

SEC's Proposed Climate Disclosures Would Bring the US into Line with Global Practices

'By mandating some climate-related information is filed, rather than furnished, with explicit measurements of Scope 1 and 2 GHG emissions backed by assurance, the SEC seeks higher visibility and credibility of climate disclosures. This is balanced by a more circumspect approach on Scope 3 emissions reporting, and a phased-in timeline for assurance on Scope 1 and 2 emissions.'

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The US Securities and Exchange Commission's (SEC) much-anticipated proposals for climate-related disclosures aim to align with existing or emerging practices in major jurisdictions. They propose to mandate a comprehensive set of disclosures on materially important impacts of climate-related risks on companies' operations and financial profiles.

Financial Materiality at Proposals' Core

Most importantly, the proposals focus on financial materiality that will require domestic and foreign, public companies registering and filing with the SEC to submit quantitative and qualitative statements on such issues as:

- Risks and opportunities from physical and transition climate risks on their business and profitability over various time frames;
- Transition plans (if any) and time-specific targets; and
- Greenhouse gas (GHG) emissions in absolute levels, with third-party assurance specifically for Scope 1 and 2 emissions data for larger entities.

The proposals represent a significant bolstering of climate-related reporting requirements in the US, both in relative terms (the SEC is starting from a largely voluntary and recommendations-based regime) and absolute terms (disclosures are mandatory, as opposed to the comply-or-explain approach adopted elsewhere).

According to the SEC, the aim of updating and strengthening climate-related disclosures is to enhance and standardise them for greater transparency and usability for investors, reduce information asymmetries, and lead to better asset pricing and allocation.

Challenges Lie Ahead

While these proposals clearly chart the SEC's intended direction of travel in relation to climate-related disclosures, the path to adoption and implementation could well stretch beyond the SEC's expected timetable of end-2022 for formal adoption. Proposals adopted following the consultation and subsequent updates may face legal challenges, creating uncertainty over the timetables.

In this report, Sustainable Fitch highlights how some of the main parameters of the proposals fit within the climate disclosure ecosystem and assesses the impact they may have on the voluntary carbon markets and net zero pledges, climate-related litigation and the rising importance of climate governance in the US.

ESG Disclosure Trends Reinforced by SEC Proposals

TCFD-centric Approach Is in Harmony with Other Jurisdictions

The proposals are the first major ESG disclosure requirement in the US. By endorsing and adopting the Task Force on Climate Related Financial Disclosures (TCFD) framework, the SEC is proposing to align climate related disclosures with other jurisdictions that have adopted, or have proposed to adopt, the TCFD, including:

- The EU's Corporate Sustainability Reporting Directive (CSRD);
- Japan's Financial Services Agency regulation for prime listed companies;
- The proposed (voluntary) disclosures by the newly formed International Sustainability Standards Board (ISSB), which also use the TCFD as the preferred disclosure framework; and
- The UK's mandated Climate-related Financial Disclosures for large companies from April 2022, with a goal of 'economy-wide' coverage by 2025.

The SEC's proposals suggest that harmonisation and alignment with global best practices was a guiding principle. It minimises the compliance burden for companies that may have already started gathering data and reporting information based on international frameworks. It also makes it easier for investors to compare the data and information released by US companies.

Lack of harmonisation in Environmental, Social, and Governance (ESG) and, specifically, the climate-related disclosures ecosystem has been a persistent challenge for investors. Prior to these proposals being released, US climate-related disclosures were based on guidance and were voluntary, even though other countries were moving towards mandatory disclosures. Investor and other stakeholder pressure has prompted US-based companies to introduce climate-related disclosures, largely on a voluntary basis thus far.

The SEC estimates that about a third of companies already publish some climate-related information. Most US companies use the Sustainability Accounting Standards Board (SASB) framework, which is being absorbed into the ISSB.

The SEC is also proposing alignment with the GHG Protocol, which established the definitions for Scope 1,2 and 3 emissions, as the pre-eminent GHG accounting standard. However, it is also worth noting that the SEC is recommending organisational boundaries (entities, operations, assets) for GHG disclosures are the same as those used in a reporting entity's consolidated financial statements; as opposed to the suggested approach under the GHG Protocol that is either attributing based on share of equity in an emitting operation (equity share approach) or share of control of an asset or entity.

In terms of where these disclosures will be made, according to the SEC's proposal, climate-related qualitative disclosures will need to be clearly captured in companies' annual reports. Climate-related financial statement metrics will need to be a part of a registrant's audited, consolidated financial statements.

Examples of ESG and Climate-Related Disclosures

Jurisdiction	Regulation	Disclosure topic	Company type	Disclosure type	Effective date
EU	Sustainable Finance Disclosure Regulation	Adverse principal impact – entity and financial product levels	Asset managers	Mandatory	June 2021
		Environmental or social – product level			
	Corporate Sustainability Reporting Directive	Environmental – climate change; water; resource use; pollution; biodiversity Social – equal work opportunities; working conditions; human rights Governance – sustainability strategy; corporate culture and ethics; political lobbying; internal control and risk	All listed companies All large companies Revenue >EUR40m, >250 employees, assets >EUR20m Banks and insurance companies	Mandatory	January 2023
US	SEC Climate Disclosure	Environmental – climate	SEC-registered companies (some exceptions)	Mandatory (proposed)	2024 phased-in (proposed)
Global	International Sustainability Standards Board	Environmental – climate		Voluntary	TBC (likely 2023)

Source: Sustainable Fitch

Financial Materiality Paramount for SEC, as Double Materiality Gains Ground

By way of comparison, similarities with EU disclosure rules extend to the mandatory nature of the proposal, the required assurance for some of the information, and the financial materiality approach that the SEC is adopting. This means considering the impacts of climate change and low-carbon transition on a company's business and financial prospects.

The main point of divergence, however, from the EU is that the EU Commission is also looking to mandate climate disclosures on the impacts a company's operations have on the environment – the so-called double materiality approach.

Double materiality is gaining more prominence as a framework for considering sustainability impacts, with the IFRS Foundation (which oversees the ISSB) in March 2022 announcing a collaboration agreement with standard setter Global Reporting Initiative (GRI), which specialises on sustainability impacts reporting. The objective of the partnership is that by aligning and coordinating their disclosure frameworks they will offer investors the means to assess climate-related impacts on enterprise value (ISSB), and, an organisation's impacts on the environment and society (GRI), in essence offering a double-materiality assessment framework.

While the SEC has not proposed adopting a double-materiality approach specifically, which in our view reflects caution around testing the limits of its mandate, the Scope 1 and 2 GHG emission assurance-backed disclosures it is proposing will nonetheless serve to highlight companies' environmental footprints. The comprehensive nature and, more crucially, standardised format of what the SEC is proposing in relation to Scope 1, 2 and (more limited) 3 emissions levels could be described as reporting, at least to a limited extent, of an entity's 'environmentally material' impact. This, in our view, does tilt part of the disclosure requirements towards double materiality, even though the SEC is not adopting that model or use the information in a way that will provide a materiality assessment in terms of environmental impacts.

Importantly, Scope 1 and 2 claims will need to be verified by an independent third party. This highlights the importance the SEC is placing on companies providing accurate information to investors, with high levels of accountability. The main objective of disclosing Scope 1 and 2 emissions is for investors to be able to gauge exposure of each reporting entity to transition risks, including regulatory changes, technological disruption, and changes in demand for products and services.

The SEC disclosures would require companies to report on GHG emissions and on a variety of climate-related financial metrics and qualitative disclosures, including:

- Climate-related risks and their material impacts on the registrant's business, strategy, and outlook;
- The registrant's governance of climate-related risks and relevant risk management processes;
- If the registrant uses an internal carbon price and how it is set;
- Impact of climate-related events and transition activities on the line items of consolidated financial statements, including estimates and assumptions;
- Scope 1 and 2 GHG emissions, broken out by GHG, in the aggregate, and in absolute (not including offsets) and intensity terms;
- Scope 3 emissions, only to be disclosed if material, or if the registrant has set a GHG emissions target that includes Scope 3; and
- Information on climate-related targets and transition plan, if any (including scope of targets, strategy to meet them, data on progress and on use of offsets).

Closer alignment with the ISSB, to lower compliance burden for companies that could be adopting this disclosure standard on a voluntary basis is an open-ended question for the SEC, likely to be determined following review of public responses to the consultation. Absorption of the Value Reporting Foundation (including SASB) into the ISSB means there will be a baseline of existing reporting by US entities that will align with the ISSB.

Attestation for Scope 1 and 2 Balanced by Exceptions for Scope 3

Scope 3 emissions are the largest source of indirect emissions by a company, defined as emissions along its value chains and use of its products. Reporting on Scope 3 remains the most challenging aspect of GHG emissions and one that companies most vociferously challenge when it comes to inclusion in disclosures, given the challenges they face on collecting and providing an accurate picture.

The SEC proposals take a circumspect stance on Scope 3 emissions, placing emphasis on 'material' rather than exhaustive Scope 3 disclosures and exempting smaller reporting companies. More limited Scope 3 disclosures seek to mitigate high administrative burdens and extra costs. However, the requirement to disclose Scope 3 emissions "if material" leaves room for interpretation as to where that threshold of materiality lies.

Required attestation and assurance by a third-party expert will be limited to Scope 1 and 2 emissions, while statements on Scope 3 emissions will be covered by 'safe harbour' legal and regulatory liability protections.

This could create incentives for companies to outsource emissions-intensive activities if this lowers their operational climate risk profile. At the same time, the proposed inclusion of Scope 3 emissions will create pressure on private companies to monitor and report emissions data to the public companies they service, given the former's increasing requirements to report on these.

The potential for regulatory arbitrage of these disclosure requirements in private markets is also high. Our research has previously explored how publicly listed power and mining companies under growing pressure to divest from emissions-intensive assets from activist investors sell assets but which then continue to operate under private equity ownership, thus only transferring ownership of GHG emissions.

The stipulations for Scope 1 and 2 are fairly thorough and will make imprecise or deliberately vague emissions accounting difficult by requiring disaggregating GHG emissions by gas type, reporting in absolute terms and not including carbon offsets.

If the proposed disclosures come into effect as planned, first reporting will come in 2024, covering the 2023 fiscal year. This means that companies, especially larger public companies, will need to begin planning for these disclosures soon. However, that deadline may be ambitious considering this may be challenged in courts or delayed due to a high volume of responses.

Even in this most ambitious of timeframes, disclosures from the US will somewhat lag UK and EU disclosures by a year or more in some cases. The UK is mandating climate risk disclosure rules (from April 2022) and EU's CSRD is due to be adopted by October 2022 and required from 2023. New Zealand is also requiring mandatory climate disclosure by 2023 and Hong Kong exchange is introducing mandatory TCFD disclosures by 2025.

Climate-Related Disclosures – Example Timelines (Assuming Adoption of SEC Proposals by End-2022)

Registrant Type ^a	Disclosure Compliance Date	
	All proposed disclosures, excluding Scope 3	Scope 3 and associated intensity metric
Large Accelerated Filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)
Accelerated and Non-Accelerated Filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)
Smaller Reporting Company	Fiscal year 2025 (filed in 2026)	Exempted

^a Size of registrant/filer subject to public float and revenue thresholds as defined by the SEC.
Source: Sustainable Fitch, SEC (Enhancement and Standardization of Climate-Related Disclosures, Fact Sheet, March 2022)

Climate Related Disclosures and Assurance – Example Timelines (Assuming Adoption of SEC Proposals by End-2022)

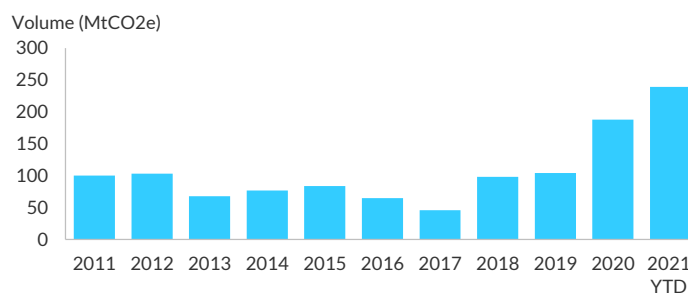
Filer Type ^a	GHG Disclosures – Scope 1 & 2	Limited Assurance	Reasonable Assurance
Large Accelerated Filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)	Fiscal year 2026 (filed in 2027)
Accelerated Filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	Fiscal year 2027 (filed in 2028)

^a Size of registrant/filer subject to public float and revenue thresholds as defined by the SEC.
Source: Sustainable Fitch, SEC (Enhancement and Standardization of Climate-Related Disclosures, Fact Sheet, March 2022)

Carbon Offset Disclosures Seek Accountability for Net Zero Strategies

Carbon offsets are gaining prominence as a means of achieving carbon neutrality by offsetting hard-to-abate emissions, but they have been subject to scepticism and criticism by investors and other stakeholders on their credibility and ultimately reported impact. Limited disclosure by organisations on the extent of their use of offsets (as opposed to actual GHG reductions) threatens the integrity of net zero pledges.

Market Size by Traded Volumes of Voluntary Carbon Offsets



Source: Fitch Ratings, Ecosystem Marketplace, Forest Trends

The SEC's climate disclosures would require much more granular information on the use of voluntary carbon offsets for companies that have publicly set climate related targets, including net-zero goals. If carbon offsets or renewable energy certificates (RECs) have been used as part of the company's plan to achieve climate-related targets or goals, information about the carbon offsets or RECs will be required. This would include the amount of carbon reduction represented by the offsets or the amount of generated renewable energy represented by the RECs.

The aim of the carbon-offset specific disclosures is to increase the transparency and comparability of net zero strategies, as investors and other stakeholders would be able to track the efforts of organisations to reduce their emissions against their level of offsets. This may indirectly improve the integrity of voluntary carbon markets and help them develop as a core and importantly more credible component of net zero strategies. Offset prices could rise in this scenario, particularly for higher-quality carbon offset projects.

Increased Disclosure Raises Litigation Risks

Recently we noted that ESG and climate-related litigation has been rising, with plaintiff strategies expanding in scope and ambition. The proliferation of disclosures and data is one of the drivers behind the increase in litigation as companies are encouraged, or mandated, to disclose their net-zero strategies, emissions data and transition plans.

Safe harbour provisions will apply to any forward-looking statements that the SEC mandate, offering protection from liability on the request to include “publicly set climate-related targets or goals”. Companies would therefore not be exposed to litigation risk for saying they plan to reach a certain emissions-reduction goal and then failing to meet the target. Scope 3 emissions will also be covered by safe harbour provisions, reflecting the high uncertainty associated with reporting these numbers.

Where litigation risks for fillers can become more pertinent is around disclosures required on existing and presumably known metrics by companies, in other words, metrics that report facts rather than projections/aspirations. The risks that those can be used in litigation by investors, non-government organisations (NGOs) or other stakeholders to either seek financial restitution or, as in *Milieudefensie et al. v. Royal Dutch Shell plc*, force a change in business strategy in relation to low-carbon transition can rise substantially.

The regulation may also increase litigation risk for companies if they have data discrepancies across different reports. In the US, sustainability reporting outside of annual reports or mandatory filings is not regulated. An investor or consumer could bring a legal challenge against a company if climate data disclosed to the SEC significantly differs from that presented elsewhere in voluntary ESG reporting or marketing material.

Climate Governance Becomes a Key Management Issue

If adopted in its current or near current form, the rules will represent a sea-change for how companies in the US consider, report, comply with and integrate climate-related risks and opportunities in their day-to-day operations. Requirements to disclose information about the oversight and governance of climate-related risks by the registrant’s board and management will make climate governance a priority for boards and executive teams.

While the SEC noted that a third of companies already report on climate-related issues, compliance with these new rules, including introducing third-party assurance, will almost certainly increase the time needed for reporting, notwithstanding alignment with TCFD, GHG Protocol and possibly the ISSB.

A Narrow Path Towards Adoption and Implementation

It is important to stress that while these proposals clearly chart the SEC’s intended direction of travel in relation to climate-related disclosures under its purview, the path to adoption and implementation may stretch beyond the SEC’s expected timetable of end-2022 for formal adoption.

After a 60-day consultation period (until late May 2022), the SEC will consider and respond to any important points raised. The proposals may then be amended, before being voted on by the four sitting commissioners, likely by end-2022 based on the announcements.

We understand that the final rules could be subject to legal challenges, from states, lobby groups or other entities, challenging whether the SEC has the mandate and authority to tackle climate issues, and/or around the definition of materiality. If such legal challenges materialise, there could be delays to adoption and implementation, subject to the nature, scope and extent of any legal challenge.

Implications for Other Sectors

The SEC noted that its proposed rules will not apply, at least initially, to asset-backed issuers, even though they also file and register with the SEC, while it considers how, to what extent and in what format the sector would need to make climate-related disclosures.

While sectors that are not registered with the SEC will not be affected by these disclosure proposals directly and as a first order, the direction of travel can influence how other regulators and authorities seek to approach climate-related disclosures in the US.

US municipal issuers are not registered with the SEC, although it regulates participants in municipal financings. However, they are exposed to the risks of transition and in particular physical climate risks.

The SEC’s Municipal Securities Rulemaking Board has recently indicated its interest in related matters through a Request for Information for public input on ESG practices in the municipal securities market. The request covered ESG-related risk factors, including a question of whether any ESG-related factors could pose a systemic risk to the municipal securities market.

While the time frame is expected to significantly lag the announced proposed requirements for publicly listed SEC-registered companies, and climate risk has been grouped within ESG-related matters, Fitch believes at a minimum, physical risk disclosure requirements for municipal obligations could be introduced.

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