# REVIEW OF THE SEC'S PROPOSAL OF "ENHANCEMENT AND STANDARDIZATION OF CLIMATE-RELATED DISCLOSURES FOR INVESTORS"

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*Executive remuneration today is driven by incentives that may no longer align with shareholder interests or reflect broader societal responsibilities.*

*Reward Value Foundations' mission is to support the development of remuneration policies that contribute to long-term sustainable and inclusive value creation. The Foundation seeks to further the debate on executive remuneration with investors, business schools, and the business community at large to develop evidence-based, long-term, sustainable, and stakeholder-inclusive executive remuneration policies.*

*Reward Value Foundation is a not-for-profit research initiative. Reward Value can be reached by email (contact@rewardvalue.org). For more information on Reward Value please visit our website www.rewardvalue.org.*

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On March 21st, 2022, the United States Securities and Exchanges Commission (SEC) issued a formal proposal to implement and standardise climate-related disclosures by U.S. registered companies.[1] The proposed amendments to the Securities Act and the Exchange Act aim to protect both investors and issuers by improving the accessibility of "consistent, comparable, and decision-useful information" for investors, while mandating a series of disclosures that will leave issuers less vulnerable to climate-related litigation.[2] This review paper from Reward Value Foundation (RVF) seeks to analyse the content of the SEC proposal as well as its context, analysing the numerous forces currently shaping climate-related corporate governance trends and regulation in the United States. It also examines the proposal's missed opportunity for encouraging long-term-value-linked executive remuneration frameworks, discussing the domestic factors that led to this omission. This report will be complemented by a future response from RVF before the conclusion of the comment period.

Upon review of the proposal, RVF praises the SEC's significant leap forward in ensuring that companies operating in the United States are transparent regarding climate-related risks and opportunities, and that investors can make sustainable, climate-friendly decisions. Building upon SEC guidance released in 2010 concerning the growing relevance of climate change in business practices, the adoption of the proposal would mark the Commission's first set of regulatory actions to inform investors of the climate-related risks and opportunities that businesses encounter.[3] Despite the introduction of new emission-related domestic legislation, international accords, and advancements in ESG corporate governance practices, the United States has experienced a twelve-year gap in regulatory guidance. This has contributed to the development of piecemeal and often discordant disclosure frameworks among companies operating in the United States, all in the shadow of the rapid deterioration of the climate's stability. If the proposal is adopted, the SEC would be providing much-needed leadership to companies and investors desperate for uniformity in the adoption of ESG-linked corporate practices. As the United States is the world's largest corporate economy, the impact of the proposal's adoption would be truly momentous, contributing to sustainable, long-term-value-driven corporate behaviour on a global scale.

Furthermore, we welcome the proposal's discussion of ESG-linked executive remuneration and its request for public comment regarding its relevance.[4] Reward Value Foundation recommends that the SEC undergo further consideration of a disclosure requirement asking a company to declare any links between executive remuneration and the creation of sustainable, long-term value. Current SEC regulation mandates the disclosure of "all material elements of a registrant's executive compensation, including the objectives of

[1] Securities and Exchanges Commission (2022) https://www.sec.gov/news/press-release/2022-46.
[2] Ibid.
[3] U.S. Securities and Exchanges Commission (SEC) https://www.sec.gov/rules/proposed/2022/33-11042.pdf p. 13-14.
[4] Ibid., p. 104.

the registration's compensation programs and what each compensation program is designed to reward".[5] This existing framework thus guarantees that companies disclose their executive remuneration frameworks, irrespective of their linkage to climate-related risks or other ESG-oriented goals. However, the downward pressures on registrants that would accompany a mandated disclosure of executive remuneration linked to long-term value creation could encourage companies to better view the climate transition as a chance for not only adaptation in corporate governance practices, but innovation as well. Incorporating climate-related performance criteria in executive remuneration, addressing material environmental issues, will further align executives to corporate purpose. It is important that companies put their money where their mouth is and therefore demonstrate their commitment to climate through related capex investments, R&D investments, and executive remuneration design.

## PROPOSED DISCLOSURE REQUIREMENTS

The SEC cites two major inspirations for the proposal. Firstly, the 2017 Task Force on Climate-related Financial Disclosures (TCFD) Principles, created by the Financial Stability Broad, laid the foundation for developing "consistent climate-related financial risk disclosures for use by companies, banks, and investors in providing information to stakeholders".[6] Secondly, the GHG Protocol "establishes comprehensive, standardise frameworks to measure and manage greenhouse gas emissions from private and public sector operations, value chains and mitigation actions".[7] Its three-tiered scope system allows actors to effectively organise their greenhouse gas emissions. Specifically, Scope 1 refers to the direct emissions from the controlled resources of the company, Scope 2 refers to indirect emissions arising from purchased energy sources, and Scope 3 refers to any emissions linked to a company via the supply chain, both upstream and downstream.[8]

The eight proposed requirements would mandate the disclosure of both quantitative and qualitative climate-related data to the SEC, including records of greenhouse gas emissions and substantive company strategies for mitigating climate-related risks. The proposed disclosures are as follows:[9]

[5] Ibid., p. 102.
[6] "TCFD - Task Force on Climate-related Financial Disclosures". UNEPFI. https://www.unepfi.org/climate-change/tcfd/.
[7] Greenhouse Gas Protocol. https://ghgprotocol.org/about-us#:~:text=What%20is%20GHG%20Protocol%3F,value%20chains%20and%20mitigation%20actions.
[8] U.S. Securities and Exchanges Commission (SEC) https://www.sec.gov/rules/proposed/2022/33-11042.pdf p. 41.
[9] Ibid., p. 44-45.

*Section E*

*Subsection 1: Content of the Proposed Disclosures*

1. *The oversight and governance of climate-related risks by the registrant's board and management*
2. *How any climate-related risks identified by the registrant have had or are likely to have a material impact on its business and consolidated financial statements, which may manifest over the short-, medium-, or long-term*
3. *How any identified climate-related risks have affected or are likely to affect the registrant's strategy, business model, and outlook*
4. *The registrant's processes for identifying, assessing, and managing climate-related risks and whether any such processes are integrated into the registrant's overall risk management system or processes*
5. *The impact of climate-related events (severe weather events and other natural conditions as well as physical risks identified by the registrant) and transition activities (including transition risks identified by the registrant) on the line items of a registrant's consolidated financial statements and related expenditures, and disclosure of financial estimates and assumptions impacted by such climate-related events and transition activities*
6. *Scopes 1 and 2 GHG emissions metrics, separately disclosed, expressed both by disaggregated constituent greenhouse gases and in the aggregate, and in absolute and intensity terms*
7. *Scope 3 GHG emissions and intensity, if material, or if the registrant has set a GHG emissions reduction target or goal that includes its Scope 3 emissions*
8. *The registrant's climate-related targets or goals, and transition plan, if any*

Qualitatively, the proposal calls for the disclosure of past, present, and future climate-related risks faced by the registrant, their impact on business strategy, model, and outlook, any climate-related risk management and transition plan formulation, and details of scenario analyses conducted by the registrant.[10] Climate-related goals and targets, if pursued by the company, must also be disclosed under the new proposal with annual updates regarding their progress.[11] Furthermore, the proposed framework includes the ability for companies to disclose any climate-related opportunities that are relevant to governance, strategy, and risk management.[12]

Quantitively, the proposal's emissions requirements request a company's disclosure of Scope 1, Scope 2, and Scope 3 emissions adhering to the tiered scope system of the GHG Protocol.[13] Due to the significant

[10] U.S. Securities and Exchanges Commission (SEC) https://www.sec.gov/files/33-11042-fact-sheet.pdf p. 2.
[11] Ibid.
[12] Ibid.
[13] U.S. Securities and Exchanges Commission (SEC) https://www.sec.gov/rules/proposed/2022/33-11042.pdf p. 41.

challenges many companies may face in calculating their value chain emissions, registrants are provided with a phase-in period, delaying the Scope 3 emissions disclosure requirement by one fiscal year beyond the first round of Scope 1 and Scope 2 disclosures.[14] The timeline for disclosure of greenhouse gas emissions is linked to the size of the registrant, with large-accelerated filers being the first to face emissions disclosure obligations in fiscal year 2023.[15] Smaller reporting companies (SRC) are thus provided with the largest time window for emissions disclosures and have been uniquely granted an exemption from Scope 3 disclosures.[16] Furthermore, companies would be required to disclose the use and mechanisms of internal carbon prices, financial estimates of the impacts of climate-related events, and metrics regarding the use and greenhouse gas equivalencies of carbon offsets or renewable energy certificates.[17]

Corporate liability is a key topic of concern in the proposal, with multiple "safe harbor" mechanisms having been put in place, particularly concerning accuracy of Scope 3 emission reports.[18] Liability protection for forward-looking statements provided under the Private Securities Litigation Reform Act (PSRLA) would be extended to such climate-related disclosures, so long as the PSRLA's terms and conditions are honoured.[19] However, the SEC has proposed that the new wave of climate-related disclosures must be filed, not furnished, thus significantly raising the risk of liability under Exchange Act Section 18.[20] The report states that the proposed phase-in period provides ample time to formulate the disclosures, which" should be subject to the same liability as other important business or financial information that the registrant includes in its registration statements and periodic reports".[21] This decision strongly emphasises the proposal's priority to protect investors over issuers.

[14] U.S. Securities and Exchanges Commission (SEC) https://www.sec.gov/files/33-11042-fact-sheet.pdf p. 3.
[15] Ibid.
[16] Ibid.
[17] Ibid., p. 2.
[18] U.S. Securities and Exchanges Commission (SEC) https://www.sec.gov/rules/proposed/2022/33-11042.pdf p. 47.
[19] Ibid., p. 70-71.
[20] Ibid., p. 424.
[21] Ibid., p. 298.

## AN ACTIVE NON-REGULATORY COMMUNITY

In March 2021, Acting SEC Chair Allison Lee requested public input regarding climate-related disclosures from a variety of market actors, determining that many respondents wished for a uniform climate-related disclosure framework to better compare issuer data.[22] The proposal cites private sector reliance on a variety of third-party disclosure frameworks, contributing to a fragmented reporting environment over the past several years.[23] Many U.S. companies have been appropriately preparing for the adoption of a climate-related disclosure framework by the SEC; prior to the proposal's release, actors such as State Street have encouraged others to "set your own agenda, not to wait for external pressures".[24] The lack of regulatory action in the United States has thus fostered a distinct environment in which the private sector has not only had to fend for themselves, but also lead the way in the development of climate-related disclosure practices; such behaviour, coupled with the discordance of disclosure approaches, placed the necessary pressure on the SEC to release this proposal.

Concerning Commissioner Lee's initial request, the SEC received a wide array of responses from "academics, accounting and audit firms, individuals, industry groups, investor groups, registrants, non-governmental organizations, professional climate advisors, law firms, professional investment advisors and investment management companies, standard-setters, state government officials, and US Senators and Members of the House of Representatives".[25] Many of the comments expressed support for the implementation of climate-related disclosure principles; however, some responses to the SEC's request for public input expressed concern in mandating climate-related disclosures, citing federal overstep and potential violations of the U.S. Constitution's First Amendment, ensuring freedom of expression.[26]

In reaction to the proposal's release in March 2022, the community response has largely reflected the comments submitted one year before. The proposal echoes the wishes of most investors, who have been calling for an increase in ESG-related disclosure requirements.[27] Reena Aggarwal, director of the Georgetown University Center for Financial Markets and Policy, remarks that companies who fail to apply clean energy practices soon will lose out over time, suffering both an increase in the cost of capital and a loss in revenue".[28] As for companies who have already developed climate-friendly corporate behaviour, Aggarwal predicts they will soon emerge as the victorious actors as a result of the proposal.[29] Furthermore,

[22] Ibid., p. 18-19.
[23] Ibid., p. 21.
[24] S&P Global Ratings: ESG – The New Differentiator Series. Webinar (2022). https://www.spglobal.com/ratings/en/events/webcasts/esg-the-new-differentiator-march-3-2022.
[25] U.S. Securities and Exchanges Commission (SEC) https://www.sec.gov/rules/proposed/2022/33-11042.pdf p. 19.
[26] Ibid., p. 21.
[27] Matt Levine. Bloomberg (2022). https://www.bloomberg.com/opinion/articles/2022-03-22/the-sec-will-regulate-climate/.
[28] Catherine Clifford. CNBC (2022). https://www.cnbc.com/2022/03/23/sec-climate-rule-winners-and-losers.html.
[29] Ibid.

Rich Sorkin of Jupiter, a climate risk analytics firm, argues that the expertise of advisors, consultants, and auditors will now be in significant demand, thus emerging as key victors in the SEC disclosure framework[30] Naturally, many actors within the oil and gas industry have expressed great concern with the SEC release. The influential trade association, the American Petroleum Institute, responded to the proposal: "The U.S. oil and natural gas industry has a long history of sustainability reporting…we are concerned that the Commission's sweeping proposal could require non-material disclosures and create confusion for investors and capital markets".[31]

## THE INFLUENCE OF PARTISAN AGENDAS

The 3-1 vote for the proposal among the SEC Commissioners along partisan lines is a stark reminder of the influence that partisan polarisation the United States holds over regulatory actors' engagement in the ESG transition. SEC Chair Gary Gensler, appointed by President Biden, made clear his intentions to incorporate climate-related risk in SEC disclosure procedures in July 2021, citing the growing pressure of investors for regulatory action – "[investors] want to know how climate related risk will affect the companies they own", Gensler stated.[32] In a February 2022 follow-up, Gensler expressed three points of interest for the upcoming SEC disclosure proposal: consistency and comparability of climate-related disclosures, placing such disclosures on Form 10-K alongside other important investor-sought data, and the inclusion of sufficient qualitative and quantitative details.[33] The proposal received three votes of approval from Chair Gensler and his two fellow Democratic counterparts, Commissioners Allison Lee and Caroline Crenshaw, the former describing the proposal as a "watershed moment for investors and financial markets".[34]

The proposal strongly reflects the Biden Administration's "whole-of-government approach" to enact concrete climate-friendly policies, against which the White House has met significant resistance from the Republican Party and a small coalition of conservative Democrats.[35] The SEC's single vote of refusal came from Republican Commissioner Hester Peirce, who issued a lengthy counterargument claiming a forceful

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[30] Ibid.

[31] David Blackmon. Forbes (2022). https://www.forbes.com/sites/davidblackmon/2022/03/22/sec-climate-rule-opens-a-new-front-in-bidens-war-on-oil-and-gas/?sh=1f5b452d3713.

[32] Gary Gensler. Twitter (2021). https://twitter.com/GaryGensler/status/1420391385421815815.

[33] Gary Gensler. Twitter (2022). https://twitter.com/GaryGensler/status/1492269191021436928.

[34] Allison Lee. (2022) https://www.sec.gov/news/statement/lee-climate-disclosure-20220321.

[35] Shannon S. Broome. The National Law Review (2022). https://www.natlawreview.com/article/what-s-worth-understanding-sec-proposes-mandatory-climate-disclosure-regime-public.

overreach of legal authority on the part of the SEC and the proposal's adherence to "a set of risks and opportunities – some perhaps real, others clearly theoretical. "We are not the Securities and Environment Commission, at least not yet", Peirce remarked.[36] Senator Joe Manchin, a conservative-leaning Democrat from West Virginia, criticised the proposal in a letter to the SEC in which he outlines the proposal's aggressive targeting of the fossil-fuel industry and the Commission's desire to "seemingly politicize an agenda aimed at assessing the financial health and compliance of a public company". The current partisan make-up of the SEC favours the approval of the proposed climate-related disclosure requirements, however, the significant ideological differences along partisan lines could pose a threat to climate-related or other ESG-oriented regulatory action in the future, should the partisan demographics of the SEC shift.

Furthermore, should the SEC move forward with the proposal, this would not provide the amendments with protection from legal challenges. In 2011, the U.S. Court of Appeals rejected an SEC rule on the basis that "it failed to adequately consider economic costs of compliance".[37] Such precedent poses a concern regarding the potential costs on companies in calculating Scope 3 emissions, a proposal that has been strongly criticised by conservative respondents to the SEC release.[38] Furthermore, the significant conservative majority in the U.S. Supreme Court only exacerbates the legal threat to the disclosure proposal.

## CONCLUDING THOUGHTS: WHO LEADS THE WAY?

The conclusion of the proposal's formal comment period will shed further light on the larger community response; in accordance with SEC administrative guidelines, the Commission must respond to all important data provided in public comments.[39] Therefore, there remains potential for changes to the proposed disclosures before the vote takes place.

The proposal's adoption would stimulate a sea change in ESG-oriented goals and targets in corporate governance practices in the United States. Its framework represents a significant improvement over the fragmented, discordant reporting environment of the last decade, and would satisfy the 2021 G7

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[36] Hester Peirce. (2022) https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321.

[37] William M. Manson & Daniel E. Walters. New Hampshire Bulletin (2022). https://newhampshirebulletin.com/2022/03/28/commentary-heres-where-sec-climate-disclosure-rules-may-be-vulnerable-to-legal-challenges/.

[38] Ibid.

[39] Shannon S. Broome. The National Law Review (2022). https://www.natlawreview.com/article/what-s-worth-understanding-sec-proposes-mandatory-climate-disclosure-regime-public.

commitment to force banks and companies to disclose exposure to climate-related risks.[40] However, the slow-moving nature of the SEC, as well as the persistence of political obstacles, begs the question as to whether U.S. regulatory actors are truly up to the task of leading the way in the transition to sustainable corporate governance. Truly proactive behaviour has been practiced by non-regulatory actors, to which the regulatory actors respond reactively. The SEC proposal's inspiration from the TCFD recommendations, the GHG Protocol, and a variety of actors outside the public sector demonstrate this clearly.

Furthermore, recent efforts for global conformity in sustainability-related disclosure frameworks raise interest in the SEC's ability to align to such international standards. On March 31st, the International Sustainability Standards Board (ISSB) released their proposal for climate-related disclosure frameworks, which faces a 120-day consultation period before official adoption can occur.[41] Both frameworks' strong reliance on the TCFD recommendations suggest that their co-existence may prove to be complementary. The SEC proposal praises the global "convergence of investors and issuers around the TCFD as a useful framework for communicating information about climate-related risks that companies may face".[42] Specifically, the Commission positively references the efforts of both the United Kingdom's Financial Conduct Authority and the European Commission to align their frameworks to future ISSB standards.[43] The SEC proposal's primary agenda is to eliminate the discordance of disclosure standards within the United States. However, considering the prevalence of multinational companies operating within their jurisdiction as well as the complex interlinkages of the global economy, we wish to emphasise that the Commission must strive to construct a framework that not only contributes to disclosure uniformity on the domestic level, but the international as well. Close Domestic political agendas must not overshadow the fact that the necessity for sustainable corporate governance practices is a global affair.

Nevertheless, we at Reward Value Foundation hope that the SEC proposal generates a new era of dialogue on how U.S.-registered companies can effectively harness corporate governance to stimulate long-term value creation and confirm their commitment to the climate through ESG-linked executive remuneration.

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[40] Mark, John. (2021). https://www.reuters.com/business/environment/g7-backs-making-climate-risk-disclosure-mandatory-2021-06-05/.

[41] IFRS (2022). https://www.ifrs.org/news-and-events/news/2022/03/issb-delivers-proposals-that-create-comprehensive-global-baseline-of-sustainability-disclosures/.

[42] U.S. Securities and Exchanges Commission (SEC) https://www.sec.gov/rules/proposed/2022/33-11042.pdf p. 33.

[43] Ibid., p. 301.

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