SEC Climate Disclosures – Key Takeaways for Private Markets

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Key Takeaways

- The SEC's final climate disclosure rule mandates public companies to report material Scope 1 and 2 greenhouse gas emissions. The rule is designed to enhance transparency into climate risks.
- The rule has faced legal challenges from business interest groups and several states' attorneys general, which contributed to the SEC's decision to exclude Scope 3 emissions from the reporting requirements.
- Unlike the EU's Corporate Sustainability Reporting Directive (CSRD), the SEC's rule focuses on financial materiality and does not incorporate "double materiality" (whereby business impacts on society and the environment are deemed material to financial disclosures).
- The rule has indirect implications for private market investors. In future years, the rule may influence benchmarking activities, due diligence practices, investor expectations, and asset valuation models. Further, as more public companies fall under the scope of the rule, Scope 1 and 2 emissions disclosures may increasingly be expected from private companies by blue-chip customers.
- Despite legal scrutiny, the rule signifies a push for integrating climate considerations into the capital markets regulatory landscape. Investors may build on the rule should they expect climate considerations to be included as an important component of financial disclosures.

Introduction

The effects of climate change pose a significant threat to businesses, with research showing that worst-case warming scenarios may cause losses of ~$0.45 for every $1 of cumulative operating cash generated up to the year 2050. In recent years, the Securities and Exchange Commission (SEC) has sought to integrate climate disclosures within regulatory expectations for public companies in the United States. The SEC has acknowledged the significant impact climate change may have on investment decisions and business performance, such as operational and supply chain disruptions due to extreme weather events, and has sought to enhance transparency of climate risks and opportunities accordingly.

The SEC's journey toward formalizing climate disclosure requirements began in 2021 as a response to growing demand from investors for more transparency. Specific sources of demand have included proxy battles, shareholder activism, and UN-backed industry groups. These investor demands reflect global trends toward sustainability and responsible investing, as similar regulatory developments have progressed in the EU. Initially, the SEC explored voluntary guidelines in 2010, but has now recognized the need for standardized, mandatory reporting to ensure comparability and reliability of information.

The proposed climate disclosure rules faced significant scrutiny and debate, delaying the SEC's final issuance. Business leaders, industry groups, and some investors voiced concerns over complexity, potential compliance costs, and the SEC's regulatory reach. The SEC thus reassessed and modified its initial proposal to balance demands for increased environmental transparency against practical challenges and reservations expressed by a broad spectrum of stakeholders. The SEC has stated that the rules will not mandate disclosures until March 2026, in part to avoid any further delays in implementation.

Disclosure Summary

The SEC's final rule on climate disclosures mandates public companies to report their material Scope 1 and 2 greenhouse gas emissions. The SEC derives its interpretation of materiality from precedents articulated by the U.S. Supreme Court. These precedents define material information as information that a reasonable investor would likely consider important to their decisions. In mandating Scope 1 and 2 emissions reporting, the SEC has underscored climate impact as a relevant factor for investing. Moreover, the disclosure requirements emphasize that companies must have governance systems in place for climate risks, illustrating a push to integrate climate considerations into corporate strategy and reporting.

The SEC's climate disclosure rule has attracted significant attention from legal experts and policymakers. Shortly after the SEC's initial announcement in 2021, business interest groups and state attorney generals filed court challenges. These challenges argued that the SEC overstepped its regulatory authority by mandating disclosures that extend beyond material financial information and into environmental policy, which is within the scope of the Environmental Protection Agency (EPA) and state and local regulators. The SEC has already paused implementation of the rule, pending court review amidst partisan proceedings.

To account for challenges, the SEC had opted to remove Scope 3 emissions from its mandatory reporting requirements. Measuring and tracking Scope 3 provides a full picture of the emissions produced by a corporate asset's value chain and is relevant to holistic asset decarbonization strategies. However, measuring Scope 3 emissions is complex, and necessitates collaboration and engagement with diverse stakeholders (e.g., distributors, suppliers, vendors). Subcategories of Scope 3 emissions usually can be measured, but fulsome Scope 3 figures are challenging to collect unless business suppliers and vendors can readily report their own Scope 1 and 2 emissions. These complexities help explain the SEC's decision to omit Scope 3 from the rule.

By finalizing the climate disclosure rule, the SEC has signaled to investors and large public corporations that proactively engaging with climate risks and building climate resilience is a public priority, and should be institutionalized as a business priority. The SEC's ruling shows that the U.S. regulatory landscape is making definite progress towards institutionalizing climate considerations that promote transparency in the capital markets.

Comparison to EU Developments

The SEC's rule contrasts to the EU's incoming framework, the Corporate Sustainability Reporting Directive (CSRD). CSRD embraces "double materiality": companies must explain how sustainability issues affect their business (financial materiality), as well as the impact of their business on society and the environment (impact materiality). In contrast, the SEC's rule focuses primarily on financial materiality, aiming to provide investors with information deemed directly relevant to risks and returns. The SEC thus has not commented on whether measuring emissions is objectively a positive or negative practice, only that the figures are reasonably likely to be material to investors.

The SEC's decision to exclude double materiality reflects a somewhat measured and cautious stance on sustainability disclosure regulation. Amidst legal and political pushback, the SEC is remaining focused on financial materiality to keep its disclosure rule within its established scope as an agency. The bar for compliance is thus distinctly lower in the U.S. than it is in Europe. For private market investors with global portfolios, though, these rules will continue to affect compliance requirements, reporting practices, and integration of ESG factors into investment analysis across jurisdictions.

Impact for Private Markets

The SEC's climate disclosure rule is for public companies, but it has implications for private market investors and their portfolio companies. For example, publicly traded private equity firms would be subject to the reporting requirements. In addition, portfolio companies intending to go public would need to begin publishing climate disclosures in accordance with the rule. The increased transparency and standardization of climate information from public companies may stir institutional investors' appetites for similar disclosures from private market sponsors.

The disclosure of Scope 3 emissions imposes a network effect on business entities across a value chain. While Scope 3 emissions have been carved out of the SEC's proposed mandate, more companies will inevitably begin tracking and disclosing those metrics voluntarily, either due to regulatory pressures elsewhere (e.g., the EU), or other factors, such as competitive fundraising. Businesses may be incentivized to solicit Scope 1 and 2 emissions data from customers, partners, vendors, and suppliers, which could manifest climate disclosure requirements in the private markets. Public blue-chip brands and retailers are already requesting sustainability data from their private market suppliers, a practice that will likely become more widespread with the SEC rule. These requests can incentivize more private market suppliers to differentiate themselves in contract bidding processes with strong Scope 1 and 2 emissions tracking controls. As such, asset managers have a vested interest in equipping their portfolio companies with Scope 1 and 2 emissions tracking and disclosure programs. Investors hold private capital firms to a high accountability standard, stressing the importance of proactively seeking compliance with ongoing developments in the ESG regulatory landscape. With the SEC establishing a baseline for climate reporting, private market investors have opportunities to motivate sophisticated climate resilience strategies from their assets, such as full value chain emissions analyses and asset decarbonization.

Concluding Thoughts

The SEC's climate disclosure rule marks an increased emphasis on climate risk in the U.S. investment regulatory landscape. Other regulations are emerging from U.S. states too, namely California's SB 253 and SB 261. Over the next three years, these measures will mandate reporting on material climate risks to California businesses, as well as Scope 1, 2, and 3 emissions, dependent on revenue. The emergence of these regulations in the U.S. follows global financial trends, with investors focusing on standardized sustainability reports.

The SEC is laying groundwork at the national level for what shall likely become standard climate reporting practice in capital markets. Although the revised rule is not as encompassing as the original proposal, the SEC is setting a baseline for materiality of climate risk, opening the door for private market investors to shape how climate mitigation and resiliency evolves in the medium- and long-term.

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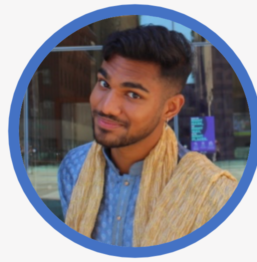

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