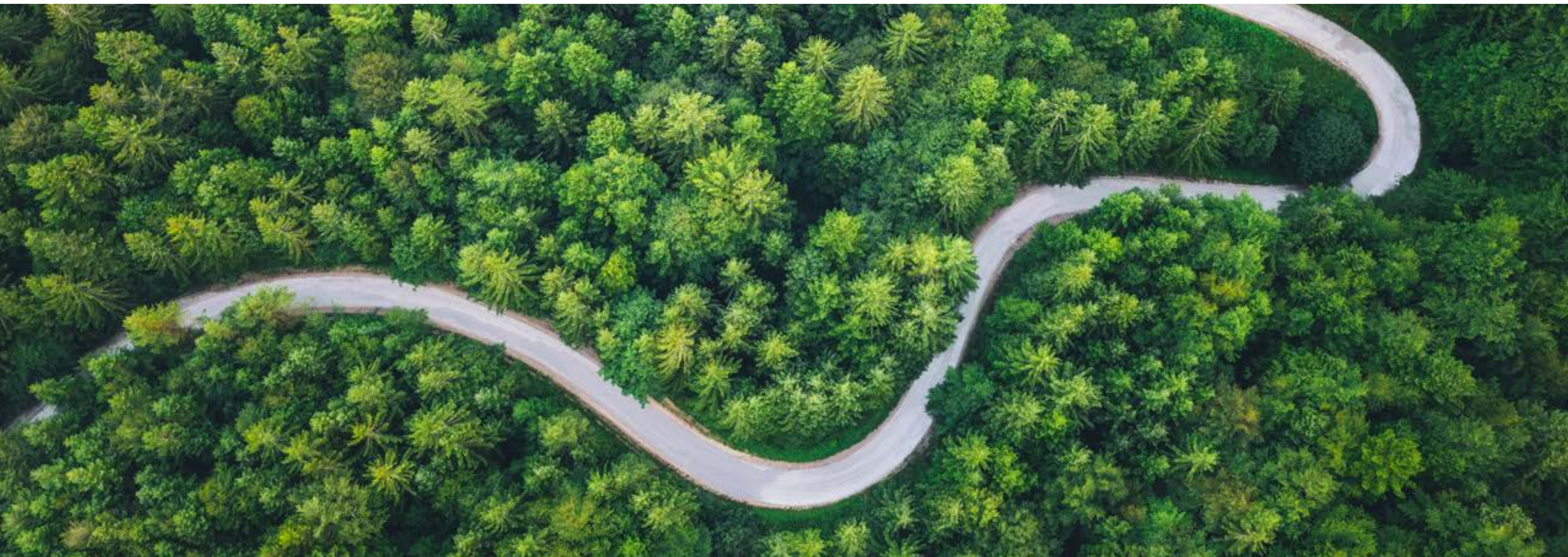
Climate change is positioned to reshape the 21st century. Accordingly, climate risk, as a substantial threat to financial market stability and long-term value, has become increasingly important over the past two decades.

Investors representing more than $130 trillion have been making increasingly forceful requests for Environmental, Social, and Governance (ESG) information,[1] including climate data as a risk assessment tool. Investors have also been calling to standardize that data through regulation. This has given rise to a burgeoning set of beyond-compliance standards and frameworks, and fragmentary data disclosures from those who access the capital markets.

In parallel, climate-related damage has been accelerating, as climate-driven weather events become more frequent and have material financial impacts on firms, markets, and investors. Munich Re, the German global insurer, found that natural disasters caused some $280 billion in damages globally in 2021 alone.[2] About $120 billion involved assets covered by insurance—an increase from $82 billion and $57 billion in 2020 and 2019, respectively.[3]

In concurrence with the view that more comprehensive and standardized climate data is valuable to overall financial stability, the United States Securities and Exchange Commission (SEC) proposed disclosure rules that would require enhanced disclosures of climate risk information from registered entities. This represents the culmination of a decade's worth of analysis since the SEC first promulgated voluntary climate disclosure guidance in 2010. The proposed rule passed by a 3 to 1 vote on March 21, 2022, and has now entered the period for public comment. In terms of timeline, the SEC is optimistic that the disclosure rules will be adopted with an effective date of December 2022.[4]

1. Simon Jessop & Andrea Shalal, "COP26 coalition worth $130 trillion vows to put climate at the heart of finance," Reuters, last modified 3 November 2021, https://www.reuters.com/business/cop/wrapup-politicians-exit-cop26-130tn-worth-financiers-take-stage-2021-11-03/.
2. "Hurricanes, cold waves, tornadoes: Weather disasters in USA dominate natural disaster losses in 2021," Munich Re, 10 January 2022, https://www.munichre.com/en/company/media-relations/media-information-and-corporate-news/media-information/2022/natural-disaster-losses-2021.html.
3. See footnote 2.
4. Securities and Exchange Commission, "FACT SHEET: Enhancement and Standardization of Climate-Related Disclosures," last accessed 28 March 2022, https://www.sec.gov/files/33-11042-fact-sheet.pdf.



Who Is Covered by the Proposed Rulemaking?

The proposed rules apply to "domestic and foreign registrant" firms. The timelines for disclosure are phased based on size of the registrant—larger companies could have to disclose as early as 2024 (with data from FY 2023), while smaller companies would have until 2026 (with data from FY 2025) and would be exempt from certain categories of disclosures, such as Scope 3 greenhouse gas (GHG) emissions.

What is Proposed?

The disclosure rules would require companies to report climate-related information designed to increase transparency about how they are addressing climate risks:

Climate risks: A headline topic is the disclosure of both physical and transition risks for the firm. The proposed rules require significant detail about identified risks over the short, medium, and long term, and actual/likely material impacts on business, strategy, and outlook. The rules also provide examples of ways in which climate risk may impact a business, including impacts to operations, products, and services, a business's value chain, activities to mitigate climate risk, and research and development, and notes that disclosures should be both current and forward-looking. Along with material impacts, companies would be required to disclose information such as carbon offsets or renewable energy credits (RECs) used as part of their emissions reduction strategy, the use of an internal carbon price, and details relating to any scenario analysis performed. Finally, the proposed rules also provide companies with the option to report on climate-related business opportunities.

Governance of climate risks: The rules propose a series of new disclosure requirements related to the overall governance of climate-related risks, inclusive of relevant risk management processes, and oversight and governance by a firm's board and management. For example, with respect to board governance, the rulemaking requires registrants to disclose the board members or committees charged with oversight of climate risk, the level and nature of climate risk expertise among the board of directors, and the way in which the board takes climate risk into consideration in its decision-making. The rules will also require similar information regarding management's role in addressing climate-related risks, as well as the process for reporting climate-related risk to the board.

Greenhouse gas emissions: Firms would be required to disclose their GHG emissions. The rulemaking specifies that firms may not include carbon offsets in their footprint.

1. Scope 1 and 2: Firms would be required to disclose direct Scope 1 and 2 emissions (from fuel and electricity consumed). Larger firms' Scope 1 and 2 emissions disclosures are subject to phased-in assurance, beginning with limited assurance for large accelerated filers in 2025 with FY 2024 data, and extending to reasonable assurance for large accelerated, accelerated, and non-accelerated filers over time.
2. Scope 3: Scope 3 (indirect) emissions include emissions from purchased good and services, third-party logistics, or, for financial institutions (FIs), financed emissions. Large firms would be required to disclose their Scope 3 emissions, if Scope 3 emissions are deemed material[5] to the firm's financial performance. For example, if Scope 3 emissions represent a significant percentage of an organization's overall emissions, or if the firm has set targets involving Scope 3 emissions, they will require disclosure to the SEC. Importantly, the proposed rulemaking includes a safe harbor from liability for Scope 3 emissions disclosures.

Climate targets, goals, and transition plan: Companies with public climate targets would need to provide additional information about the scope of those targets, including the activities involved, the unit of measurement and baseline time period, the timeline for meeting the target, and any interim targets set. In addition, companies would need to disclose details regarding their plan to meet the targets, including the use of offsets or RECs to meet the targets, as well as progress against targets annually.

5. As the SEC noted in the proposed rule, in the US, for these purposes, "a matter is material if there is a substantial likelihood that a reasonable investor would consider it important when determining whether to buy or sell securities or how to vote" (p. 69).

Presentation

As appropriate, companies should disclose relevant information in their registration statements and Exchange Act annual reports (i.e., Form 10-K). In addition, they should include disclosure of climate-related information, including climate-related risks reasonably likely to be material (or, if desired, opportunities) as a separately captioned section in Regulation S-K filings. Certain climate-related financial impact metrics should be included as a note in Regulation S-X consolidated financial statements.

Methodologies

The SEC was not prescriptive with respect to specific methodologies for reporting climate risks, giving latitude for firms to use their preferred methods, so long as they are transparent about their process. However, the proposed rulemaking includes suggestions for established approaches that align with the frameworks on which the proposed rules were modeled.

Task Force on Climate-related Financial Disclosures

The proposed rules acknowledge its alignment in large part with the Task Force for Climate-related Financial Disclosures (TCFD) Framework, a framework created by the Financial Stability Board that has rapidly become the most commonly applied international standard for reporting climate-related risk and opportunities. The framework asks reporting organizations to describe their approach to identifying, assessing, monitoring, and managing climate-related financial risks for different climate scenarios. The SEC rulemaking aligns to TCFD, and while TCFD is not prescriptive in how organizations should approach each recommended action, it provides structure for standardized climate-related disclosures.

GHG Protocol

The proposed rulemaking's GHG emissions disclosure requirements are modeled on the GHG Protocol, which it notes has become the leading standard for accounting and reporting GHG emissions. The proposed rules acknowledge the necessity of use of emission factors, or ratios that typically relate GHG emissions to a proxy measure of activity at an emissions source, where direct data is unavailable.

Partnership for Carbon Accounting Financials

The SEC recognizes that for many FIs, Scope 3 emissions disclosures are likely to include financed emissions and require FIs to describe the methodology used to measure their financed emissions. Although the proposed rulemaking does not require a particular methodology, it specifically calls out the Partnership for Carbon Accounting Financials (PCAF) as a methodology that aligns with the GHG Protocol and can serve as a useful complement for FIs to calculate their financed emissions.

Science-Based Targets Initiative

The SEC rulemaking also proposes a strategy for companies to report to shareholders and investors the approaches they are taking to transition operations toward lower-carbon strategies for the purpose of climate risk mitigation. Again, the rulemaking does not endorse any specific approach, but references the role that RECs and Science-Based Targets—such as those established in accordance with the Science-Based Targets initiative (SBTi)— play in helping facilitate a firm's transition planning.

Timelines, Phase-ins, and Carve-outs

The proposed rules will be phased in between FY 2023 and FY 2027. Large accelerated filers are required to adopt disclosures first. Smaller firms are required to adopt disclosures in later years. Additionally, the smallest firms are exempt from certain types of disclosure and assurance.

Proposed Phase-in Timeline for Disclosures

	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027
Large Accelerated Filers	• All proposed disclosures, excluding GHG emissions • Scope 1 and 2 emissions	• All proposed disclosures, excluding GHG emissions • Scope 1 and 2 emissions • Scope 3 emissions (if material or part of target setting) • Limited[6] assurance of Scope 1 and 2 emissions	• All proposed disclosures, excluding GHG emissions • Scope 1 and 2 emissions • Scope 3 emissions (if material or part of target setting) • Limited assurance of Scope 1 and 2 emissions	• All proposed disclosures, excluding GHG emissions • Scope 1 and 2 emissions • Scope 3 emissions (if material or part of target setting) • Reasonable[7] assurance of Scope 1 and 2 emissions	• All proposed disclosures, excluding GHG emissions • Scope 1 and 2 emissions • Scope 3 emissions (if material or part of target setting) • Reasonable assurance of Scope 1 and 2 emissions
Accelerated Filers and Non-Accelerated Filers	-	• All proposed disclosures, excluding GHG emissions • Scope 1 and 2 emissions	• All proposed disclosures, excluding GHG emissions • Scope 1 and 2 emissions • Scope 3 emissions (if material or part of target setting) • Limited assurance of Scope 1 and 2 emissions	• All proposed disclosures, excluding GHG emissions • Scope 1 and 2 emissions • Scope 3 emissions (if material or part of target setting) • Limited assurance of Scope 1 and 2 emissions	• All proposed disclosures, excluding GHG emissions • Scope 1 and 2 emissions • Scope 3 emissions (if material or part of target setting) • Reasonable assurance of Scope 1 and 2 emissions
Smaller Reporting Companies (SRCs)	-	-	• All proposed disclosures, excluding GHG emissions • Scope 1 and 2 emissions	• All proposed disclosures, excluding GHG emissions • Scope 1 and 2 emissions	• All proposed disclosures, excluding GHG emissions • Scope 1 and 2 emissions

6. In a limited assurance engagement, the practitioner gathers sufficient appropriate evidence to conclude that the subject matter is plausible under the circumstances, and gives a report in the form of a negative assurance.
7. In a reasonable assurance engagement, the practitioner gathers sufficient appropriate evidence to conclude that the subject matter conforms in all material respects with identified suitable criteria and gives a report in the form of a positive assurance.

How this Compares to Other Countries and Requirements

The new SEC disclosure rules have precedent within the G20. Countries including New Zealand, the UK, Japan, and France have passed rules requiring TCFD-aligned disclosures. The scope of required disclosures vary, however. For example, the UK's rule goes into effect in April 2022 and applies to fewer entities (approximately the 1,300 largest companies) than will the SEC's proposed rulemaking.

The European Union is also increasing pressure on ESG disclosure, but with a slightly different approach. Rather than a TCFD-aligned focus on climatological financial risks, the EU is requiring disclosure on broader ESG and sustainability topics. The EU's Corporate Sustainability Reporting Directive is an attempt to set a more robust, standardized global framework for ESG disclosure across corporations. It takes effect at the end of 2023 and is expected to impact more than 49,000 firms.

This diversity of approaches reflects a dynamic discussion around what firms should be required to disclose.

What Happens Next?

The current proposed rulemaking has now entered a 60-day comment period. After this comment period, the SEC is expected to issue its final rules and its final enforcement date. Although the timeline for a final rulemaking remains uncertain, the SEC's disclosure timelines assume a December 2022 date for the final rule to take effect.

Implications

Registrants

1. **Literacy:** Ensure that relevant personnel throughout the organization understand the proposed rules and implications. Executives and senior management may not have previous experience confronting these topics and will require varying levels of education to engage in informed decision-making. Comprehension of the proposed rulemaking's requirements as they apply to a particular organization, based on the organization's size and business model, is a key first step.
2. **Governance and Integration:** Start establishing appropriate governance and internal controls to ensure those responsible for decision-making regarding climate risks have the information they need, and that climate risk is formally integrated with the company's core enterprise risk management processes via COSO or other relevant frameworks.
3. **Data:** Identify and begin collecting the data required to meet potential disclosure obligations, including data required to account for Scope 1 and 2 GHG emissions. Firms should also perform a Scope 3 screening to determine whether their Scope 3 emissions are material and, therefore, require disclosure. Other relevant indicators include data on risks, impacts, progress on climate targets, consumption of renewables, and current and future climate opportunities.

Financial institutions should begin preparing for measuring and reporting financed emissions. They can do this by familiarizing themselves with the PCAF methodology and determining whether membership might be right for them. They should also start performing an inventory of their financed emissions to identify hot spots in their portfolios.

4. **Systems and Processes:** Begin developing the necessary systems and processes to ensure accuracy and precision required by the proposed disclosures. Reporting of climate-related risks will now require a degree of internal and external confidence that can only be derived from a robust reporting infrastructure similar to what companies have in place for other regulated disclosures.
5. **Opportunities and Upside:** Use this transition toward increased scrutiny of climate risk management to identify and drive benefits within the firm. Assessing climate impacts can provide business opportunities for new, differentiated products and services, as well as increased efficiency, improved resilience, and employee engagement.
6. **Engagement and Preparation:** Create a detailed roadmap and begin taking the steps necessary to prepare to meet the proposed requirements. This may include creating or expanding climate risk governance and a climate team, compiling a risk register of potential climate risk impacts to the business, upgrading data flows and calculations, and targeted engagement with compliance, investor relations, and regulatory affairs.

Others

The rules are also likely to have important impacts on entities beyond registrants. Private firms are likely to see increased pressure to provide similar information as these requests become normalized in the capital markets. Additionally, increased data may generate increased interest in the investment product space.

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