EXPLAINER | CONGRESSIONAL PROGRESSIVE CAUCUS CENTER

Strengthening the SEC's Proposed Climate Disclosure Rule

Last updated July 25 2022

Author:
Justin McCarthy, Climate Policy Associate (justin@progressivecaucuscenter.org)

Introduction

In March, the U.S. Securities and Exchange Commission (SEC) released a long-awaited proposed rule mandating corporate disclosure of climate-related financial risks.[1] This proposed rule is of enormous importance. It would require all publicly traded companies to disclose climate-related risks and annual greenhouse gas emissions, as well as their long-term plans to ensure solvency in a low-carbon economy. The SEC's proposed rule would raise awareness of the carbon bubble and provide investors — including everyday people with a retirement plan like a 401k, pension, or IRA — with the information they need to make climate-smart investments. This is essential since publicly traded companies are responsible for 40% of greenhouse gas emissions.

While the SEC's proposed rule represents a massive leap forward from current practices, which rely on companies' electing to make voluntary climate disclosures, there is more the SEC can do to strengthen this landmark rule. Specifically, the SEC should require companies to disclose indirect emissions. Those disclosures, of what are known as "Scope 3 emissions," would be made voluntary under the proposed rule, but are often a company's largest contribution to greenhouse gas emissions.

The SEC's Proposed Climate Disclosure Rule: An Overview

Under the SEC's draft rule, publicly traded companies would be required to begin disclosing their direct and indirect contributions to climate change in FY2024 — one year after the rule's proposed effective date.[2] Specifically, the SEC's proposed rule would require the following disclosures:

[1] U.S. Securities and Exchange Commission, "The Enhancement and Standardization of Climate-Related Disclosures for Investors," 87 FR 21334 (March 21, 2022).

[2] The proposed rule would establish enhanced disclosure requirements for all SEC registrants but excludes registered investment companies and asset-backed issuers. The SEC released a parallel proposal covering investment funds in May.

- Scope 1 emissions, which cover direct emissions from owned or controlled sources;
- Scope 2 emissions, which cover indirect emissions from the generation of purchased energy;
- Scope 3 emissions, which cover all other indirect emissions that occur upstream or downstream in a company's value chain;
- The oversight and governance of climate-related risks by the company's board and management;
- How climate-related risks that are reasonably likely to have a material impact may affect a company in the short, medium, or long term;
- Climate-related targets, if the company has set any such targets (e.g., emissions reductions, conservation, water usage, etc.);
- The company's processes for identifying, assessing, and managing climate risks (e.g., rising sea levels, wildfires, etc.) and how those processes fit into overall risk management.

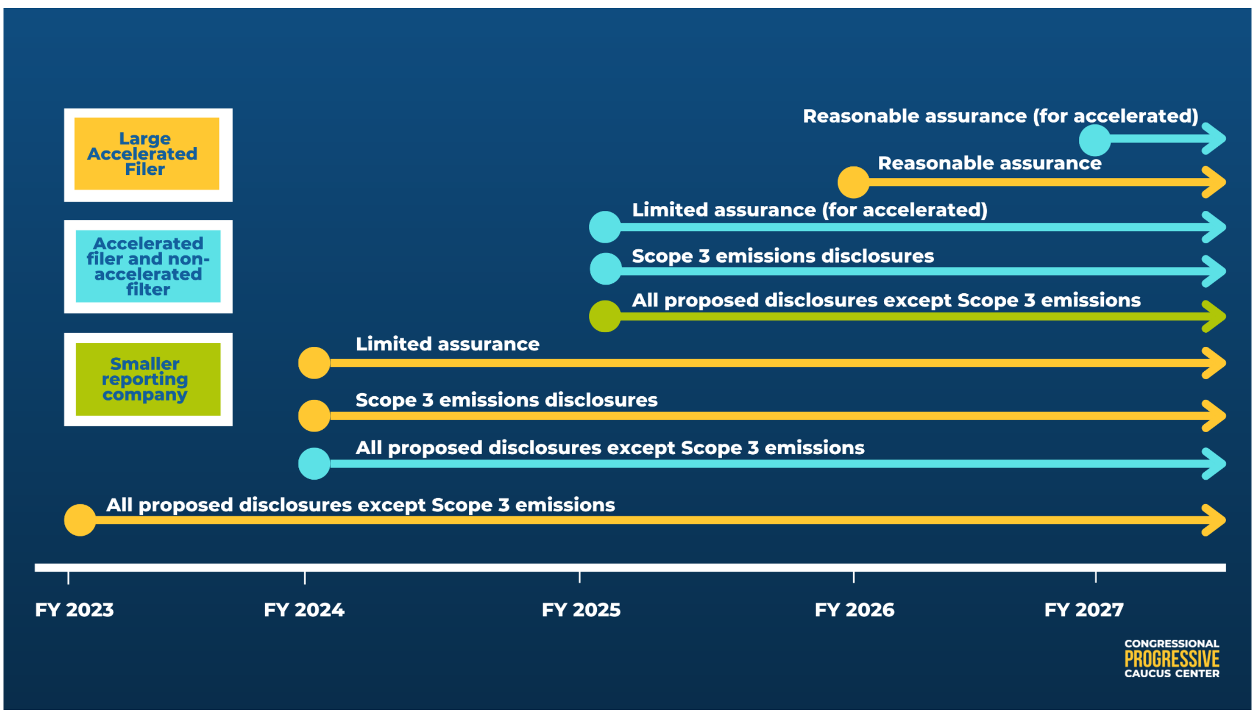
Figure 1

In the case of a fossil fuel company, Scope 1 emissions would include emissions from making a barrel of oil or running a refinery, while Scope 2 includes emissions from the electricity the company uses to power its corporate offices. If they purchase power from a coal plant, for example, those emissions would be considered Scope 2. The emissions created from actually burning the barrel of oil the company produced would be Scope 3 emissions. For companies that sell polluting products, Scope 3 emissions are both substantial and unavoidable. Scope 3 emissions of some oil and gas companies are estimated to exceed 75% of their total emissions.

Under the SEC's proposed rule, Scope 1 and Scope 2 emissions must be separately disclosed and expressed in absolute terms (excluding offsets). These disclosure requirements would be phased in beginning in FY2023, with small and mid-size companies provided additional time to meet disclosure mandates. For large companies, Scope 1 and 2 emissions disclosures would also require verification by a third party to ensure the reliability of reporting (a “reasonable assurance” opinion).[3]

In contrast, disclosure of [Scope 3 emissions](#) would not apply to smaller reporting companies.[4] In the case of large companies, the disclosure of value-chain emissions would only be required if those emissions are (1) "material" or (2) if the registrant has set an emissions reduction target that includes Scope 3 emissions. In determining materiality, the SEC explains that companies should consider whether Scope 3 emissions are a “relatively significant portion” of their greenhouse gas emissions that would impact the decision-making of a reasonable and informed investor. As an example, the SEC notes that Scope 3 emissions are likely to be material for the auto industry, oil and gas companies, and the power sector.

Figure 2: Implementation Dates By Type Of Filer



---

[3] The proposed rule states that "a reasonable assurance opinion provides positive assurance that the subject matter is free from material misstatement" and that reasonable assurance is equivalent to the level of assurance provided in an audit of a registrant’s consolidated financial statements included in a Form 10-K. The proposed rule describes limited assurance as equivalent to the level of assurance provided with respect to a registrant’s interim financial statements included in a Form 10-Q.

[4] Under the SEC's proposed rule, Smaller reporting companies (SRCs) would be exempt from disclosing Scope 3 emissions (defined at 17 CFR § 229.10).

The requirements of the proposed rule are consistent with the SEC's legal authority to require disclosures that ensure investors are informed of the information they need to make sound decisions. It also builds on past disclosure requirements, including guidance issued in 2010 clarifying how the SEC's existing disclosure requirements apply to climate change matters.[5] Since then, "Environmental, Social, and Governance" (ESG) investing has grown exponentially, with sustainable investing now accounting for 33% of total U.S. assets now under professional management.

Climate Disclosure: A Growing International Trend

The SEC's proposed rule is an especially important step in bringing the U.S. into alignment with the growing number of countries in the process of enacting climate disclosure protocols. Last year, New Zealand became the first country in the world to pass rules requiring corporate climate disclosure, and in January, the U.K. became the first Group of 20 country to make the reporting of climate-related risks mandatory for publicly-traded companies. Beginning in 2023, Hong Kong and Singapore — which already require climate reporting — plan to institute enhanced disclosure rules far surpassing the SEC's current proposal.

The SEC's proposed rule draws heavily on the "four pillar" disclosure framework developed by the Task Force on Climate-related Financial Disclosures (TFCD) in 2017.[6] These recommendations covered the accounting and reporting of seven greenhouse gasses in accordance with Greenhouse Gas Protocol (GHGP): carbon dioxide; methane; nitrous oxide; hydrofluorocarbons; perfluorocarbons; sulfur hexafluoride; and nitrogen trifluoride. All seven of these GHG emissions are included within the scope of the SEC's proposed rule.

Strengthening the SEC's Climate Disclosure Rule

Although the SEC's proposed rule takes critical steps to protect investors from climate-related risks and strengthen transparency, there are four concrete steps the SEC can take to strengthen their rule. Most importantly, the SEC must make the disclosure of Scope 3 emissions mandatory for large companies. Scope 3 emissions often account for the majority of a company's emissions, but the SEC's proposed rule would allow many companies to evade this disclosure.

As noted above, disclosure of these value-chain emissions would be voluntary unless a company deems them "material" or the registrant has set a public Scope 3 target.

[5] 15 U.S.C. § 78l(b)(1). The Securities Act and the Securities and Exchange Act authorize the SEC to require disclosures that are "necessary or appropriate in the public interest or for the protection of investors."

[6] The Task Force on Climate-related Financial Disclosures (TFCD) is a 32-country multilateral organization founded in 2014 to improve and increase reporting of climate-related financial information.

The SEC threshold for materiality — if climate affects more than 1% of any line item (e.g., inventories, revenue, or long-term debt) — is quantitatively lower than what the market generally thinks of as material, the conceptual level governing what companies are supposed to reveal on the basis of being important information to investors. This loophole allowing registrants to self-determine which emissions are material could result in an estimated 75% of overall greenhouse gas pollution going unreported.

Second, the SEC's proposed rule includes a safe harbor clause that Scope 3 disclosures made without reasonable assurance by an independent verifier would be deemed not to be fraudulent unless it can be shown the statements were made without a reasonable basis or disclosed other than in good faith. This safe harbor provision was included on the grounds that Scope 3 data may be unreliable or unavailable. However, numerous companies are currently disclosing Scope 3 emissions and successfully navigating the associated data acquisition and accounting challenges. For companies that encounter data challenges, the SEC's regulations could still be crafted to be flexible enough for them to describe their Scope 3 emissions as a range of values and disclose reasons for the lack of data. Such a requirement would not be unduly burdensome. The SEC's proposed Scope 3 accounting and reporting standards were developed more than a decade ago (in 2011) and are already used by thousands of companies worldwide.

Third, the SEC's proposed rule does not take into account the impacts of climate change on Native and environmental justice communities. When climate-related disasters strike, these communities are often the most impacted. For example, from 1964 to 1992 oil company Texaco deliberately discharged billions of gallons of toxic water into the Amazon rainforest. Since then, the Ecuadorian Secoya people throughout that region have suffered thousands of excess cases of cancer and other health problems. In the U.S., African-American communities in Louisiana's "Cancer Alley" continue to face severe health impacts caused by the local petrochemical industry. Understanding and disclosing climate and health impacts on the communities they operate in must be a reporting requirement for companies.

Finally, the SEC's implementation timeline for third-party attestation reports — until fiscal year 2027 for accelerated filers — is unnecessarily protracted considering some are already offering limited and, in some cases, reasonable assurance of greenhouse gas emissions reporting.[7]

[7] The SEC's proposed rule would require that by FY2027 disclosures of accelerated filers be evaluated and assured by third parties, in a manner similar to the requirements on assurances made for corporate financial reporting.

Conclusion

The SEC's proposed climate disclosure rule is a tremendous victory for financial transparency — investors have a right to know how companies plan to remain solvent in a low-carbon economy. The current practice of relying on companies' voluntary climate disclosures is inefficient, costly, and fails to provide investors with the information they need to make informed decisions. However, there are key steps that the SEC can take before finalizing the rule to enhance its effectiveness further. This includes making disclosure of Scope 3 emissions mandatory for large companies, eliminating or sunsetting the safe harbor clause, and expanding companies' required reporting of their impacts on Native and environmental justice communities.

CPC Center thanks Evergreen Action, and Public Citizen for their comments and insights.