Stantec

Rationalizing the SEC's Enhanced Climate and ESG Disclosures

By: Sanjeev Kulkarni and Michael Mondshine
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This whitepaper will outline the 'who, what, why, and when' aspects of the noted enhanced disclosure provisions. The paper will speak to prevailing frameworks, standards, and regulations focused on climate, ESG, and sustainability and outline the potential benefits of rapid convergence. In addition, we will outline how these protocols provide requisite data and enable ecosystems to meet the SEC's disclosure requirements while aligning with stakeholder expectations.

The U.S. Securities and Exchange Commission (SEC) has yet to publish the final rules on Enhanced Climate and environmental, social, and governance (ESG) Risk Disclosures. However, the main provisions were summarized for the former in March 2022; and the latter in May 2022. The rulings require companies and investors to provide transparent and understandable risk disclosures that are financially material, decision-useful, and forward-looking to the 'reasonable' investor. Ultimately, by mandating enhanced disclosures for corporations and investors, the SEC is standardizing the basic reporting requirements for US-registered companies.

In mandating the enhanced disclosure requirements, the SEC wishes to standardize the climate disclosures in Form 8k, 10k, and other relevant sections by onboarding the principles of the Task Force on Climate-related Financial Disclosures (TCFD) framework adopted across sectors and international capital markets. The SEC also wishes to regulate the labeling of 'ESG-integrated, ESG-focused, and Impact funds' that market their 'green and/or sustainability' credentials to enhance data comparability and help investors differentiate between investment strategies. We are covering both rulings to provide a combined understanding of the regulatory changes in the ESG/climate disclosure space from a US perspective while being mindful of the more stringent requirements in the European landscape.

While The SEC's rulemaking is delayed, the International Sustainability Standards Board (ISSB) which now incorporates the Sustainability Accounting Standards Board (SASB) has developed sustainability standards that are widely used by companies for various disclosures. In addition, The European Financial Reporting Advisory Group (EFRAG) established by the European Union, has implemented a Corporate Sustainability Reporting Directive (CSRD) and is also at an advanced stage of rulemaking and adoption.

The three proposals–SEC, ISSB, and CSRD–align on TCFD principles, greenhouse gas (GHG) reporting (absolute and intensity terms), governance, scenario analysis and risk management. However, the CSRD standards are more prescriptive on Scope 3, double materiality, and timelines, and include private companies of significant size.

SEC's Enhanced Climate Disclosures

Current climate-related disclosures are inadequate and incomplete, not reflecting the future pricing of risks in securities, increasing the exposure to the 'reasonable' investor. The SEC rulings will require climate-related risks to connect to specific channels of financial impacts such as revenues, assets and liabilities, differentiated costs, and cost of capital (using enterprise valuation models). These disclosures will provide contextually relevant historical trends, prevailing risks in the reporting year, and future risks for medium and long-term pricing following the recommendations of TCFD.

The SEC does not prescribe specific accounting standards for filing non-financial disclosures; however, as indicated above, the ISSB standards have been adopted by many companies specific to climate and ESG implementation, performance, and disclosures. Based on the International Financial Reporting Standards (IFRS) standards, ISSB is widely accepted in Europe and internationally. There is also popular sentiment among investors that companies adopting the ISSB disclosure standards tend to tread the safe middle ground between the very prescriptive CSRD standards and the less stringent SEC requirements.

With the ISSB focused on a sector/industry-specific basis, sustainability data on specific topics, key performance indicators (KPIs), and management discussion and analysis (MD&A) are key disclosure components. As contained in the Technical Bulletin on Climate Risks (2022 revision), these align with the line items in the financial disclosures and enable peer comparisons.

The climate metrics and MD&A content in the ISSB standards for the relevant sector and industries will likely be appropriate for meeting SEC's climate disclosures. The enhanced disclosures also apply to the financial and investment portfolio exposures to physical and transition risks, as well as migration of capital to the low-carbon economy.

Enhanced ESG Labeling Disclosures

The ESG disclosure rules mandate that advisers, fund managers, and business development companies of such funds use evidence-based data on ESG policies, strategies, and integration to disclose the funds' ESG performance vis-à-vis committed impacts and present them along with forward-looking plans.

To regulate ESG investing, the SEC has a separate ESG/climate task force to enforce themed investment funds delivery on the stated ESG commitments to investors. Similarly, climate-focused funds are required to disclose portfolio GHG intensities among their KPIs. The SEC does not prescribe specific ESG integration standards.

The ISSB standards for the banking, insurance, and financial services (BIFS) sector and the ESG integration guidelines of the United Nations Principles of Responsible Investments (UN PRI) act as the industry standard for ESG/climate risk-adjusted tracking and disclosures in investments and securities.

SEC Enhanced Disclosure Schematic

The illustrated schematic describes the integration of climate-related risk disclosures and ESG labeling disclosures, in addition to how the ISSB and supporting frameworks are vital standards for compiling and reporting non-financial disclosures. They align companies and investors around ESG/climate factors linked to enterprise value creation, enabling consistency in ESG scoring, ranking, and comparisons for price-informed buy, sell, and hold decisions.

The enhanced integration of ESG/climate data into the financial channels enables the capture of risks and growth opportunities to adjust enterprise valuations. This increases the accuracy of non-financial reports, providing a better definition of the enterprise's intangible values not captured in the company's financial reports. Pairing sustainability reports and financial reports leads to better price discovery and market efficiencies.

By making the above disclosure requirements equivalent to the process followed in annual financial reporting, SEC-registered companies, and investors are forced to integrate enhanced climate and ESG risks and opportunities in their enterprise risk management (ERM) and risk appetite statements. Therefore, the same guidelines that apply for financial reporting to evaluate controls, risk management, and fraud deterrence developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) also apply to ESG/climate management and reporting at the board level.

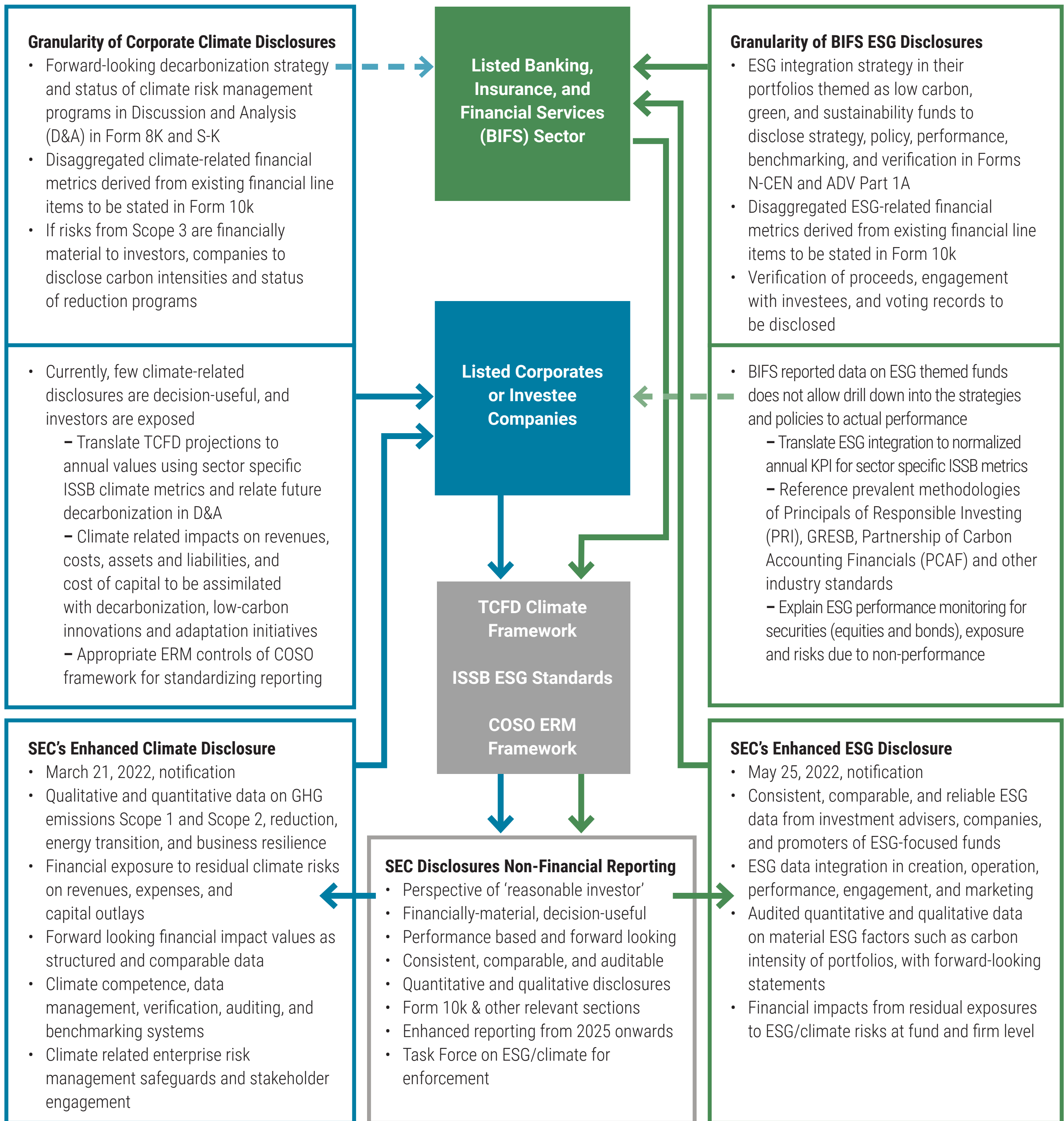
Implementing SEC Provisions

How do companies meet SEC's climate disclosure requirements beyond the current efforts of stating GHG emissions, updating mitigation/transition plans, writing off stranded assets, and including TCFD-based scenario analysis in their risk appetite statements? How can climate-risk-adjusted values in the financial line items reflect growth projections from future forays in the low-carbon economy? Since climate risks manifest differently for different sectors, SEC's mandate is for companies to standardize their disclosures to enable analysts/investors to compare and discover the market price.

While this could be a complex process, ISSB 2022 Technical Bulletin on Climate Risk provides quantitative and qualitative accounting metrics for various sectors that serve as a useful starting point. Numerous companies in the energy, extraction, and financial sectors are using standardized metrics in the financial impact channels to map line-item adjustments in their financial statements. Others in the food & beverage, infrastructure, manufacturing, and service sectors are aligning their data analytics and control systems to capture such details. The SEC recognizes that this effort is a significant enhancement to the historic disclosures and provides a ramp-up period to 2025.

On the specific issue of regulating ESG-labeled funds to ensure financially material disclosure of ESG integration and performance, the SEC's call for standardized disclosures is followed by many advanced ESG-integrated funds and climate/energy-themed portfolios. However, the passive ESG-themed index funds and other green securities will need to augment disclosures significantly to meet SEC's requirements.

SEC DISCLOSURES NON-FINANCIAL REPORTING



Examples of ISSB Metrics

Since the SEC does not prescribe enhanced metrics for climate disclosure and ESG labeling, we lean on the sector-specific sustainability standards of ISSB that have gone through multiple consultations and comply with the International Accounting Standards Board (IASB) followed in over 140 countries.

Enhanced Climate Disclosure – Refining Company

Below is an example of the quantitative and qualitative metrics for refineries that ISSB views as being 'financially material and complete'.

Three important points are:

- Scope 1 GHG emissions aside, water and biofuels are also topics of disclosure for climate risks
- Water usage, recycling, and availability have GHG emissions and need addressing
- Biofuel content in the blend lowers carbon intensity and requires disclosure

Refinery Example – ISSB Standards (Climate Risks)

GHG	Gross global Scope 1 emissions, percentage methane, percentage covered under emissions-limiting regulation	Quantitative	Metric tons of carbon dioxide (CO_2) equivalent, Percentage (%)
	Discussions of long-term and short-term plan to manage Scope 1 emission reduction targets and performance	Qualitative	N/A
Water	(1) total fresh water withdrawn; (2) percentage recycled; (3) percentage in regions with high water stress	Quantitative	Thousand cubic meters (m^3) Percentage (%)
Biofuels	Percentage of renewable volume obligation through (1) production of renewable fuels (2) separate purchase of renewable identification number (RIN)	Quantitative	Percentage (%)
	Total addressable market and share of market for advanced biofuels and associated infrastructure	Quantitative	Reporting Currency, Percentage (%)

Most refineries only report on GHG emissions and do not provide emissions associated with water use or decrease in carbon intensity due to biofuel additives. ISSB's prescriptive nature drives standardization and comparability for refining companies.

ESG Labeling - Asset Management Company

In the example below for an asset management company, merely stating the assets under management (AUM) by class does not satisfy the labeling requirements. The disclosure must include the investment philosophy, ESG integration process, proxy voting, and investee engagement policies and procedures. For instance, there would otherwise be the risk that ESG-themed index funds incorporate ESG during portfolio construction but lack active monitoring, which may result in the carryover of poor ESG performers in the fund.

Asset Management Example – ISSB Standards (ESG Labeling)

ESG Integration	Amount of AUM by asset class, that employ (1) Integration of ESG; (2) sustainability themed investing; and (3) screening	Quantitative	Reporting Currency
	Discussion of approach to incorporation of ESG factors in investment and/or wealth management processes and strategies	Discussions and Analysis	N/A
	Description of proxy voting investee engagement policies and procedures	Discussions and Analysis	N/A

The above examples show the sector-specific nature of ESG/climate topics and minimum disclosure requirements per ISSB standards. Nonetheless, companies are free to include additional data such as Scope 3 emissions in their climate disclosures, or in the case of ESG Labeled funds, include data such as Return on Social Investments to differentiate their value proposition to investors.

The adage that the 'devil lies in the details' truly applies to SEC disclosures. Given the legal ramifications, this requires careful forethought and planning to set the stage for SEC-compliant disclosures and sustainability reporting across various channels and international jurisdictions.