Understanding the SEC's Proposed ESG and Climate Disclosures

IN COLLABORATION WITH:

Overview of SEC Proposals

In 2022, the SEC issued two new proposals on climate and ESG disclosure requirements.

1. Climate Proposal: aims for consistent, comparable, and reliable climate risk data from public companies.[1]
2. ESG Proposal: aims to standardize how SEC-registered funds and advisors incorporate and disclose ESG considerations into their investment practices.[2]

The SEC proposed the climate and ESG rules in March and May 2022, respectively, with the comment period for the proposals intended to run until June (later extended to November) and July 2022, respectively.[3] However, the SEC postponed finalizing the proposed rules to review public comments on *West Virginia v. EPA*, a ruling that may affect its ability to implement sustainable disclosure regulations.[4] As such, these rules have not come into effect.

The SEC's most recent update to its rulemaking agenda indicates intent to finalize by March-April 2023.[5] The information provided on these disclosure requirements will be updated pending a finalized rule(s) from the SEC.

[1] SEC, SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors
[1] SEC, The Enhancement and Standardization of Climate-Related Disclosures for Investors

[2] SEC, SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices

[2] SEC, Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices

[3] SEC, SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices
[3] Bloomberg Law, SEC Climate Rules Pushed Back Amid Bureaucratic, Legal Woes
[4] Harvard Law School, West Virginia v. EPA Casts a Shadow Over SEC's Proposed Climate-Related

[5] Thomson Reuters, SEC Plans to Finalize Two Dozen Rules in 2023

KEY TAKEAWAYS

- The SEC issued proposals in 2022 that, if passed, would require public companies to provide climate risk data and SEC-registered funds and advisors to disclose how they incorporate ESG into their investment practices
- The two proposals aim to standardize how climate and ESG data is reported by public companies, registered funds, and advisors, contributing to a similar goal as SFDR in the EU
- The rules are are currently in proposal stages and face regulatory hurdles for implementation; if passed, they could necessistate more comprehensive ESG disclosures across the industry, arming asset owners with more actionable climate and ESG data

Proposed SEC Climate Disclosure Requirements

The climate proposal would require public companies to include climate information in registration statements and reports (e.g., 10-Ks). Per the original proposal, disclosure requirements would be phased-in over the next four years, with large companies beginning to report by 2024 and smaller companies by 2026; these timelines may change once the SEC finalizes the proposal. Public companies would have to report climate risk, track greenhouse gas emissions (GHG), and establish climate-related goals. These requirements would not impose burdens on private companies, unless those companies are included in funds that face ESG disclosures or are part of Scope 3 emissions for public companies (see definitions of emissions Scopes further below).

Disclosure of Climate Risks

The proposed requirements include disclosure of material climate risks and historical climate impacts. Climate risks are comprised of a combination of physical and transition risks. Physical risk affects companies with assets concentrated in regions exposed to extreme weather events (EWEs) and other physical weather impacts with frequency and intensity influenced by climate change, like floods, hurricanes, wildfire, and drought. Transition risk affects firms through the global shift to a low carbon economy. In-scope companies will be required to disclose risk identification, assessment, and management processes, as well as internal structures for oversight and governance at the board and senior management levels. These disclosures would be written in registration statements and 10-Ks in financial statement footnotes.

Disclosure of Emissions

The table below explains Scope 1, 2, and 3 emissions categories, which are used to classify emission types in company operations. It also indicates companies' obligations for disclosure under the SEC's proposed climate rules.

Emission reporting requirements would include disclosing Scope 1 and 2 GHG emissions. Scope 3 emissions would only be required if the company has "material" Scope 3 emissions or has set GHG. emission targets that include Scope 3 reductions. The SEC has not specified a materiality threshold for Scope 3 emissions, which created challenges in preparing for the proposal requirements. In-scope companies must disclose emissions in absolute terms (i.e., excluding offsets) and include emission intensity (per unit of economic value of production). Disclosure requirements are intended to provide standardized data on companies' carbon footprint while furthering emission reduction goals. These disclosures would be required in a newly created section of the annual SEC report, Form 10-K (Item 6).[6] During the proposal's phase-in period, Scope 1 and 2 emissions disclosures would be subject to limited assurance, followed by reasonable assurance audit requirements.

[6] Deloitte, The SEC unveils environmental disclosure requirements

Climate Goals and Targets

The proposal does not explicitly require reducing emissions; it would only apply when a company sets independent emissions reduction targets. Though optional, should a company publicly set climate goals (i.e., annual emission reductions), it would be required to disclose the scope of activities and emissions included in the targets, the established timeline for completion, and interim targets, as applicable. Should firms set targets, it will require disclosing planned initiatives to meet such targets (e.g., reduced travel, renewable energy sourcing), data to demonstrate progress, and detail on the use of renewable energy certifications (RECs) and carbon offsets to reach these targets, if applicable. Companies that have already voluntarily implemented climate goals would need to evaluate published targets to assess alignment with requirements under the proposed rule.

SCOPE CATEGORY	DISCLOSURE DESCRIPTION	WHERE TO DISCLOSE
Scope 1	Direct sources of GHG emissions from a company's controlled or owned sources (e.g., fuel combustion, vehicles, fugitive emissions)	Mandatory
Scope 2	Indirect sources of GHG emissions from a company's generation of purchased electricity, steam, heating, and cooling consumed (e.g., purchased electricity or gas)	Mandatory
Scope 3	All other indirect sources of GHG emissions from a company's value chain, both upstream and downstream (e.g., purchase of goods and services, business travel, use and end-of-life treatment of sold goods and services, transportation and distribution, investments, leased assets and franchises)	Mandatory for material Scope 3 GHG emissions

Proposed SEC ESG Disclosure Requirements

The SFDR encompasses sustainability risks and PAIs, which are two key factors that standardize how fund managers and FMPs disclose sustainability information.

The ESG disclosure proposal intends to classify the types of ESG strategies used by registered investment companies and advisors and require specific disclosures for each ESG classification. Further, one of the SEC's objectives is to target greenwashing. The proposed rules will likely focus on firms and funds that disclose and/or promote ESG performance publicly (e.g., on website, in annual report).

Rule Applicability

The proposed rules would apply to SEC-registered investment companies and registered investment advisors (RIAs) that include ESG considerations in investment selection processes (e.g., incorporating ESG into investment committee materials) or strategies (e.g., incorporating ESG KPIs into annual investor updates). Notably, the proposal does not define ESG, creating ambiguity around what qualifies as an "ESG consideration" that would trigger disclosure requirements. Funds that do not incorporate ESG considerations (and do not claim to do so) would not face requirements.

General Partners (GPs), as private fund managers, would be subject to firm-level disclosures required of RIAs.

Additionally, GPs that manage registered investment companies (i.e., mutual funds, closed-end funds, unit investment trusts) that integrate ESG considerations in investment selection processes would also be subject to similar disclosure requirements at the fund level. Because the proposal is currently vague in defining ESG, basic organizational structures (e.g., an audit committee) could be considered governance considerations under the "G" of ESG for a company, thus triggering requirements. These disclosures could create reporting challenges for GPs, but they would be valuable to asset owners in standardizing public ESG information about investments.

ESG Categorization

The SEC's proposed rules would amend annual registration forms (e.g., Form ADV) to require in-scope firms and funds to identify their ESG investment strategies as "ESG Integration" or "ESG-Focused." "ESG-Focused" strategies also contain a subset referred to as "ESG Impact" strategies. GPs in private equity are not required to register with the SEC as investment advisers, but some are registered. Those that are registered would face these requirements. Each strategy is defined below.

GPs would need to determine the types of ESG strategies utilized by each fund and fulfill related disclosure requirements for its corresponding strategy. Notably, GPs may use and disclose more than one strategy at the fund level. Those that do not incorporate ESG into their process would not need to select any category and would not be subject to disclosure requirements.

STRATEGY	DISCLOSURE DESCRIPTION
ESG Integration	• Considers one or more ESG factors alongside other financial factors in investment decisions • ESG may be considered in the investment selection process but are generally not as materially considered when compared to other factors
ESG-Focused	• Focuses on one or more ESG factors by using them as a significant or main consideration in selecting investments or in engaging with portfolio companies • Certain ESG-Focused strategies may exclude or include certain investments based on ESG criteria (e.g., carbon emissions screens, board diversity, data security and governance)
ESG Impact	• Has a stated goal to achieve a specific ESG impact or generate specific ESG benefits • Targets portfolio investments that drive specific and measurable ESG outcomes

Disclosure Requirements

Under the proposed rules, firms that employ one or more of the three ESG strategies would be required to report all ESG strategies employed for more than a "small portion" of fund assets; "small portion" has not yet been quantified. These disclosure reports would be contained in annual SEC registration documents, prospectuses, brochures, and firms' annual reports.

STRATEGY	DISCLOSURE DESCRIPTION
ESG Integration	• ESG strategies employed • ESG factors considered • ESG consultants/providers • ESG proxy voting policies (if applicable)
ESG-Focused	• ESG overview table describing strategies employed and frameworks used • ESG factors considered • Carbon footprint (if applicable) • ESG consultants/providers • ESG proxy voting policies (if applicable)
ESG Impact	• ESG overview table describing strategies employed and frameworks used • ESG factors considered • Intended impact, impact measurement, time horizon, and relation to returns • Carbon footprint (if applicable) • ESG consultants/providers • ESG proxy voting policies (if applicable)

Implications for Asset Owners

Both SEC disclosure regimes provide asset owners with increased transparency and availability of sustainability information for their GPs and financial products. As the proposals apply only to entities within the SEC's purview (i.e., registered companies and advisors), any asset owner registered with the SEC would be required to comply with the proposed rules.

The proposed climate rule would increase pressure for GPs to track climate information in their portfolios. For instance, portfolio companies with public exit strategies will be required to track and report on sustainability and climate data; in advance of the IPO, the portfolio company would need to prepare for emission tracking. Further, increased transparency in tracking corporate climate impact will likely drive investments to businesses that prioritize climate risk mitigation, resilience, and sustainability. More broadly, the SEC's proposed rules have paved the way for asset

owners to request and expect climate data from its GPs.

The proposed ESG disclosure requirements would allow asset owners to better benchmark and characterize ESG strategies among investment products. Asset owners can expect GPs to provide these disclosures regarding employed ESG strategies. As asset owners aim to bolster or achieve their own sustainable investment commitments, the proposed disclosure rule would provide clear information regarding the types of ESG strategies GPs may leverage. Asset owners would have stronger and more voluminous amounts of data to make investment decisions with GPs attempting to fundraise.

How Does the SEC's Proposed Regime Compare to the EU SFDR?

The SEC's disclosure rules around ESG and climate change share similarities with the EU Sustainable Finance Reporting Directive (SFDR). At a high level, both regimes will increase the availability of sustainable information available to asset owners in the market and signal public market demands for such data, increasing the value of investments that disclose sustainability measures. Both regulatory frameworks also aim to prevent greenwashing and standardize ESG information, which should ultimately enable asset owners to make more informed decisions about fund allocations to GPs and financial markets participants that demonstrate responsible investment practices.

However, the SEC's proposed disclosure rules are smaller than SFDR in scope and applicability. The SEC's climate proposal would only apply to public companies, while the SEC's ESG proposal would only apply to SEC-registered companies and private funds. The SEC's ESG strategies do not align with those defined under the SFDR, which specifically defines sustainability risks and principal adverse impacts (PAIs) to be disclosed with support from the EU Taxonomy. While the SEC's proposals face regulatory hurdles toward implementation in the US, the SFDR regime is already being implemented. However, the SEC proposals, if implemented, would represent a shift in demand for sustainability information. See Navigating SFDR Compliance for more information on the SFDR.