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Investment Institute Sustainability

Why the US Securities and Exchange Commission climate disclosure rules will matter, and why they may not

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Jamison Friedland
Sustainability Analyst
AXA IM

Key points

- The SEC's decision to address climate-related risks is long overdue but it will be a positive step for both investors and those supportive of transitioning to a low-carbon economy
- When the final decision is announced, it will however have limitations
- Investors must continue pushing for companies to disclose material climate information necessary to make the best risk-adjusted investments

Another delay. After receiving a record 15,000-plus public comments, and more than 12 months of analysis, negotiations, and adjustments, the US Securities and Exchange Commission (SEC) ***did not*** release its final ruling in April 2023 as was expected. Without it, we still do not know what SEC-registered filers, both foreign and domestic, will be required to disclose regarding carbon emissions and climate data.

With all the leadup and debate around the potential requirements, the fundamental question is – when it eventually comes, will this ruling even change anything? We believe **it does, at least partially.**

Overall, the SEC's decision to address climate-related risks is long overdue. When released, it will be a positive step for both investors and those supportive of transitioning to a low-carbon economy.

However, even when the final decision is announced, it will have obvious limitations related to the scope of the SEC's regulatory authority, what emissions disclosure will be required, and potential delays in the implementation.

Because of these limitations, large investors, like AXA IM, must continue pushing for companies to disclose material climate information necessary to make the best risk-adjusted investments in a world transitioning toward a more sustainable, low-carbon economy.

Why the rule matters

Signaling

As the regulator for the largest financial market in the world, the SEC's decision reinforces the notion that emissions data, and climate risk more broadly, are material information necessary for investors to judge the financial risk of companies.

The Intergovernmental Panel on Climate Change (IPCC's) final instalment *Synthesis Report: Climate Change 2023*[1] makes the case for how humanity can "defuse the climate time-bomb". The report highlights that "finance will be key to this", and the SEC rule, along with existing and upcoming regulations in other jurisdictions, solidifies the commitments the financial sector is making to meeting these climate goals.

A well-known maxim is "you can't manage what you can't measure". The SEC's proposal for required publication of standardized emissions data will allow companies to better manage their emission reduction strategies. Investors will also have a better understanding of which companies are having the biggest climate impact, and which are managing their transition more effectively. This understanding allows for a more efficient allocation of capital throughout the carbon transition.

Alignment with existing third-party frameworks

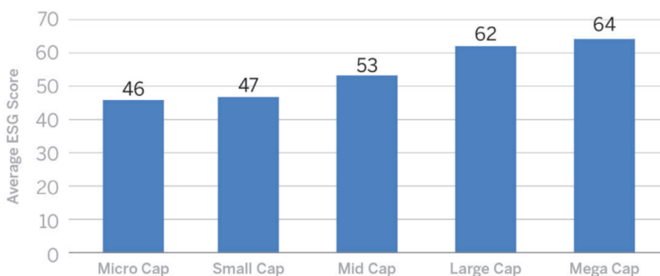
A common argument against the SEC's emissions mandate and other environmental, social and governance (ESG) disclosures are the additional costs associated with increased reporting. As with any new disclosure requirement, companies *will* incur costs in obtaining and reporting this information. However, the SEC designed its standard to simplify and reduce the *overall* costs corporations are incurring when trying to abide by the various existing emissions frameworks.[2]

With the voluntary frameworks such as the Global Reporting Initiative (GRI), Greenhouse Gas (GHG) Protocols, the Sustainability Accounting Standards Board (SASB) and Task Force on Climate-related Financial Disclosures (TCFD) all having slightly different reporting requirements, the SEC's view was that these "multiple frameworks failed to produce consistent and comparable information that investors need".

Instead, the SEC disclosure requirements, which borrow heavily from both the GHG Protocols and the TCFD frameworks, should allow companies to move away from the practice of aligning to multiple costly frameworks and instead follow a single methodology.

Reducing bias

Another reason the SEC's proposed standardization matters is to reduce some of the known biases embedded in *voluntary disclosures*. There is significant documentation showing that ESG scores tend to have a bias toward 'larger' companies, with the average ESG score being higher as you increase company market cap.[3]



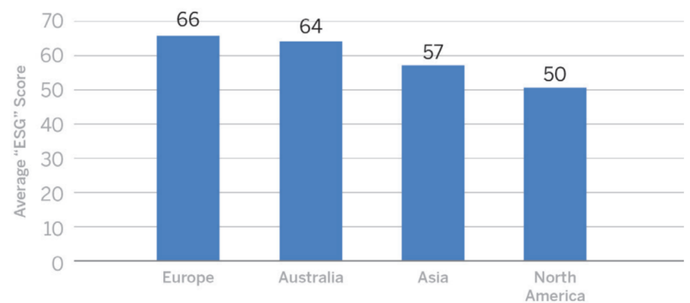
Source: European Commission - Study on Sustainability Related Ratings, Data and Research

This market cap bias happens for two main reasons. The first is that ESG rating companies have limited capacity and must have a cut-off in their coverage availability. This means that some smaller companies do not even receive scores from the dominant rating agencies like MSCI or Sustainalytics. The second compounding effect is that larger companies have more resources available to devote towards sustainability-related information.

Larger companies typically use some combination of in-house sustainability teams and the hiring of specialized sustainability consultants to help with ESG disclosure, often through annual sustainability reports and information on company websites. Because larger companies can devote more resources, they are able to respond more efficiently to data requests from the rating agencies and often have the information already pre-packaged and available to the public in a clearer way.

This allows rating companies to gather more relevant data, which translates into larger companies scoring noticeably better than smaller peers. By mandating emissions disclosures, the hypothesis is the SEC rule will reduce this bias, as more of the data utilized by rating agencies will be publicly available and in a standard format, regardless of company size.

In addition to reducing market cap bias, the geographic bias, particularly against North American companies, should also be reduced through standardized reporting. Similar to the situation with market cap bias, the voluntary nature of reporting means US companies have often been left 'under-scored' compared to other geographic regions due to lower quality and quantity of disclosure.



Source: European Commission - Study on Sustainability Related Ratings, Data and Research

The SEC ruling should, again, shrink this regional disparity as rating companies will be able to glean more information from public reports which in turn should help normalize some of the geographic scoring differences.

Comparability (complete data sets on *standardized* timelines)

Despite overall increases in climate disclosures, some of the biggest challenges facing the ESG space are the questions around completeness and integrity of the data. When companies fail to disclose climate data, this creates gaps in the data set, making it difficult for investors to have a complete picture of a peer group, sector, or index.

Even when data is available, there can be inconsistency in the methodologies of gathering and reporting. Some companies will report actual measured data while others might rely heavily on estimated calculations. 'Company A' might choose to report emissions offsets in their calculations while 'Company B' does not. One company may report data gathered over a calendar year while a peer chooses to report based on a fiscal period.

The SEC ruling should eliminate these discrepancies as companies will likely be required to report with a standard methodology, format, and over the same period as audited financial statements. The changes should also bring consistency around the timeline of reporting, which alleviates investors searching for whether the company has published its latest annual sustainability report, or if emission data is from the most recent financial period.

Clear expectations on what information will be reported, when it will be disclosed, and under what format makes it notably easier for investors to compare a company to peers.

Laggard adoption

Although more companies continue to voluntarily disclose at least some portion of their emissions data, there continue to be laggards in the process. The comment letters sent to the SEC in response to the proposed rule gave a clear indication of some of the major objections to disclosure regulation, particularly regarding Scope 3 emissions, i.e. those found along a company's value chain, both upstream (before) and downstream (after) its own operations.[4]

These reasons include potential legal liability, difficulty in obtaining the data, and lack of reliability and consistency in the data sets. While the SEC had initially attempted to address each of these critiques, either directly or indirectly, much of the final ruling uncertainty centers around this topic.

While most companies can accurately measure and report emissions from internal operations (Scope 1), and energy consumption (Scope 2), the decision on whether to include Scope 3 and if the SEC grants "safe harbor provisions", which allows companies to be protected from legal claims if reporting was done reasonably and in good faith, will determine how large an impact on disclosure laggards the ruling has.

The language in the ruling could even have a trickle-down impact on companies that are not directly regulated but feel the need to report emissions to remain eligible as suppliers to regulated companies.

Why the rule does not matter

Legal Challenges

Despite the record feedback received, or as evidenced by it, when it is finally published, the SEC regulation will almost certainly face legal challenges. The political climate in the US effectively guarantees any ESG legislation or regulation will be quickly opposed.

For example, after the US Department of Labor (DOL) proposed a final rule allowing ERISA[5]-governed retirement plan fiduciaries to "consider the potential financial benefits of investing in companies committed to positive environmental, social, and governance actions", legislation was passed in both chambers of Congress seeking to repeal this rule through the Congressional Review Act.

Ultimately, President Joe Biden decided to issue his first presidential veto to block these legislative measures, but the SEC ruling will likely face similar – if not more ardent – challenges as the potential changes are more prescriptive. While the DOL rule only adjusted the language such that fiduciaries were *allowed* to consider ESG factors in investment decisions, the SEC rule *would force* companies to disclose ESG-related information.

Another potential legal challenge, already being floated by some Congressional leaders writing to SEC Chair Gary Gensler, is the argument that the disclosure rule "exceeds the SEC's authority".[6] As evidence, they are referring to the June 2022 Supreme Court ruling that the Environmental Protection Agency (EPA) does not have the legal authority under the 1970 Clean Air Act to put state-level caps on carbon emissions.[7]

The interpretation of this ruling is that regulatory authorities, like the EPA or SEC, only have powers that Congress has specifically delegated to them – and that just because topics are generally within the agency's jurisdiction, i.e. carbon emissions for the EPA or climate related financial risks for the SEC, does not mean the regulatory body has the authority to issue rules on it.

The general opinion is that SEC's rule differs from the EPA's in that one of the Congressionally-appointed roles of the SEC is to require firms to disclose "material" information and many of the largest institutional investors are already on record arguing that climate risk equals financial risk. However, this will still be challenged in the courts.

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Implementation timeline

Regardless of the eventual outcome of the legal challenges, the mere necessity to litigate the rule will impose implementation delays. This is in addition to the already year-plus delay from the initial proposal. The original proposal assumed a 2022 final adoption and so the phase-in periods were written with the expectation that "large filers" (the first to be affected) would initially begin reporting on fiscal year 2023 (filing in 2024). The continued delays in finalization mean that the phase-in periods will have to be adjusted and that the first filers will likely not be responsible until at least fiscal year 2024 (filed in 2025) and that smaller companies would have even another year after that before required compliance.

Voluntary adoption – based on investor/customer demand

The various implementation hurdles of the SEC rule also do not appear to be having a significant impact on how stakeholders feel about climate disclosure. According to a PwC survey, an overwhelming 98% of corporate leaders said they may not wait for finalization of the rule to begin compliance.[8]

Corporations are showing that these comments are not just empty platitudes as they have been displaying widespread adoption of climate-related reporting. As of 2022 year-end, 96% of companies within the S&P 500 and 81% of companies in the Russell 1000 have already issued sustainability reports.[9]

With global investors continuing to push for more disclosure, this practice is likely to only become more common. Evidence of this push comes from the Carbon Disclosure Project (CDP), which reported in its annual announcement that its members have signed a joint letter addressed to the boards of more than 15,000 companies globally, asking for more information on a range of ESG topics including climate and emissions data.

CDP's membership, of which AXA IM and AXA Group are both part, consists of 746 financial institutions controlling more than $136trn in assets. Actions like the CDP letter highlight the investor demand for more information, which has led to a 38% year-on-year increase in corporate climate disclosures since 2021.[10]

In addition to the push from investors on disclosure, companies who have already made net-zero or carbon reduction commitments must report emissions data to minimize any potential appearance of greenwashing. Even companies not amongst the growing group making these commitments may find themselves being pressured to report if their customers have made commitments and need to accurately report Scope 3 data.

Additionally, some large customers, including both the US and UK governments, have either passed or proposed rules mandating that companies within their supply chains must disclose greenhouse gas emissions. With over $630bn in annual purchasing power, the US government is the single largest buyer globally, and companies may recognize the importance of disclosing emissions data to remain a potential eligible supplier.[11]

Further regulation and legislation

These 'softer' forms of influence on voluntary emission disclosures are supplemented by additional regulatory initiatives at both US state and international levels. While the SEC, due to its size and impact, may be the most closely watched in the US, similar initiatives requiring emissions disclosure have been proposed or already passed elsewhere.

For example, in the California Senate, the Climate Corporate Leadership and Accountability Act (SB-253) – now named the Climate Corporate Data Accountability Act – was proposed in January 2023 requiring disclosure of Scope 1, 2 and 3 GHG emissions in line with the GHG protocols.[12] The proposed rule would apply to all companies (not just SEC-registered entities) who are doing business in California – the world's fifth largest economy – and have over $1bn in annual revenue. The bill proposes that companies should implement disclosure based on 2025 fiscal data, which given potential implementation delays, could end up similar to the SEC's timetable.

International legislation is also going to impact a considerable number of US companies' disclosure requirements. In November 2022, the European Union (EU) adopted the Corporate Sustainability Reporting Directive (CSRD) to standardize sustainability reporting. The CSRD applies to over 50,000 companies, both public and private, operating in the EU and sets requirements for climate and environmental disclosure.

Of the 50,000 plus companies, analysts estimate at least 10,000 of these companies are non-European corporates, with one third of those being American, and potentially affected by the SEC's regulation.[13] The CSRD reporting standards include language on the company's impacts on climate change and on emission data covering Scope's 1,2 and 3.

The European Financial Reporting Advisory Group is still working to provide exact guidance on timing and expectations of each of the different emission scopes, but large European corporates, some of which are SEC-registered entities, are expected to report based on 2024 fiscal data. Non-European corporates have a longer implementation period, but given the potential delays around the SEC rule, may end up needing to report to both governing bodies starting around the same time.[14] [15]

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Corporate Sustainability Reporting Directive – who it applies to	CSRD (from 2024) – European Union	
	Financial Year	Reporting Year
Non-European corporate • Revenue of more than €150m on the EU market for the last two years • Al least one branch within EU which generate a revenue of more than €150m and meet the large corporate criteria	2028	2029
Large corporate with over 500 employees which meets at least one of the following criteria: • Balance sheet – more than €20m • Revenue – more than €40m	2024	2025
Corporate with over 250 employees which meets at least one of the following criteria: • Balance sheet – more than €20m • Revenue – more than €40m	2025	2026
Quoted small and medium sized businesses which meet at least two of the following criteria: • 50-plus employees • Balance sheet – more than €4m • Revenue – more than €8m Small and non-complex credit institutions • 75% of institutions consolidated assets and liabilities related to counterparties located in EU • Classified as a small and non-complex institution by the relevant authority	2026	2027

Source: Corporate sustainability reporting (europa.eu)

Another international ruling that may overlap with some SEC registered entities has been proposed by the International Financial Report Standards (IFRS). Issued through the International Sustainability Standards Board (ISSB), the proposed rule would require companies to report on several environmental metrics, including absolute Scope 1, 2, and 3 emissions, regardless of the materiality of Scope 3 data, by fiscal year 2024.[16]

However, given the complexity around Scope 3 reporting, in December 2022, the ISSB announced they would provide a relief exemption for just Scope 3 for the first year, to allow companies to "embed and improve their processes for measurement and disclosure of Scope 3 emissions".[17]

While US-domiciled companies predominantly use Generally Accepted Accounting Principles (GAAP), the IFRS standards are used or required across 167 jurisdictions globally, impacting a substantial number of SEC registrants, and signaling that this information is material to investors.

Disclosure only matters if it covers everything (Scope 3, public vs. private)

With other regulations and investor pressure, companies will continue to increase disclosure. However, it is important to recognize that such requests may not be covering all emissions or reaching a broad enough range of companies. Under the initial SEC proposal, the requirement for Scope 3 emission disclosure was one of the more contentious areas.

Questions focused on accessibility of the data, particularly from smaller global suppliers who may not be tracking or reporting emissions, and from downstream emissions where companies may not have full information on product use. We have already discussed that currently Scope 3 emissions data is incomplete,

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and that other regulation has been giving companies extra time to finalize their calculation methodologies, but if it is not included in the final disclosure, it would significantly diminish the impact of the SEC's regulation.

The initial language in the rule is already limited in that it would not require smaller reporting companies (SRCs), which the SEC estimates to be approximately half of all regulated entities, to report on Scope 3 emissions. If the final decision does not include or partially delays the reporting requirements for Scope 3, the disclosure rule would potentially be missing between 65% to 95% of the remaining companies' potential climate risks.[18]

The exact Scope 3 emission language is particularly important because while companies have been actively reporting emission data, less than half are reporting any emissions attributed to their supply chains.[19]

If Scope 3 data is limited, either in implementation delays or in depth of coverage, or worse, removed entirely, the potential trickle-down impact to laggards would also be reduced as unregulated entities would not face the same customer pressure to report. This pressure is important because unlike the CSRD, which was adopted at the legislative level, and therefore applies to both public and private companies, the SEC rule only applies to a limited number of registered companies.

By using public companies as a proxy for SEC registered companies, and screening for only large firms – those with annual revenues greater than $100m and who would be responsible for a disproportionate percentage of emissions – we see that unless Scope 3 reporting indirectly impacts them, the SEC ruling would not account for *any* of the climate risks for an estimated 87% of companies.[20]

Should the SEC maintain the Scope 3 disclosure requirement, there is a small risk that it may inadvertently accelerate the trend of companies staying or becoming private as they seek to minimize some of the additional reporting burdens. While it is unlikely the acceleration toward privatization will be as extreme as it was following other disclosure regulation, any additional companies pursuing this path would reduce the total impact the ruling has on understanding businesses' potential climate risk.

Backward disclosure does not equal forward guidance

The SEC rule focuses on companies disclosing "information about climate-related risks that are reasonably likely to have a material impact on their business", with emissions data being the commonly used metric to assess such risks.[21] Unfortunately, the use of emissions data as the metric may not give the complete view of how companies are managing climate-related risks.

Emissions data can allow investors to view how a company has *historically* decarbonized its operations and supply chains. However, because it is backward-looking, it fails to take into consideration the potential complexity of corporate decarbonization plans.

If they only consider emissions data, investors and regulators would miss that a company may instead be addressing climate-related risks through methods such as shifts in business models, investments in capex or research and development that might lead to longer-term emissions reductions, or by changing which suppliers they are using.

As the CDP notes, a "credible" transition plan is one that "clearly outlines how an organization will pivot its existing assets, operations, and entire business model".[22] By not including broader disclosure requirements the SEC rule misses an opportunity to give investors a more complete picture of how companies are addressing climate-related risks.

The upshot for investors

With all the passed and proposed climate disclosure regulation, investors and corporations need to acknowledge the upcoming shift in sustainability reporting. More information on climate risks will be available and as this data becomes more prolific, investors should continue to reward companies that are transparent in both their disclosure and their actions taken to address these risks.

While the SEC rule was established to "help issuers more efficiently and effectively disclose [climate risks] and meet investor demand [for reliable information]", until we get a final decision, investors can continue to utilize information available from voluntary and other regulatory disclosures to incorporate these risks into investment decisions.[23]

While there are likely to be significant implementation delays and there is always more information that investors would appreciate having when trying to understand potential risks, the SEC's proposed rule is a strong first step in both recognizing the materiality of climate data on a company's financial conditions and standardizing what data is disclosed.

(Additional contributions from AXA IM, Investment Grade Credit Research Analyst, Clotilde Queneudec)

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[2] Ten Thoughts on the SEC's Proposed Climate Disclosure Rules (harvard.edu)
[3] Study on Sustainability Related Ratings, Data and Research | European Commission, 2020
[4] Scope 1: Direct impacts from a company's own operations; Scope 2: Indirect emissions derived from energy generation; Scope 3 covers indirect impacts. Read more here: Understanding scope 3: How responsible investors can wrestle with the unruliest of emissions | AXA IM (axa-im.com)
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