IN SUPPORT OF SEC RULEMAKING ON CLIMATE-RELATED DISCLOSURE

While the SEC continues to evaluate comments received on its proposed climate-related disclosure rulemaking (*see* my previous briefing note, available here and the SEC's proposing release), an increasing number of voices, buoyed by the Supreme Court's decision in June in what is now generally referred to as the EPA case, are taking issue with the propriety of the SEC mandating climate-related disclosures. In light of these challenges, I think it is useful to reiterate the arguments in support of the SEC undertaking most recently advanced by SEC Commissioner Caroline Crenshaw at the Inaugural ECGI Responsible Capitalism Summit in Brussels.[1] In her speech last week, Commissioner Crenshaw set out what the SEC's motivations, and hence objectives, are and, more importantly what they are not. She also makes the case that, because investor demand and the markets have evolved well past the world envisioned by those seeking to roll back legislative efforts in the climate space, the SEC, in fact, is moving in parallel with what investors and the markets expect. It is an effort that must succeed.

SEC Objectives and Motivations

Let us start with what the SEC is not trying to do. As Commissioner Crenshaw sets out, the SEC is not trying to reimagine capitalism or the corporate form. It is not trying to take a position on, let alone influence the outcome of, ongoing debates as to whether business, as a matter of governance, should advance stakeholder interests versus shareholder interest. It is not seeking to promote a social equity or a civic agenda. It is not trying to impact climate change, by accelerating the transition to a net zero economy or otherwise, or to achieve a particular climate outcome. It is neither seeking, by regulation or otherwise, to modify climate-related behavior of public companies, nor is it engaged in climate-related policymaking. It is not seeking to usurp the role of a board of directors or management in addressing the range of issues a registrant may face, and it is not making materiality decisions for registrants. From the SEC's perspective, it is irrelevant whether registrants have embraced a sustainability strategy or not.

Also, the SEC is not an outlier among global securities regulators once it published its proposed rulemaking last March. On the contrary, the SEC is very much in line with EU and UK regulators, albeit regulators have taken different paths in certain defined areas.

Finally, the SEC is not a lone voice in the wilderness. To the contrary, there is significant support for the SEC to propose climate-related disclosure requirements (in the words of former Commissioner Lee, an "overwhelming majority of [first-round] comments") from investors, registrants, accounting firms, lawmakers, academics and third-party standard setters. The SEC, in its proposing release, cites a number of examples of investor initiatives undertaken to urge companies to provide more useful information about the impact that

[1] The SEC will miss its own October deadline to promulgate final climate-related disclosure rules. Presumably this is due to the need to sift through voluminous comments and also take account of the decision in the EPA case. A technical glitch meant that the comment period was extended to November 1. The gating items may well be the rules relating to Scope 3 emissions and quantifying the financial statement impact of climate-related matters (with a 1% materiality threshold).

climate change has had, or is likely to have, on their businesses and to urge governments and companies to take steps to reduce the exposure of investors to climate risk. These include:

- the 2021 Global Investor Statement to Governments on the Climate Crisis, which had 733 investors collectively managing over $52 trillion in AuM;
- the 2022 Global Investor Statement to Governments on the Climate Crisis, which has been submitted to COP27 with 602 investor signatories representing close to $42 trillion in AuM (coordinated with the seven founding partners of the Investor Agenda, namely the Asia Investor Group on Climate Change, Ceres, CDP, the Institutional Investors Group on Climate Change, the Investor Group on Climate Change, Principles of Responsible Investing and the UN Environment Programme-Finance Initiative);
- the UN Principles for Responsible Investment, which represented as of the end of 2021, 609 asset owners ($121.3 trillion of AuM) and 3,826 signatories;
- the UN-convened Net Zero Asset Managers Initiative, representing 299 signatories with $68 trillion of AuM;
- Climate Action 100+, representing 700 investors with $68 trillion in AuM; and
- the Glasgow Financial Alliance for Net Zero, representing over 100 financial institutions.

And, in the vacuum created by the absence of a single set of global disclosure standards, the following have issued/will be issuing their own standards:

- the Global Reporting Initiative ("GRI")
- CDP (formerly the Carbon Disclosure Project);
- the International Sustainability Standards Board, which consolidated the Climate Disclosure Standards Board as well as the Value Reporting Foundation (formed through a merger of the Sustainability Accounting Standards Board ("SASB") and the International Integrated Reporting Council); and
- the Task-Force on Climate-related Financial Disclosures ("TCFD"), which reports it has 4,000 "supporters" (organizations that believe the TCFD recommendations provide a useful framework to increase transparency on climate-related risks and opportunities within financial markets).

As to what the SEC is trying to do, simply put, goes to the heart of its longstanding mandate – to protect investors and the markets by ensuring that the disclosure provided by registrants meets the standards set for all public disclosures. And, as investors and the markets seek out and use climate-related information to drive investment decisions, the SEC legitimately needs to create a standardized framework for consistent, comparable, decision-useful disclosures. The SEC is not trying to impair free speech and, in fact if its climate-related disclosure rules were deemed to impair free speech, then its entire mission since 1933 would be suspect.

The Markets Are Acting, and Speaking

Public companies are setting out climate-related goals and commitments, and they are providing disclosure, often with reference to TCFD guidance or the GHG Protocol (*see* my previous briefing note, available here). To date, this is voluntary and haphazard.

Goals/Commitments

According to an article published in August by Jonathan Goddard in the Harvard Business review[2], more than 700 of the largest 2,000 publicly traded companies have made net zero commitments, with 59 of the FTSE 100 committing to net zero emissions by 2050. Two-thirds of the S&P 500 have set emission reduction targets of some kind. The survey confirms that the leaders surveyed are serious about sustainability. Public company executives (54%) are even more willing than the overall survey population (51%) to address ESG issues even if that reduces short-term financial performance. Fifty-one percent of the leaders surveyed view ESG as a growth driver. Another 20% focus on ESG in the context of innovation. They are backing up their commitment with investment. According to survey respondents, the major focus for action and investment over the next five years is "sustainable services/products and their distribution."

Honeywell in collaboration with Futurum Research found, in preparing the Environmental Sustainability Index Q4 2022 (which measures key trends pertaining to global efforts in climate change mitigation and other sustainability initiatives), that when asked to rank or prioritize corporate initiatives over the coming six months, 65% of respondents cited sustainability as among their top five goals, with 80% of respondents reporting that their enterprise had established sustainability targets for energy evolution and efficiency, 59% cited emissions reductions, 58% cited pollution prevention and 49% cited recycling and circularity. Nine out of ten companies report they will increase their sustainability budgets over the coming 12 months, with approximately 40% reporting increases in sustainability investments of over 20%.

The World Economic Forum's Global Risks Report 2022 lists among the ten most severe risks on a global scale over the next decade reported in its annual survey, climate action failure (#1), extreme weather (#2), biodiversity loss (#3), human environmental damage (#7) and natural resource crises (#8). The report notes that "governments, businesses, investors and communities are increasingly converging on the need for a quicker transition—each group setting higher expectations of the other."

Corporate Disclosure

From a disclosure perspective, in light of the pervasive impact of climate change on business and society, corporate strategies may well have a climate component, either because climate is addressed or because climate is not addressed (in effect, doing nothing is a decision). An increasing number of registrants are making climate disclosures, and investors are making investment decisions on the basis of that information.

Commissioner Crenshaw reiterated SEC staff estimates (included in the March 2022 proposing release) that, between 2019 and 2020, 33% of all public company annual reports contained climate-related disclosure (albeit a greater proportion came from non-US registrants, and large accelerated filers were more likely than accelerated filers and non-

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[2] Based on research by L.E.K. Consulting (of 400 global C-suite and senior executives of companies in a range of industries and at a variety of scales, including 28% with annual revenue over $10 billion) of which the author of the article is a partner.

accelerated filers to address climate).[3] The SEC staff made reference to a study that, while 35% of Russell 3000 companies provided climate-related information in 2006, that figure grew to 60% in 2020. In 2009, Russell 300 firms mentioned climate risks 8.4 times on average in their annual reports. In 2020, the figure was 19.1 times.

The proposing release also notes that:

- a survey of 436 companies across 17 sectors conducted by the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness (CCMC), in collaboration with several other organizations, found that 52% of respondents are publishing corporate social responsibility, ESG, sustainability or other similar reports (with a majority of these being outside SEC filings, and the most frequent topic is emissions); 34% disclose climate change, GHG emissions or energy sources in their SEC filings (typically in the risk factors);
- a 2021 survey conducted by the Governance & Accountability Institute ("G&A") found that, in 2020, 70% of Russell 1000 companies and 92% of S&P 500 companies published a sustainability report;
- the CDP reported that out of 524 US companies in their Climate High Impact Sample, 402 disclosed through the CDP system, and 22.1% of these companies reported Scope 3 data in 2021; and
- a study referred to in a *Wall Street Journal* article found that two-thirds of S&P 500 companies have set a target for carbon emissions

The surge in corporate disclosures gives rise to two issues. The first is that disclosures lack consistency, vary as to specificity and are located in different places – all of which greatly complicate comparability. The 2021 G&A study found, for example, that companies used a range of metrics, including GRI standards, SASB standards, TCFD recommendations and specific UN Sustainable Development Goals. They also had different approaches to external assurance.

The second issue is that there is gap, potentially widening, between aspiration and reality. The Honeywell study reports that only one-third of respondents are extremely optimistic their enterprises will achieve their sustainability goals over the coming 12 months, and under 40% are extremely optimistic their enterprises can achieve their 2030 targets. The L.E.K. research suggests that many organizations are struggling to deliver on their commitments – 51% reported that they were willing to trade off short-term financial performance to their achieve long-term sustainability goals, but 58% report their organizations are unable to agree on what the trade-offs should be and that the more that leaders try to operationalize sustainability, the more they find their organizations are ill-equipped for the task, out of alignment and lacking essential skills and metrics.

Both of these trends underscore the need for enhanced disclosure requirements – first, from an external perspective, to ensure that investors understand the direction of travel of the

[3] Natural language processing analysis suggested that climate disclosures falls into four categories: business impact, emissions, international climate accords and physical risks. Firms in electric services, oil and gas, steel manufacturing, passenger air and air freight, and maritime transportation have the most ample climate-related discussion, on average. The majority of disclosures focus on transition risk rather than physical risk.

companies in which they are investing and, second, that investors have the means, based on consistent, comparable and decision-useful metrics, of making comparisons among those companies.

There is also an internal imperative, by reasons of the fact, as Jonathan Goddard notes, that "putting sustainability at the heart of strategy requires analysis of financial and non-financial benefits of the strategic choices to achieve ESG goals, as well as an understanding of the many risks — energy cost, supply chain factors, regulatory risks, and risk to reputation — inherent in ESG reporting." Leaders are aware of these risks, but often lack metrics or KPIs to track progress – only a quarter (27%) of companies have any enterprise wide ESG KPIs in place, and fewer still have a full set in place (just 3%).

Concluding Thoughts

It is unfortunate that, while the planet faces an existential threat, politics intrude. Politics intruded in the form of zero Republican support for the Inflation Reduction Act (*see* my previous briefing note, available here). Republican lawmakers are challenging (*see, e.g.*, Kennedy and Toomey) in various waves the SEC's authority to promulgate any climate-related disclosure requirements, suggesting that existing disclosure requirements are sufficient.

Ironically, as Commissioner Crenshaw noted, as more companies move from risk mitigation to capitalizing on the opportunities presented by the incentives under the Inflation Reduction Act for households and businesses to transition to more sustainable practices and activities, climate-related disclosure will be yet more important to investors. While one can legitimately take issue with aspects of the SEC's proposal, challenging the entire exercise is out of step with the disclosure programs in the European Union[4] and the United Kingdom, and out of step with the laser-like focus of investors on climate and the growing awareness among business leaders of the need to confront the threats posed, as well as seize the opportunities presented, by the transition to net zero.

As I note above, one can legitimately take issue with certain of the approaches proposed by the SEC. That said, those are details, but the overall disclosure framework is a critically

[4] The pending EU Corporate Sustainability Reporting Directive (when transposed into national law) will impose on approximately 49,000 companies mandatory climate-related disclosure, including US companies with significant operations in the European Union (*see* my previous briefing note, available here).

important.[5] The urgency of the climate crisis should compel the SEC to vote on its final rule as soon as possible, and business leaders should support this effort.

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[5] I have set out in various briefing notes why urgent action is needed: UN reports. Unpacking net zero, April IPCC report, February IPCC report and Climate change by the numbers.