Insight

# SEC Proposes Mandatory Disclosures for Public Companies of Climate-Change Risks

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## Executive Summary


- A new proposed rule by the Securities and Exchange Commission (SEC) would require public companies to provide climate-related risk data in their disclosures for the first time.
- These disclosures would cover not just the financial risks stemming from climate (itself notoriously difficult to model) but would extend to both a company's greenhouse gas emissions and its climate-related strategy and risk processes.
- It is not clear that the SEC rule is necessary given the current risk practices of public companies and preexisting disclosure requirements; it is also not clear that the proposed rule is within the SEC's constitutional mandate, or lastly that the disclosure requirements would create comparable data of sufficient quality to have value to investors or the general public.


## Context

An SEC proposed rule would, for the first time, require public companies operating in the United States to provide climate-related information in both their registration statements and annual reporting. These disclosures would require businesses to provide information on the climate-related risks they face, their governance and risk management processes in place to mitigate those risks, and their greenhouse gas (GHG) emissions.

## The SEC's Proposal

- the oversight and governance of climate-related risks by the company's board and management;
- how climate-related risks have or will impact a company's strategy and outlook;
- the company's processes for identifying, assessing, and managing climate-related risk;
- the "likely" "material" impacts to a business and its consolidated financial statements over any time frame;
- direct GHG emissions (Scope 1) and indirect GHG emissions (Scope 2) from purchased electricity and other forms of energy, in addition to indirect GHG emissions resulting from the business' supply chain (Scope 3); and
- would require companies to publicly state not just any internal climate-related targets but also any progress towards these goals, including the use of carbon offsets or renewable energy certificates.

In addition, the proposed rule would mandate that for certain aspects of the proposed requirements, most notably those sections related to GHG disclosures, public companies must obtain, over time, first "limited" and then "reasonable" "assurance" of the accuracy of the data provided. "Assurance" in this instance is guided by the attestation standards of global accountancy and seem to suggest that data provided in these disclosures will eventually require third-party audit or consultation.

**Timeline and Accommodations**

The proposed rule provides phase-in timelines for public companies depending on their "filer status," ranging from large accelerated filers to smaller reporting companies (SRCs). Operating under the assumption that the proposed rule would be adopted in December 2022, compliance —first with part and then with all the proposed requirements — would be necessary between fiscal years 2023 and 2025, with the various "assurance" requirements in force in following years.

| Registrant Type | Disclosure Compliance Date | |
|---|---|---|
| | All proposed disclosures, including GHG emissions metrics: Scope 1, Scope 2, and associated intensity metric, but excluding Scope 3 | GHG emissions metrics: Scope 3 and associated intensity metric |
| **Large Accelerated Filer** | Fiscal year 2023 (filed in 2024) | Fiscal year 2024 (filed in 2025) |
| **Accelerated Filer and Non-Accelerated Filer** | Fiscal year 2024 (filed in 2025) | Fiscal year 2025 (filed in 2026) |
| **SRC** | Fiscal year 2025 (filed in 2026) | Exempted |

| Filer Type | Scopes 1 and 2 GHG Disclosure Compliance Date | Limited Assurance | Reasonable Assurance |
|---|---|---|---|
| Large Accelerated Filer | Fiscal year 2023 (filed in 2024) | Fiscal year 2024 (filed in 2025) | Fiscal year 2026 (filed in 2027) |
| Accelerated Filer | Fiscal year 2024 (filed in 2025) | Fiscal year 2025 (filed in 2026) | Fiscal year 2027 (filed in 2028) |

Source: SEC Fact Sheet

As can be seen above, the smallest reporting companies would be exempt from Scope 3 GHG emission metrics entirely, and all companies disclosing Scope 3 data would have a safe harbor from liability.

As per normal procedure, the proposed rule will be open to comment from interested parties for 60 days after being posted in the Federal Register.

**Analysis**

*Who is this for?*

While the intended beneficiary of the SEC's proposed rule is clearly the public in furthering the Biden Administration's social goals relating to climate change, the SEC in the proposed rule goes to considerable lengths to name-check groups of concerned investors demanding not simply that public firms disclose climate-related risks but that governments mandate these requirements (most notably the Glasgow Financial Alliance for Net Zero, a coalition of over 450 firms from 45 countries managing assets over $130 million). A public company's investors and shareholders quite rightly exert broad control over the direction and goals of a company, and in coordinated effort tend to have their demands met.

This makes the SEC's proposed rule largely unnecessary – where public company investors demand climate related disclosures they *do* so and have the power to have their needs met, no government involvement required. It is for this reason thousands of companies already disclose their emissions and reduction targets under voluntary standards set by their own industries. The SEC proposed rule noted two particular examples — the Task Force on Climate-Related Financial Disclosures and the Greenhouse Gas Protocol – but it is not clear that the existence of standards without the SEC is as strong an argument for its involvement as the SEC appears to think it is.

Certainly the United States is considered to trail its international colleagues in the implementation of disclosure standards on climate-related risk, particularly the European Union. As is often the case with financial services regulation, European practices strongly influence U.S. regulatory developments. Therefore, the United States will very likely end up with ESG standards in some form or other but the implementation of these standards and understanding the differences between U.S. and international markets will remain key.

Perhaps the most interesting fundamental question is whether SEC's proposed rule even represents an additional disclosure requirement. Companies are already required to disclose any material information in their risk assessments, and this can and does already include, for many companies, data related to climate-related risks. In essence, the proposed rule may simply duplicate existing requirements.

*How useful would the proposed rule be?*

The SEC's stated goal is to codify existing practices with a view to consistency and comparability. While these are goals shared by the investor community when they look at the quality of the data available to them, realizing this dream represents a significant challenge, particularly as the quality of climate-related risk data remains poor. Climate science itself suffers from a wide range of assumptions and estimates, competing methodologies and definitional issues, and the financial models predicated on these can and do achieve wildly different results on the same input data. Garbage data in means garbage data out.

The SEC proposal represents two unique data challenges. The first is the difficulty in assessing GHG emissions along an entire supply chain. The second is the reliance on the accounting concept of materiality, itself a somewhat subjective measure on which to hang an entire disclosure framework, as businesses will be required to decide for themselves what is material to whom, dooming comparability from inception. Both of these questions are made immeasurably more complex by the proposed requirement that businesses assess these over the long term and timeframes that could span decades.

Of course, simply having an SEC disclosure requirement and data formats will likely encourage data standards in climate-related risk to improve, but this process will likely take years before investors – the target beneficiary of the rule – will make investment decisions based solely on climate data reported. This also puts a significant burden on the SEC to both determine and provide guidance on the standards and scenarios it itself will require of reporting companies in an effort to obtain standardization. Allowing businesses themselves to make these judgments as to the appropriateness of models and scenarios (while making it difficult to compare) was certainly the easier path the SEC neglected to take.

*What are the potential costs?*

As with any landmark regulatory framework, achieving compliance will be a costly effort, with a paperwork burden of about 25 million hours and an additional $6.5 billion in regulatory costs for public companies per

year. As always, these costs will inevitably be passed onto the consumer and discourage new business entrants and companies going public.

In addition to the obvious and upfront costs, businesses will have to be wary about new legal exposure as disclosure requirements make them liable to the SEC, and potentially investors and the public, for the data that they provide (concerning even in an industry where good quality data is available). These concerns are somewhat obviated by the existence of a regulatory safe harbor, but these rarely provide exhaustive coverage. The requirement that public companies receive assurances for their disclosures will also create a new ancillary climate-related audit industry that will drive up compliance costs.

*What does this mean for the SEC?*

The SEC proposed rule raises significant concerns as to the constitutionality of such a sweeping new framework and expansion of its responsibilities. Requiring public companies to disclose non-material data (progress on climate-related goals, for instance) could violate those companies' First Amendment rights, and by the government's own standards the rule may not pass the strict scrutiny test demonstrating either a "compelling governmental interest" or that the rule has been tailored as narrowly as possible to meet this interest.

Even if the courts decide that the expansion of the SEC's role is constitutional, the new direction for the agency represents time, effort, and expense that would divert agency attention away from its traditional duties. Perhaps most compelling, the SEC is not the government agency tasked with climate-change and environmental protection. Requiring, for instance, GHG emission disclosures would necessitate the SEC to achieve a high level of knowledge and understanding of environmental science; this would be an enormous undertaking for a goal that may not be consistent with the agency's mandate and may undercut the SEC's credibility in its core mission.

More broadly, the use of government agencies to advance certain social and political goals raises questions as to picking regulatory winners and losers and interfering with the economic investment of capital, necessarily distorting the market to meet these goals. What other social ills might tangentially involved agencies seek to address?

**Conclusions**

In attempting to enhance and make comparable disclosure practices that in many cases already exist, the SEC's proposed rule raises serious questions ranging from constitutionality to even the basic necessity of a regulatory land-grab that seeks to tell businesses not only what they must do but also *how* they must address climate change. In what amounts to a desire to influence capital allocation decisions on the basis of political and social ends, the SEC arrogates a brand new mission statement to itself – policing climate change – that it has neither the knowledge base nor likely the constitutional mandate to perform. This is hardly a convincing platform on which to construct a new disclosure regime that is already largely being adhered to voluntarily, would be extraordinarily costly, and most important, not be of sufficient quality to drive investor decisions for years to come.