Market Update

March 2022

SEC Proposed Climate Rule

The Securities and Exchange Commission (SEC) proposed rule would establish a new regulatory framework for climate disclosure. The proposal broadly aligns with the Task Force on Climate-Related Financial Disclosures (TCFD) framework: Governance, Strategy, Risk Management, and Metrics & Targets, and would standardize many elements of industry practices. Disclosure requirements will be phased in over the 2024 to 2028 filing years. Impacts will vary by company depending on current climate-related programs and filer status. SEC is taking comments until at least 20 May 2022.

Overview

The SEC's proposed rule marks a major milestone as the private sector, government, and many stakeholders respond to the fact that climate risk is also financial risk. Building on industry momentum since the 2017 release of the TCFD recommendations, the announcement would establish a new benchmark for standardized, investor-grade disclosures. The SEC's actions follow climate reporting requirements in other markets including the United Kingdom, European Commission, and New Zealand, and move climate-related risk / opportunity management and reporting firmly into the Chief Financial Officer's (CFO's) office with direct board and management oversight. As outlined in ERM's SustainAbility Institute report, Connecting ESG, Capital Markets, and CFOs, we recommend that companies and their CFOs leverage the structured TCFD framework to identify material climate-related risks and opportunities and determine their impact on financial performance. The proposed rule would codify this structure and companies should start preparing for a range of changes:

- The SEC proposal outlines a specific approach to mandatory reporting, but there are many steps before it is finalized and implemented. Final decisions on many elements including scenario analysis, Scope 3 reporting, and attestation will shape corporate planning and disclosure strategies.
- While the final details are uncertain, companies should prepare for more rigorous, quantitative climate impact measurement, analyses and investor-grade disclosure. CFOs and finance teams should be working with sustainability teams and others within organizations to prepare to report this information with the same analytical rigor, data quality, governance and controls as financial reporting.
- Based on ERM's experience across other markets, companies should prepare for much greater expectations from investors and other stakeholders. The framework outlined in the SEC proposal will not be the sole influencer for climate-related disclosures. The transparency and comparability supported by the SEC requirements will provide a gateway for report users to seek a deeper understanding of climate information including the narrative around Scope 1, 2, and 3 emissions data, climate risk & opportunity assessment and scenario analysis, and transition plans.

How ERM Can Help

ERM is a recognized leader for core elements of the SEC proposal. ERM was the sole consulting firm engaged by the G20 Financial Stability Board (FSB) TCFD. The approach to scenario-based disclosures drafted for TCFD by the ERM team was acknowledged by the FSB chair as "ground-breaking innovation." ERM's experts across North America and the globe support clients in evaluating and responding to climate-related risks and opportunities. From Scope 1, 2 and 3 inventories, gap analysis, transition, and physical risk scenario analysis to strategy development and disclosure, ERM is supporting clients across all phases of climate and TCFD-related analyses. Under the proposed rule, ERM CVS meets the GHG Emissions Attestation Requirements and is well positioned to conduct gap assessment, readiness to report, pre-assurance, and attestation and audit for our clients who will now be required to report.

Climate-related Risks

The proposed rules would require a company to disclose any climate-related risks reasonably likely to have a material impact on the company's business or consolidated financial statements. An impact is material if there would be a "substantial likelihood that a reasonable investor would consider it important when determining whether to buy or sell securities or how to vote." Determining materiality of future events would require an assessment of both the probability of the event occurring and its potential significance to the company. Companies would be required to consider risks over short-, medium-, and long-term time horizons, which will be defined by the company.

SEC defines “climate-related risks” as “the actual or potential negative impacts of climate-related conditions and events on a company’s consolidated financial statements, business operations, or value chains, as a whole.”

The proposal would require a company to specify whether an identified climate-related risk is a physical or transition risk:

- If a physical risk, the proposed rules would require a company to describe the nature of the risk, including whether it may be categorized as an acute or chronic risk as well as the location of the properties, processes, or operations subject to the physical risk, if material.
- For transition risks, the proposed rules would require a company to describe the nature of those risks, including whether they relate to regulatory, technological, market, liability, reputational, or other transition-related factors, and how those factors impact the company.

Impacts on Strategy, Business Model and Outlook

Companies would be required to disclose impacts on business operations, products or services, suppliers and other parties in their value chains, activities to mitigate or adapt to climate-related risks, expenditure for research and development, time horizons, and any other significant changes or impacts.

Companies would need to discuss how they have considered the identified impacts as part of their business strategy, financial planning, and capital allocation as well as how resources are being used to mitigate climate-related risks. The proposal would require companies to disclose the following climate-related practices and strategies if they are used by the company:

- Carbon offsets or renewable energy credits or certificates (RECs) – the role these instruments play in the company’s climate-related business strategy and anticipated short- and long-term costs
- Internal carbon price(s) – total price(s), boundaries for where and how price(s) is applied, and rationale for selecting the internal carbon price(s) and how it is used
- Transition plans to develop management strategies and roadmaps to mitigate or adapt to climate-related risks, as well as annual updates to transition plan disclosures to describe the actions taken towards achieving the disclosed goals and targets.
- Analytical tools, including scenario analysis, to assess climate-related risks on its business and consolidated financial statements, or to support resilience of business strategy or business model – scenarios considered as well as parameters, assumptions, and analytical choices, and the projected principal financial impacts on the company’s business strategy under each scenario.

Risk Management and Governance

The proposal would require a company to disclose, as applicable, certain information concerning board oversight of climate-related risks and management's role in assessing and managing those risks, including:

- Board members or board committees responsible for the oversight of climate-related risks, board members' expertise on climate-related topics, and if applicable, information on the scope and cadence of board-level discussions of climate risk and climate-related targets and goals.
- Management's role in assessing and managing any climate-related risks, including responsibility for assessing and managing climate-related risks, cadence of discussions, and expertise of the position holders or members.

Financial Statements Metrics

Certain climate-related data are proposed to be included in financial statements, and would be subject to Internal Control over Financial Reporting (ICFR) regulation under rule S-X. Narrative discussions of if, and how, climate-related risks have or are likely to affect financial statements are subject to rule S-K.

- Disclosure would be required for financial impact of any identified transition risk and any effort to reduce GHG emissions or mitigate exposure to transition risk.
- Reporting would include both negative impacts and climate-related opportunities yielding a positive impact. This data would be added to relevant line items in the financial statements for the current year and any historical years in the statement.
- The proposal would also require disclosure of aggregate amounts of expenditure expensed and capitalized costs incurred, which would be disclosed as a portion of the total recorded expenditure expensed/capitalized.
- The proposal sets a threshold for the financial impact and expenditure metrics. Impact less than 1% negative of the total line item would not require disclosure.

The SEC aims to create climate-related disclosure requirements that mirror financial reporting and accounting requirements wherever possible. Because the data in this subset of the overall disclosure is subject to ICFR regulation, it would be under the scope of any required audit and subject to audit by public accounting firms.

GHG Emissions Metrics

SEC leverages other frameworks and definitions in much of its approach to GHG emissions metrics, which is intended to ease the burden of compliance.

Data compiled for Environmental Protection Agency emissions reporting will be consistent with the disclosure obligations for the SEC and can be used in partial fulfillment of those obligations. The GHG Protocol definitions and calculation methodology are used in most respects, except Scope 3 materiality.

SEC notes that for Scopes 1, 2, and 3, a company must disclose its GHG emissions data in gross terms. Any offsets that have previously been included in calculations must be disclosed separately. If GHG emissions were previously disclosed with metrics of combined emissions and offsets, the company would be required to specify the offset amount going forward.

Scope 1 and 2 Emissions

The proposal requires disclosure of Scope 1 and 2 emissions from companies of all sizes, although there are important carve-outs and safe harbor provisions to reduce burden of compliance and to protect companies from undue liability. SEC draws from the GHG Protocol for the definition and calculation of Scope 1 and 2 metrics. The disclosure would be required both as aggregate metrics, and as disaggregated constituent GHGs. The proposal requires disclosure in terms of intensity, in the form of metric tons of carbon dioxide equivalent (CO_2e) per unit of total revenue and per unit of production for the fiscal year.

For larger companies, the proposed rule includes a requirement for an attestation report to cover Scope 1 and 2 disclosures. For the initial 2 years of the attestation requirement, only limited assurance would be required, followed by a change to a requirement for reasonable assurance in the years that follow. For guidance on which companies are subject to this provision, and the schedule for compliance, please see the table below.

Along with guidance on the process of assurance and attestation, the proposed rule includes requirements for minimum qualifications of GHG emissions expertise and independence requirements for the attestation service provider.

Scope 3 Emissions

The proposal would require a company to disclose Scope 3 emissions for two reasons:

- **Materiality**: If Scope 3 emissions are considered material to the company. The materiality requirement the SEC proposes using for GHG emissions is the same standard of financial materiality already under use in other types of disclosure. SEC states Scope 3 is material if it makes up a “relatively significant” portion of the company’s overall GHG emissions, but no quantitative threshold is provided.
- **Targets or goals**: If the company has already set a GHG emissions reduction target or goal that includes its Scope 3 emissions, it would be

required to disclose those metrics, whether or not Scope 3 is material for it under the SEC's definition.

SEC's intent is to require Scope 3 disclosure when it is related to investors' needs to track company progress on transition risk. Under the proposed rule, a company would need to identify the categories of upstream and downstream activities that were included in the calculation of its Scope 3, with required disclosure limited to value chain emissions that are material.

Financed emissions are included under Scope 3 emissions when considered material, but SEC stops short of proposing or recommending any particular methodology for calculation. Outsourced emissions would be included if the company previously conducted the outsourced activities as part of its operations.

Added Provisions to Address Scope 3 Challenges

SEC notes that it expects Scope 3 reporting and metrics to evolve in the coming years. Although disclosure is expected to become less difficult over time, Scope 3 is a challenging topic, especially in certain industries or company types.

Because of the challenges, the Scope 3 requirements take effect over several years and include a Scope 3 safe harbor provision that will extend to any reference to that disclosure related to S K in any document filed with the SEC. This provision is intended to shield reporting companies from liability derived from information originating with third parties in the value chain, and is especially relevant to scenario analysis, reliance on estimates, and forward-looking statements generally.

The proposed rule includes a number of other provisions to accommodate challenges presented in reporting Scope 3 emissions data, including disclosure of data by ranges. Specific guidance on approaches to handling data gaps and overlaps is also provided to ensure companies are providing sufficient rationale for such variation.

Disclosure of Historical Data

Consistent with the proposed rule for climate-related financial impact metrics, GHG emissions disclosure would extend to all years included in the company's consolidated financial statements for larger companies.

A company would not be required to provide a GHG emissions metric if it had not previously presented that metric for the previous year and calculating the metric would involve unreasonable effort or expense.

Disclosure of Targets and Goals

For any company that has disclosed climate-related goals or targets, the proposed rule includes specific requirements for disclosure of the scope and structure of that goal. Examples would include company commitments in line with the Paris Agreement goals to achieve Net Zero emissions by 2050, and similar pledges. Along with scope and structure, disclosure would include:

- Discussion of how the company intends to meet its climate-related targets or goals, and whether progress is already being made.
- If a climate-related goal or target has been set, but a path to the goal is not yet clear for the company, disclosure should discuss the development of any strategy and plan that management has developed for achieving its stated goal.
- Specifics on the amount of GHG reductions, if any, associated with carbon offsets and/or RECs, and discussion of the source and cost to the company of those offsets.

Reporting Forms

The proposed rules would apply to registrations of securities (the Form S-1 and similar), and annual reports (the Form 10-K and 20-F). In addition, the Form 10-Q would be used to report any material changes in the climate-related data that had appeared in annual reporting on the 10-K. The 10-Q would also be used in cases where full-year GHG emissions data could not be reported in the 10-K due to constraints of timing for GHG data analysis. The annual reporting by Foreign Private Issuers, primarily on the Form 20-F, would require the same approach to climate-related disclosures as for domestic issuers. Climate-related disclosures would be required to be tagged in Inline XBRL, to ensure filings are machine-readable.

Timelines

The proposed rules include phased compliance schedules for different company sizes. In general, the SEC has made an effort to accommodate the resource restraints that many smaller companies may face regarding climate-related data management and analysis.

The table below illustrates the timeline of progress for the SEC's 10-K filer definitions, based on the assumption that a given company does not change category during the years covered. Large Accelerated Filers have worldwide public float over $700M and Accelerated Filers are generally between $250M and $700M. Smaller Reporting Companies (SRCs) and Non-Accelerated Filers are defined by a combination of public float and annual revenue.

Table 1. Reporting Timelines

	GHG Scope 1 and 2; management narratives; financial metrics and financial metrics audit compliance; targets and goals (if applicable)	GHG Scope 3	Limited assurance for Scopes 1 and 2	Reasonable assurance for Scopes 1 and 2
Smaller Reporting Company (SRC)	3 years to comply	Exempt	Exempt	Exempt
Accelerated and Non-Accelerated Filer	2 years to comply	3 years to comply	3 years to comply	5 years to comply
Large Accelerated Filer	1 year to comply	2 years to comply	2 years to comply	4 years to comply

Source: SEC Proposed Rule

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