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SEC's prescriptive climate disclosure proposal could impose new ESG obligations on Canadian inter-listed issuers

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On March 21, 2022, the United States Securities and Exchange Commission (SEC) issued a proposed rule for the enhancement and standardization of climate-related disclosures for public companies [PDF] (the Proposed Rule). The Proposed Rule would apply to domestic U.S. issuers and foreign private issuers that do not report through the multijurisdictional disclosure system (MJDS). Although the Proposed Rule currently does not apply to Canadian issuers accessing U.S. capital markets through MJDS, the SEC has requested specific comments on whether they should also be included. Canadian issuers are encouraged to submit comments on the Proposed Rule, although little time is left to do so as the comment period expires on June 17, 2022.

Introduction

The Proposed Rule would require disclosure of an issuer's climate-related risks that are reasonably likely to have a "material impact on its business, results of operations, or financial conditions" as well as specific disclosure in respect of greenhouse gas (GHG) emissions.

The Proposed Rule was introduced following a request in March 2021 for investors, registrants and other market participants to provide input with respect to SEC oversight of climate-related disclosure. That request generated over 600 unique letters and over 5,800 form letters, the vast majority of which were from individual respondents who were generally supportive of SEC action in this area. Issuers should consider commenting on the Proposed Rule or risk a relative under-representation of the issuer perspective that may adversely impact any final rule that the SEC may adopt. The Proposed Rule is highly prescriptive and we anticipate that compliance with its provisions would be very onerous, even for larger issuers. The Proposed Rule also contemplates only limited relief for smaller issuers, meaning its impact for such issuers could be even more significant.

Canadian issuers that are foreign private issuers in the U.S. are encouraged to provide feedback on the Proposed Rule and its application to them. Canadian issuers filing reports in the U.S. under MJDS are also encouraged to respond to the SEC's question as to whether the Proposed Rule should apply to them.

The Proposed Rule would prescribe material new disclosure requirements compared to requirements under Canadian securities laws and is substantially more prescriptive than the rules contemplated by the Canadian Securities Administrators (CSA) in proposed *National Instrument 51-107 – Disclosure of Climate-related Matters* [PDF]. Should the SEC conclude that climate change disclosure under Canadian securities laws — including under proposed National Instrument 51-107, if adopted as proposed — is not sufficiently comparable to U.S. standards, the SEC could decide to extend the application of the Proposed Rule to MJDS issuers as well.

General approach

The SEC states that the Proposed Rule is intended to focus on the financial consequences of climate change, and that disclosure of climate-related risks (and the metrics reflecting those risks) is necessary since those risks "can have an impact on public companies' financial performance or position, and may be material to investors in making investment or voting decisions." In general terms, issuers must disclose climate change risks that are reasonably likely to have a material impact on the issuer's financial statements. Disclosure of an issuer's climate-related opportunities would be voluntary and is not specifically required by the Proposed Rule. The Proposed Rule also mandates GHG emissions disclosure, including Scope 1, Scope 2 and, in some cases, Scope 3 emissions for each type of greenhouse gas.

The Proposed Rule is derived from the existing frameworks established by the Task Force on Climate-related Financial Disclosures and the Greenhouse Gas Protocol, a global greenhouse gas accounting standard created through a partnership between the World Resources Institute and the World Business Council for Sustainable Development.

Location of disclosure

In order to make it easier to find and compare climate change disclosure, the Proposed Rule would require disclosure to be provided in an issuer's Form 10-K (or Form 20-F, as applicable) or registration statement. The Proposed Rule notes that mandating that the disclosure be set out in continuous disclosure documents required to be filed under securities laws should enhance the reliability of the disclosures that are made, since non-compliance with the requirement will be subject to potential enforcement actions and issuers will have potential liability, including civil liability, if the disclosure contains a misrepresentation.

An issuer would also be required to include certain "climate-related financial statement metrics and related disclosure" in a note to the issuer's financial statement. This note would be required to include disaggregated climate-related impacts on each existing financial statement line item where the climate-related matter has an impact of 1% or more of the total expenses or capitalized costs incurred. Since these disclosures would be included in an issuer's financial statements, they would fall within the scope of the issuer's internal controls over financial reporting and would be subject to audit.

Climate-related risks

A key focus of the Proposed Rule is the identification and disclosure of material climate-related risks. The Proposed Rule defines material climate-related risks to be "the actual or potential negative impacts of climate-related conditions or events on a registrant's financial statements, business operations or value chains, as a whole". The issuer's value chain would include activities upstream and downstream of the issuer which are related to the issuer's operations — including activities by parties other than the issuer, such as suppliers in its supply chain and third parties involved in delivering a product or service to the end user. Disclosure of these risks would include

- *Time Frames:* an issuer would be required to assess the materiality of its climate-related risks over each of the short, medium and long term, and to describe how the issuer defines those time periods. For each timeframe, the issuer would need to disclose any climate-related impact that is material. The Proposed Rule uses the same definition of materiality applicable to disclosure under securities law generally, but the SEC release accompanying the Proposed Rule emphasizes that the assessment of a particular risk will be a function of (among other things) its magnitude and probability over the relevant timeframe.

- *Nature of Risk:* The issuer's disclosure must separately identify climate-related risks as being
  - *physical risks* relating to the physical impact of climate-related conditions and events. Disclosure relating to physical risks would need to indicate whether the particular risk is "acute" (for example, relating to event-driven risks such as extreme weather events) or "chronic" (for example, risks that result from longer-term weather patterns and related effects). Disclosure of physical risks would also need to include details relating to the aspects of the issuer's properties, processes or operations that are subject to the risk. Certain physical risks that are location-specific — such as those relating to regions exposed to flooding or water stress risks — would require additional disclosure relating to the specific location (broken down by ZIP code) and the percentage of the issuer's assets exposed to the particular risk; or
  - *transition risks* relating to a potential transition to a lower-carbon economy, including actual or potential negative impacts attributable to any changes required to mitigate or adapt to climate-related risks. Disclosure of transition risks would need to describe the nature of the risk — for example, whether it is regulatory, technological, market, liability or reputational in nature — and how the issuer is affected.

Targets and goals; impact on strategy, business model and outlook

Issuers would be required to disclose the actual and potential impact of the physical and transition risks they have identified on their strategy, business model and outlook. This would include impacts on the issuer's operations, products or services, and value chain, together with the issuer's activities to mitigate or adapt to the climate-related risks (including adoption of any new technologies or processes) and expenditures for research and development, in each case over the short, medium and long term. This disclosure will necessarily include aspects that are both current and forward-looking.

Issuers also would be required to provide disclosure relating to the following:

- where the issuer has set any climate-related targets or goals, the scope of activities and emissions included in the target, the units of measurement used (including absolute- vs. intensity-based), the intended timeline for achieving the target or goal, any interim targets and a description of how the issuer intends to meet the targets or goals
- the role that the issuer's use of carbon offsets or renewable energy credits or certificates plays in its climate-related business strategy, given the potential implications that cost and availability of offsets or credits in the future could have on the issuer
- whether an internal carbon price is used when assessing the issuer's climate-related risks and, if so, particulars of the price, the rationale for the price that is selected and how the

issuer uses that price to evaluate and manage its climate-related risks

- matters associated with the resilience of the issuer’s business strategy to potential future changes in climate-related risks, including analytical tools that the issuer uses to make this assessment; and, if the issuer uses scenario analysis, disclosures relating to the scenarios considered, and the parameters, assumptions and projected principal financial impacts on the issuer’s business strategy under each scenario

Governance and risk management

The Proposed Rule would require detailed disclosure regarding the governance and risk management of climate-related risks, specifically including the board’s role in overseeing these risks and the manner in which responsibility for climate change is allocated among the board and its committees, and among management.

This disclosure would include a description of

- any board members or committees, or management positions or committees, that are responsible for the oversight of, or for assessing and managing, climate-related risks
- any expertise of any board member or member of management in climate-related risks, or the absence of such expertise
- the processes and frequency by which the board (or board committee) discusses climate-related risks, together with the process by which any responsible member of management (or committee) is informed about, and monitors, climate-related risks
- the frequency of management’s reporting to the board (or board committee) on climate-related risks
- whether and how the board (or board committee) considers climate-related risks as part of its business strategy, risk management and financial oversight
- whether and how the board sets climate-related targets or goals and how progress against those targets or goals is overseen (including any interim targets or goals)

Issuers would also be required to describe their processes for identifying, assessing and managing climate-related risks, including

- a description of whether and how climate-related risks are integrated into the issuer’s overall risk management system
- the relative significance of climate-related risks compared to other risks facing the issuer, and how the issuer decides whether to mitigate, accept or adapt to a particular risk
- a description of any transition plan adopted by the issuer that is updated annually, including a description of how the plan addresses mitigation and adaptation of the climate-related risks identified by the issuer and the relevant metrics and targets used to identify and manage those risks and steps taken in the preceding year to achieve the goals or targets established by the plan or otherwise by the issuer

GHG emissions metrics

GHG emissions disclosure would be required on a basis consistent with the Greenhouse Gas Protocol, except that issuers would not be able to choose whether to set their organizational boundaries on either an equity share approach (a proportionate interest in a subsidiary entity's emissions) or a control approach (100% of a controlled entity's emissions). Instead, issuers would apply the same reporting boundaries used for consolidated financial statement reporting purposes. Disclosures would include

- *Scope 1 and Scope 2 emissions* disclosure, which would be required for each of the seven greenhouse gasses covered by the Kyoto Protocol individually, as well as all of them collectively, and for the same periods for which information is presented in the issuer's audited financial statements (except historical information, in certain limited cases)
- *Scope 3 emissions* disclosure, which would be required in a similar manner, but only where the Scope 3 emissions are material to the issuer *or* where a goal or target has been set by the issuer that includes Scope 3 emissions. A description of the categories of upstream and downstream activities included in the calculation of those emissions would also be required.

The Proposed Rule requires disclosure of emissions for each greenhouse gas, separate from offsets or credits used or applied, as well as the GHG intensity per unit of economic output (revenue and unit of production) broken out by Scopes 1 and 2 and separately for Scope 3, if disclosed.

Management must assess the internal controls over the GHG emissions data for the issuer, although the third-party attestation relating to GHG emissions would not need to cover these internal controls. The methodology and significant inputs and assumptions used in calculating GHG emissions must also be provided. Third-party data may be used as a basis for disclosure but where it is material, the issuer must explain the source of the information and describe any due diligence undertaken in respect of the data.

Attestation of GHG emissions

Issuers that are accelerated filers or large accelerated filers would need to obtain third-party attestation of their Scope 1 and Scope 2 GHG emissions disclosures. These attestations could be provided by persons other than accounting firms, but the attester must be independent and have relevant qualifications, which the issuer would be required to disclose.

Although attestations for Scope 3 GHG emissions would not be required, any attestation that was obtained voluntarily would need to comply with the same requirements as an attestation for Scope 1 and 2 emissions.

Attestation would be required initially on a "limited assurance" basis and ultimately on a "reasonable assurance" basis. These terms are not defined in the Proposed Rule. Reasonable assurance is equivalent to the level of assurance provided in an audit of the issuer's annual consolidated financial statements, while limited assurance is equivalent to a review engagement of the issuer's interim consolidated financial statements. Compared to limited assurance engagements, reasonable assurance engagements include more extensive testing and analysis and consideration of whether internal controls have been effectively designed.

Timeline for implementation

The Proposed Rule contemplates that the requirements would be phased in over a period of years following the year in which it becomes effective. It is not clear when the final version of the Proposed Rule (as it may be modified) will become effective. However, if it were to become effective later this year, then certain large accelerated filers could be subject to aspects of the Proposed Rule following their 2023 fiscal years.

Filer	Most disclosure	Scope 3 emissions (where applicable)	Limited assurance attestation	Reasonable assurance attestation
Large accelerated filers	First fiscal year after the year in which the rule becomes effective	Second fiscal year	Second fiscal year	Fourth fiscal year
Accelerated filers and non-accelerated filers	Second fiscal year after the year in which the rule becomes effective	Third fiscal year	Third fiscal year	Fifth fiscal year
Smaller reporting companies	Third fiscal year after the year in which the rule becomes effective	N/A	Fourth fiscal year	Sixth fiscal year

Conclusion

If adopted as proposed, the Proposed Rule would mark a substantial shift in climate-related disclosures as its scope and level of detail is significantly greater than other climate change disclosure proposals, such as those proposed by the CSA in draft National Instrument 51-107 and by the International Sustainability Standards Board (ISSB) in its exposure draft on Climate-Related Disclosures.

As previously noted, if the Proposed Rule is implemented in its current form, it will apply to Canadian issuers which report as foreign private issuers in the U.S., and the SEC is actively seeking input on whether to also apply its proposed disclosure requirements to Canadian issuers which rely on MJDS. As a result, all Canadian inter-listed issuers should take note and provide their comments to the SEC.

The Proposed Rule was issued after the CSA issued draft National Instrument 51-107 and before ISSB issued its exposure draft on Climate-Related Disclosures. Both the Proposed Rule and the ISSB's exposure draft would require disclosure beyond what is contemplated in the CSA proposal, and they may influence how the CSA will approach climate disclosure requirements for all issuers in Canada in any future iteration of draft National Instrument 51-107.