Better late than never:
SEC moves in the right direction, but questions remain

Desk Strategy
ESG Markets Strategy

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Long overdue, but timely

It has been long recognized the critical role regulators could play in pushing transparency on how climate risks are affecting companies, and how their actions in turn affect the environment and societies. The release of the SEC proposal is a landmark for climate action, even as its late arrival highlights the complicated nature of de-regulation politics.

In this piece we describe how the Commission is well-positioned to advance climate reporting by providing specific disclosure guidance. We contextualize the proposed rule and analyze the viability and strength of the requirements amid a busy year for ESG activity.

As designed, the disclosures would allow investors to make informed decisions backed by issuer-specific identified risks relating to their operations. On the other side, issuers would benefit by disclosing more efficiently and effectively, in line with investors' demands.

We note that the proposal did not come out of the blue – the majority of the rulemaking is directly derived from widely accepted frameworks such as the Task Force on Climate-Related Financial Disclosures ("TCFD"), and the Greenhouse Gas Protocol. By integrating widely-used frameworks and maintaining investor protection and legitimacy in mind, the Commission delivers on its commitment to provide guidance for more consistent, comparable, and decision-useful information.

We acknowledge the contributions by Fjordi Mulla in the preparation of this report

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It is (almost) finally here

Last week the U.S. Securities and Exchange Commission (SEC) proposed the long-anticipated rule which would require domestic and foreign SEC registrants to disclose their climate-related (physical and transition risks), as well as their greenhouse gas (GHG) emissions. The proposal has a 60-day comment period whereby the public can provide its opinions. The SEC will hold a second vote to adopt the rules, effective December 2022.

Given publicly traded companies are estimated to be responsible for 40% of total climate-warming emissions investors have a critical role to play in climate action. The SEC is emphasizing that by considering climate risks, companies will position themselves successfully in securing investor support.

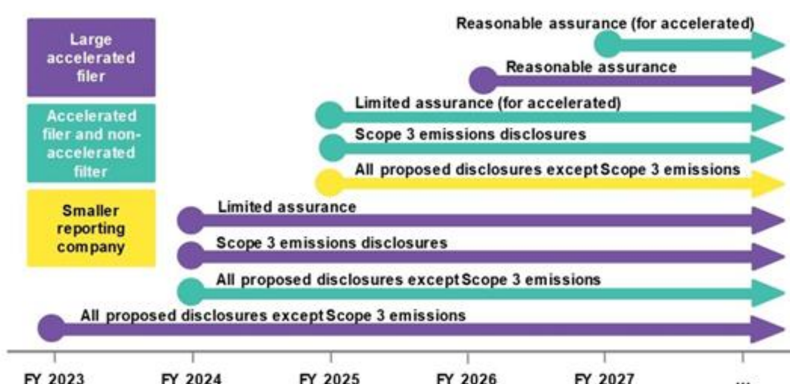
Janet Yellen praised the proposal stating the overall resilience of the financial system would be strengthened. She commended the SEC's work in providing investors and businesses with concrete, consistent and reliable guidance – something market participants have asked for years. This is what the initiative fundamentally centers around: a market-identified issue affecting systemic changes which the SEC has authority to address and monitor.

While US regulators have lagged global counterparts, companies have voluntarily provided information relating to climate risks and GHG emissions. Indeed, mounting pressure from investors has proved to be effective enough to increase transparency on climate risks, with 70% of companies in the Russell 1000 Index, and 92 percent of the S&P 500 Index publishing sustainability reports in 2020. The SEC staff, in reviewing nearly 7,000 annual reports submitted in 2019 and 2020, found that a third included some disclosure related to climate change.

So how does the SEC add value if companies are already reporting their climate plans? In short: legitimacy and investor protection. Beyond the increased participation in climate reporting, the SEC codifies the material issues investors care about and removes what has not worked. Drawing from countless research on what matters in climate reporting, we believe that the SEC positions itself prudently in the climate disclosure regime.

Phase-in Timeline of Proposed Rules

Source: BloombergNEF, U.S. Securities and Exchange Commission (SEC)



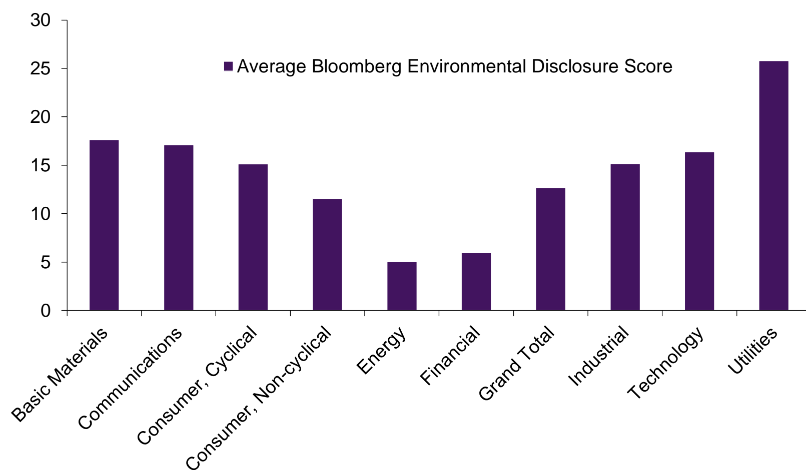
However, the challenge of disaggregated and incomparable data for investment analysis will persist. Indeed, based on our findings from Bloomberg data, only 284 companies reported environmental disclosures. This means that just 24% of all possible reporting companies appear on the investment-analysis-ready platform the majority of financial analysts use. MSCI, in

measuring existing US-listed companies' current practices performed a similar exercise: just 15% of the all possible companies in the MSCI USA IMI index disclosed Scope 1, 2, and any Scope 3 information. For reference, these were the most complete and centralized platforms out of four ESG data providers.

The data challenge will not be solved overnight. There is still material information investors can embed in traditional financial analysis as ESG-friendly indicators become more refined. For example, for the Bloomberg environmental disclosure score – defined by the degree of environmental *reporting* (not actual performance) - companies range from 70 to 0.3, a major spread that indicates the extent and rigor of disclosures. On average, companies in utilities and basic materials provided the highest level of disclosures, although the sample sizes for both industries were small. As to which companies are most likely to report on environmental disclosures, consumer (cyclical and non-cyclical), industrials and financials lead the way vs other industries (see charts below).

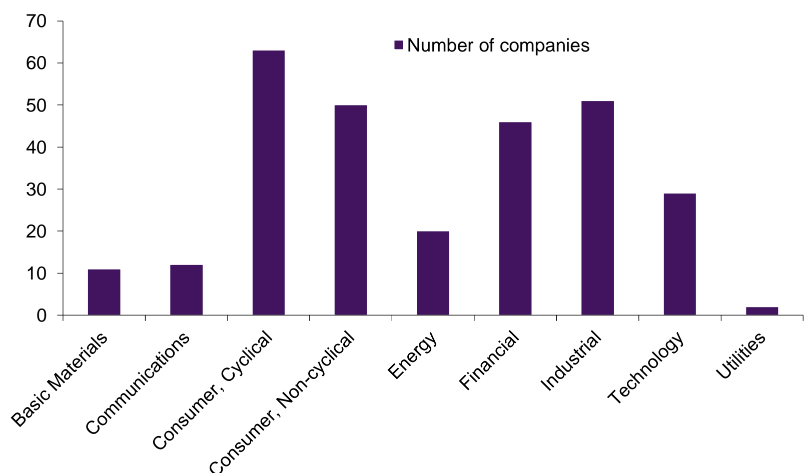
Industry-based average for Bloomberg Environmental Disclosure Score

Source: NWM Strategy based on Bloomberg data



Number of companies reporting on environmental disclosures

Source: NWM Strategy based on Bloomberg data



In addition, it is important to see whether companies are *already* doing what the Commission hopes to put in practice to identify where there is room for

improvement. Of the 284 companies providing environmental-related disclosures, 106 explicitly mention how climate change risk impacts business matters in the Management Discussion and Analysis (MD&A) section of the annual report. Of those, just 61 mentioned scope 1 emissions. This is undoubtedly an area where we would expect progress, not just in the audited statements, but also on platforms that provide ESG-ready investment-analysis usability.

Data usefulness is still in question

While these examples do not reflect the total universe of companies reporting to the SEC, it is a testament to the underlying issue of data robustness. Even under *perfect reporting practices by all companies on a pre-determined list of metrics with minimal disclosure errors*, comparability and interoperability will not come easy. In order to make more conclusive investment decisions, companies and investors ought to think beyond regular, mandatory reporting.

The SEC's proposal is a good first step to achieving transparency, but transparency itself is not the end-goal. The most important actions will and should be taken *after* comprehensive disclosures occur. For instance, companies and investors must ask:

- To what extent will the additional data signal investment outcomes and risks?
- How wide-ranging and applicable is the data in scenario analysis, climate-testing, and decarbonizing portfolios?
- Most importantly, are the existing reporting infrastructures sufficient in aiding investor decision-making for risk mitigation and opportunity creation?

In finalizing and voting on the proposal, the SEC will be heavily dependent on the incoming public comments. However, additional backlash from anti-regulation groups and a possible Congressional review may roll out in the coming weeks. Most importantly, a reexamination and ultimate critique of materiality by the Supreme Court can ultimately freeze the proposal. Moving in the right direction is abundantly clear, yet big questions about the proposal's viability still loom.

A summary of the decision

Below we highlight the main points in the Fact Sheet.

Applicability

- Who: Domestic and foreign registrants
- When and where: Time of registration and periodic reports, such as form 10K, starting reporting in 2024
- Frameworks referenced: Task Force on Climate-Related Financial Disclosures (TCFD) and Greenhouse Gas Protocol (GHG Protocol)
- Comment Period: 60 days from the day of the announcement: 3/21/22 – 5/21/22

Main Content of the Proposed Disclosures

Material Impacts and Disclosures

- Information about the oversight and governance of climate-related risks by the company's board and management, how identified climate related risks impact strategy, business model and outlook, and the process used by the company to identify, assess and manage these risks.
  - Climate-related metrics must be included in consolidated financial statements as required in audit processes, just like financial information.
- For companies that have adopted a transition plan, the rules would require a description of the plan, including the metrics and targets used to identify and manage physical and transition risks.
- For companies that use scenario analysis to assess resilience to climate-related risks, the rules would require information on the scenarios used including the parameters, assumptions, analytical choices and projected financial impacts from the scenarios.
- The rules would require:
  - Disclosure about company's use of an internal carbon price, including information about the price and how it is set,
  - Disclosure of information on the impact to financial statement line items of climate-related events, such as severe weather events, and of risks related to the transition to a low carbon economy, such as regulatory, market or competitive changes.
- When registrants include climate-related targets or goals, companies must disclose:
  - If a carbon offset strategy is used to achieve those goals and certain information relating to the purchased carbon offsets or RECs including the carbon reduction amount,
  - The time horizon by which the targets are intended to be achieved and whether progress is being made towards the goals.

Reporting of GHG emissions

- Scope 1+2 will be mandatory, scope 3 per company decision as included in metric mentions, or, if material, per definition:
  - As defined by the Commission and consistent with Supreme

Court precedent, 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.

  - The SEC has indicated that the materiality determination is largely fact-specific and one that requires both quantitative and qualitative considerations.
  - The Supreme Court has articulated, the materiality determination, with regard to potential future events, requires an assessment of both the probability of the event occurring and its potential magnitude, or significance to the registrant.

- The GHG emissions reporting proposals also recommend:
  - Exempting smaller companies from the Scope 3 reporting requirements,
  - Utilizing a longer phase-in period relative to Scope 1 and 2 disclosures, and
  - Including a safe harbor for liability for Scope 3 emissions disclosure.

Implications

- The disclosure proposals, if passed, will likely lead to considerable investment in tools and services by companies to track emissions.
- Enhanced standardization in the US will mean a convergence towards global standards adopted in the EU, UK, Asia, and ISSB.
- The proposals on climate-related risks and GHG emissions based on the TCFD and GHG protocol follow existing reporting regimes in the US, as supported by asset owners and asset managers.

Related Material

- Full Proposed Rule
- Fact Sheet
- Submitted Comments

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