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# SEC Introduces Climate Disclosure Requirements, Litigation Intensifies

By Ben Peterson and Dave Lindsay

In March, the Securities and Exchange Commission (SEC) voted in favor of compulsory climate impact disclosures by publicly traded firms. The new rules, titled the Enhancement and Standardization of Climate-Related Disclosures for Investors, represent a watered-down subset of the disclosure requirements initially on the table. Yet in seeking disclosure of firms' climate-related risks to their business strategies, operations, and finances, the rules still create a meaningful new regulatory reporting requirement—especially since climate disclosure will form part of a firm's SEC filing. Currently under a voluntary stay of implementation by the SEC, pending judicial review, the likely compliance dates for the new rules remain unclear.

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### A Relatively Mild Beginning for Climate Risk Regulation

The SEC's new requirements will inevitably be compared to the EU's earlier and more detailed Sustainable Finance Disclosure Regulation (SFDR). Both measures are primarily intended to ensure that investors are well-informed, rather than to empower regulators to scrutinize and evaluate a firm's sustainability, and both measures are likely to lay the groundwork for an ever-increasing demand from regulators and investors for sustainability metrics. But while SFDR focuses on augmenting the documentation of financial products—for example, requiring justification for products advertised as "sustainable"—the SEC's move is different in several ways.

Firstly, the SEC is seeking to standardize disclosure as well as expand it, suggesting that regulators foresee an increasing volume of sustainability regulation that requires rationalization. Secondly, the SEC focuses on a firm's overall policies and positioning, rather than on specific product offerings. Lastly, the SEC requires that disclosure take the form of SEC filing, rather than just text on a website or a brochure—a measure which, SEC Chair Gary Gensler noted, will make disclosures "more reliable."

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### Key Disclosure Requirements

The information to be disclosed is much reduced from the SEC's original proposals, presumably in order to increase the regulation's legal survivability. In many areas, materiality is a criterion for disclosure. For example, a firm must disclose its "internal carbon price" but only if that price is a "material" input into the firm's risk calculation. The same applies to other methodology disclosures such as scenario analysis. But significant requirements remain around disclosure of:

- Climate risks that are likely to impact a firm's strategy, operations, or finances
- Any impact from climate risks already realized
- Mitigations employed by the firm, and the financial impact of those mitigations
- The firm's applicable risk management policies and processes
- The firm's climate-related goals, and their impact on the firm's operations or finances
- The firm's use of carbon offsets or renewable energy credits, and the costs and losses incurred

While greenhouse gas (GHG) metrics are covered in the new rules, the requirement has both a materiality and an eligibility condition. Only large and medium-sized firms designated as "large accelerated filers" and "accelerated filers" are eligible. And only the relatively simplistic Scope 1 and Scope 2 standards of the GHG Protocol are required, for direct emissions and those associated with purchases such as electricity. Independent third-party review is also deferred for now, as part of the rules' generally slow phase-in plan.

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The new rules include a safe harbor provision, intended to provide some protection against lawsuits based on various types of disclosure (though not for GHG metrics) by defining them as "forward looking statements" for the purposes of the Private Securities Litigation Reform Act (PSLRA).

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While the rules are largely focused on qualitative—some would say subjective—judgments around risk and materiality, the anticipated cost of compliance for large firms is high, because of the large amount of data to be required and the need to demonstrate a methodology for modeling risks in the absence of a mature consensus approach.

#### A Cascade of Litigation

Perhaps inevitably, the new rules have been interpreted in some quarters as politically, rather than financially, significant. Litigation began within a day of the rules' release, with a group of 10 Republican state attorneys general suing on March 6, in a move the SEC can hardly have failed to predict given these states' long history of opposition to the concept of environment-related SEC rules. The full range of legal actions and threats of action is impressive, including:

- The abovementioned group of states, suing largely on the grounds that the SEC is exceeding its authority.
- The U.S. Chamber of Commerce, which has sued and stated that the SEC has "eroded the reasonable standard of materiality."
- Private corporations including Liberty Energy Inc., which have filed for an emergency stay and noted the cost of compliance. (The SEC estimates a US$26 billion cost in the first year alone.)
- Environmental groups such as the Sierra Club, which have said they are considering legal action because the rules do not go far enough.

On April 4, the SEC put a voluntary stay on the new rules and moved to combine the lawsuits. No commentator expects the combined suit, which will be heard by the Eighth Circuit Court of Appeals, to be settled quickly.

#### An Important Building Block for Future Regulation

While the legal process will be long, with an uncertain outcome, and while the March 2024 rules are far less demanding than the original proposals, the rules nevertheless provide a clear statement of what the SEC considers to be appropriate disclosure. As such, they form part of an increasingly complex environmental regulation environment that includes the EU, UK, and California. By nature, environmental disclosure regulations may represent a heavy burden for a company even if only part of its business falls under a relevant jurisdiction, since the metrics to be disclosed tend to require a global rather than local calculation.

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Not only that, the SEC rules currently under debate set up a framework that can clearly be extended and made more stringent as necessary. The financial implications of climate, nature, and other sustainability risk are increasingly hard to ignore, and the new rules seem easy to both strengthen and to integrate with other regulation. Requiring Scope 3 GHG metrics for firms' supply chains, extending eligibility, tweaking "materiality" criteria, and increasing the level of detail around risk assessment methodology and risk management processes would be relatively easy steps—if the political environment should move in that direction. Regardless of regulatory requirements, it's also likely that some categories of investor will move toward asking for more detailed disclosures—possibly spurred by the controversy generated by the SEC.

This year, then, the U.S. is attempting to join the jurisdictions in which environmental risk is a formal reporting requirement. How fast this area of regulation will progress, and in which direction, will depend on many factors, but the overall trend is clear: Firms need to assume that sustainability risk, with its complex and immature new metrics, will form part of their regulatory landscape from now on.

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**Ben Peterson**
Ben Peterson, Treliant's Data Lead for EMEA, is a technology leader with more than 20 years' experience in financial services and fintech. He understands the role that strong data management plays in increasing revenue and reducing risk, and believes that data management can have a compelling RoI at both program and organization level. He is a tireless advocate of the power of data governance to create organizational transparency, leading to better compliance and decision making. **Ben.Peterson@treliant.com**

**Dave Lindsay**
Dave Lindsay is Managing Director, Data Solutions for Treliant's Capital Markets practice. He has significant expertise in data strategy, architecture, management, and governance, and is passionate about empowering organizations through thoughtful data strategy in conjunction with new technologies. **DLindsay@treliant.com**

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