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SEC Climate-Related Disclosures Proposal: Transparency or Regulatory Burden?

Part 1 of 3

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The U.S. Securities and Exchange Commission (SEC) recently released, for public comment, an extensive set of proposed climate-related disclosures for domestic and foreign registrants to provide in their registration statements and annual reports. It is our intent to provide an overview of the proposed rules and some general considerations with respect to proposed requirements which warrant more careful consideration and refinement from a comprehensive risk perspective.

As the proposed disclosures are numerous and rather weighty, we thought it best to break up the subject into three parts. Stay tuned for parts two and three, which will be published soon.

Rationale for Newly-Proposed Disclosures

The proposed disclosures are set forth by the SEC in The Enhancement and Standardization of Climate-Related Disclosures for Investors. In its proposal, the SEC seeks to provide investors with consistent, comparable and reliable information and a step toward bridging the wide disparity between the various existing climate disclosure frameworks under which some companies voluntarily provide climate-related financial information. The comment period on these proposed changes ends May 20, 2022.

The proposed disclosures are based on two main widely accepted frameworks: Task Force for Climate-Related Financial Disclosures (TCFD) and the Greenhouse Gas Protocol (GHG Protocol). While these standards provide some guidance to companies in terms of the type of disclosures that would be appropriate, the industry just received proposed guidelines from the newly-formed International Sustainability Standards Board (ISSB) under the International Financial Reporting Standards (IFRS) Foundation regarding more uniform standards for reporting on climate-related disclosures. One striking difference between the two sets of disclosures is the lack of required industry-related disclosures in the SEC proposal, which may be appropriate given the current challenging operating environment.

New Subpart 1500 of Regulation S-K

Under the proposed rules, to be set forth in a new Subpart 1500 to Regulation S-K, a registrant must disclose any "climate-related risks" reasonably likely to have a material impact on the registrant's business or consolidated financial statements. "Climate-related risks" mean the actual or potential negative impacts of climate-related conditions and events on a registrant's consolidated financial statements, business operations, or value chains, as a whole.

A new Subpart 1500 would require climate-related disclosures in three main categories:

1. **Financial Impact Metrics** – Includes the financial impacts of severe weather events, transition activities and identified climate-related risks on line items in the consolidated financial statements above a particular threshold.

2. **Expenditure Metrics** – Includes the positive and negative impacts associated with the same climate-related events, transition activities and identified climate-related risks as the proposed financial impact metrics.

3. **Financial Estimates and Assumptions** – Whether the estimates and assumptions used to produce the consolidated financial statements were impacted by exposures to risks and uncertainties associated with, or known impacts from, climate-related events.

Proposed New Article 14 to Regulation S-X

In the proposed rules, the SEC would add a new Article 14 to Regulation S-X requiring a registrant to provide a note in its financial statements with certain disaggregated climate-related financial metrics, derived from existing financial statement line items. Any climate-related disclosures contained in audited financial statements would be subject to audit by a registered public accounting firm.

Reporting of Scope 1 and Scope 2 Emissions

All registrants would be required to disclose their Scope 1 emissions (generated by operations directly owned or controlled by them) and Scope 2 emissions (indirect emissions such as heat and electricity purchased from a utility) on a varied timeline based on the type and size of registrant, with large accelerated registrants potentially disclosing their 2023 fiscal year emissions (to be reported in 2024) and accelerated registrants reporting their 2024 fiscal year emissions (to be reported in 2025).

Reporting of Material Scope 3 Emissions

The concept of materiality would govern the disclosure of the more complex Scope 3 emissions (emissions both upstream and downstream from a company) including their value chain. The definition of materiality would be the likelihood that a reasonable investor would consider it important when determining whether to buy or sell securities or how to vote. Companies would need to assess the materiality of their emissions, in terms of the amount and magnitude over a short-, medium- and long-term time horizon – an increasingly challenging task given the complex nature of changing weather patterns. The proposed guidelines note the advances in climate modeling tools and the idea of using climate consulting firms to assist in this determination. Companies would also be requited to disclose their Scope 3 emissions if they have a set of GHG emissions reduction target or goal that includes them.

Extended Timeline for Reporting and Some Exclusions for Smaller Reporting Companies

The proposed requirements provide a longer timeline for the required planning and exclusion from more complex Scope 3 emissions disclosures to smaller reporting companies (SRCs). For the purposes of the proposed requirements, an SRC is a registered company that is not an investment company, an asset-backed issuer, or a majority-owned subsidiary of a parent company that is not a smaller reporting company and that (1) has a public float of less than $250,000,000; or (2) had annual revenues of less than $100,000,000 and either: (a) no public float; or (b) a public float of less than $700,000,000.

No Differentiation by Industry or Carbon Intensity

Surprisingly missing from the proposed requirements is the concept of differentiated compliance guidelines based on the industry of the registrant, even though the Sustainability Accounting Standards Board (SASB) guidelines have long adopted that approach. The only distinction made in the proposed requirements is by various metrics indicating size (public float of shares) or amount of revenues generated by a registrant. While many large public companies have put in place management with the expertise, internal controls, infrastructure and significant planning requirement to undertake this bold set of transformational standards, it's possible that these requirements and the quickly approaching reporting deadlines will cause a number of mid-sized registered companies to endure yet another set of pressures in this already precarious operating environment.

Briefly: Proposed Climate-Related Disclosures

These disclosures would include perspective on how climate-related risks identified by the registrant have had or are likely to have a material impact on its business and consolidated financial statements over the short-, medium- and long-term and any scenario analysis conducted by the registrant and disclosure of the use of analytical climate modeling tools. The proposed rules would require the following climate-related disclosures:

- **Climate-Related Risks** – Identification of climate-related risks reasonably likely to have a material impact on the registrant's business or consolidated financial statements, within the existing definition of materiality.

- **Impact on Strategy, Business Model and Outlook** – Explanation of how any identified climate-related risks have affected, or are likely to affect, the registrant's strategy, business model and outlook.

- **Management and Board Oversight** – Description of the manner in which a registrant's Board oversees climate-related risks and management's role in assessing and managing those risks.

- **Processes for Identifying, Assessing and Managing Climate-Related Risks** – Whether any such procedures are integrated into the registrant's overall risk management system or processes.

- **Climate-Related Financial Metrics and Goals** – Various climate-related financial metrics and climate-related targets and goals, if the registrant has set them. If a registrant has identified a transition plan to net zero emissions, information regarding the plan including how progress would be tracked and measured would need to be disclosed.

- **Disclosure of a Set of Greenhouse Gas Emissions** – Scope 1 emissions (direct emissions from sources owned or controlled by the registrant) and Scope 2 emissions (indirect emissions such as purchased electricity and purchased heat) and for accelerated and large accelerated registrants, disclosure of Scope 3 emissions (both upstream and downstream from a registrant's value chain) if material or if the registrant has set targets for Scope 3 emissions. After the first year of disclosure, greenhouse gas emissions disclosures would require independent attestation.

Contact Us

We continue to monitor the potential implications of the quickly evolving climate risk and carbon measurement disclosures required by global regulatory entities, including the SEC.

If you have any questions about this article, please contact your client engagement partner or:

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