Academy ESG

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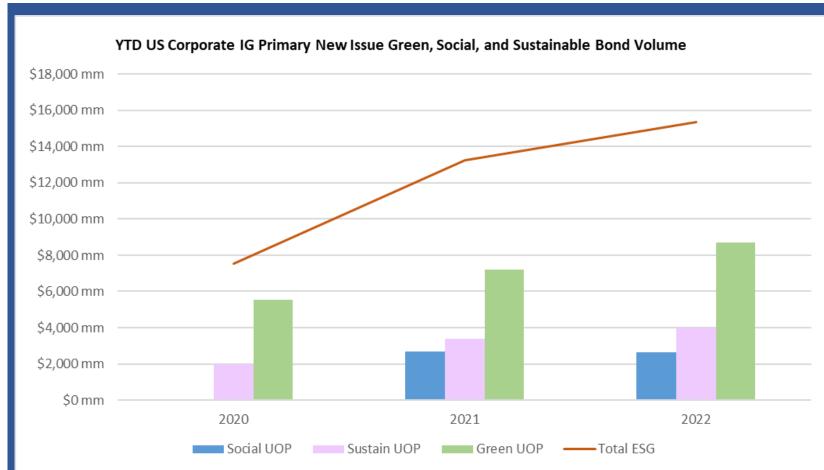
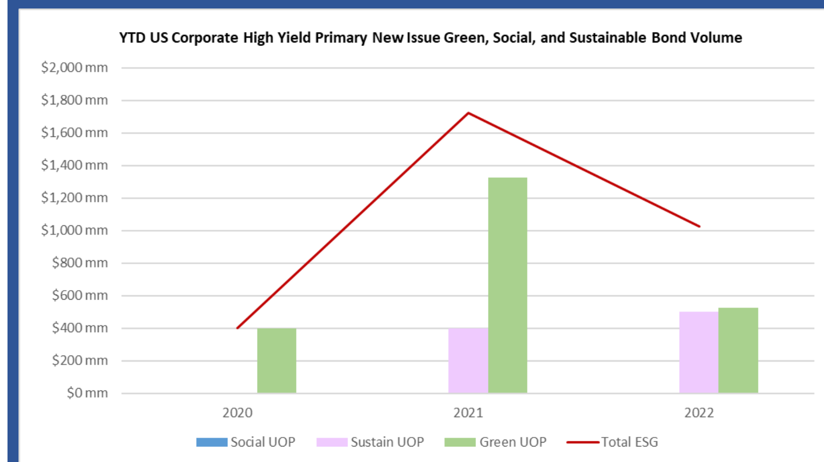
In the past few weeks, we have seen a swath of sustainability and ESG related regulatory developments, including proposed rules on both cyber and climate change disclosure, as well as two exposure drafts from the IFRS on sustainable and climate related reporting. In this month's report we examine:

- The SEC's proposed climate change and cyber disclosure rules
- The IFRS & ISSB's exposure drafts
- Costs & pushbacks to the proposed reforms
- Benefits



Investment Grade: While 2022 US IG ESG themed issuance remains elevated above global volume, there has been a significant deceleration in volume. Only one issuer came to market in April with a Sustainable bond offering.



High Yield: No new issuance for April as ESG themed high yield debt issuance remains down 40% YoY.

The SEC: Cyber & Climate

The broad sentiment coming from the SEC on its recent proposed disclosures for both cyber and climate change is the Commission's concern that existing disclosures do not adequately protect investors. In their eyes, the information being provided is often done outside of fillings and with varying degrees of comparability and completeness, which has led to a bifurcation of information. Presently, the Commission has found that since climate related financial risks have become part of the decision-making processes for both public companies & investors, it is within the agency's purview to act. The SEC's aggressive engagement on this front likely stems from the Biden administration's executive order that federal agencies begin to integrate climate related concerns into their workflow.

While the 500+ pages of proposed rules is quite dense, we attempt to highlight the key points.

In general, the SEC's proposed rule covers disclosure content, presentation, and phase-in periods for registrants. For the disclosure component, the SEC is considering disclosures for material impacts of climate change on the business model, strategy, and outlook (if carbon offsets & renewable energy credits are being used), and if any maintained internal carbon pricing and scenario analysis is being used. They also want to know how climate is considered in governance (board management & oversight), risk management, financial statements, and assumptions. As for GHG emissions specifically, all 8 must be disaggregated and exclude offsets. In addition to GHGs, any previously stated climate goals and targets must also be reported. As for the timetable for compliance, larger accelerated filers will need to disclose scope 1 & 2 for fiscal year 2023 (reported in 2024) and fiscal year 2024 for scope 3. Non-accelerated filers get one extra year. For small reporting companies, scope 1 & 2 are to be reported in fiscal year 2025, with no

scope-3 reporting required. Both TCFD and GHG Protocols were the primary sources referenced, setting them up as a more globally accepted standard.

The other recent disclosure development is applied to cyber security. Similar to climate change, the SEC, has taken notice of the cyber breaches discussed in the media, but not consistently reported in financial disclosures by registrants. The Commission is now looking to propose a new reporting standard that builds off its 2018 interpretive release and 2011 staff guidance. Currently, the SEC is proposing to amend reporting so that material cyber incidents or breaches are reported on form 8-K 4-days after the breach is found to be material, and is introducing a new item (106) to Reg S-K that would amend forms 10-Q and 10-K to more clearly communicate registrants policies on cyber security risks, management's role in the process, board expertise, and updates on previously reported incidents (among other changes). All these cyber disclosures will also be presented in the XBRL format, and be required of registrants including BDCs and Foreign Private Issuers. As it relates to the 8-K and cyber breaches, they are looking at disclosures that would briefly communicate when the incident was discovered, the nature & scope of the incident (and if ongoing), and if any data was stolen, accessed, or used.

IFRS & ISSB

In addition to the SEC's proposed rules, the International Sustainability Standards Board, which was set up by The Trustees of International Financial Reporting Standards Board, released its two disclosure exposure drafts for both climate change and sustainability. The goal and focus for the ISSB and IFRS is to make sure that all information and inputs needed to accurately assess enterprise value are reported, including both financial statements and sustainability related disclosures.

The sustainability related disclosure draft is focused on material sustainability issues, and these could be climate related, governance (i.e., cyber), or social (i.e., health & human safety). They are suggesting disclosure on all related sustainability risks and opportunities as it relates to a said corporation's governance, strategy, risk management, metrics, and targets. The information provided also needs to be presented in such a way that it highlights connections between sustainability risk/opportunities. The other exposure draft document zeros in on climate disclosure, and like the ISSB's Sustainability Exposure Draft, is focused on governance, strategy, risk management, metrics, and targets. Unlike the SEC's disclosure, materiality is a key component to ISSB who primarily sources SASB/VRF and CDSB, as opposed to TCFD and GHG protocol.

Costs & Pushback

Compliance will come with a cost. For those with TCFD in place, the SEC's estimates the annual cost of compliance is around $100k-$500k, sometimes more. One large cap energy company reviewed by the SEC spent $1.35mm in external advisory services for sustainability and climate disclosures. It will also impact burden hours, increasing them by 3,000+hrs. There could also be indirect costs, like litigation, and the possible disclosure of proprietary information. It is also likely that this will add to portfolio costs as asset managers will have to hire and put in place policies for investing around these metrics.

These developments haven't been without their fair share of pushback. Internally, within the SEC, Commissioner Hester Pierce has stated that the SEC is not the "Securities and Environment Commission." The US Senate is also looking at the SEC's recent proposals. States too are pushing back! In Minnesota, the "Stop Environmental Social Governance and Social Credit Score Discrimination Act" has been introduced. ALEC has also drafted a legislation

template similar to the Trump's Administration's DOL ERISA rule called the "State Government Employee Retirement Protection Act" which would prohibit state pensions from using non-financial/material information (ESG data) in the investment process.

We'd also like to point out that even if these disclosures go through, they are not set in stone. For instance, in 2014 the US Court of Appeals struck down the SEC's Conflict Minerals Rule—a possible precedent for these recent rules.

Benefits

The chief downside to these disclosure rules is that they're likely to contribute more to near-term inflation. Both the IFRS/ISSB's and SEC's requirements will necessitate significant resources (tech and labor) to build out, review, and maintain compliance. For asset managers and others, they will probably have to increase fees to accommodate—again highlighting the near-term inflationary characteristics of ESG.

Benefits, however, are likely to outweigh the downsides. For instance, both the IFRS & ISSB exposure drafts will help facilitate more efficient and consistent comps, which means investors and stakeholders will no-longer have to review multiple and separately furnished disclosure documents. Issuers might also see cost savings as disclosure is more standardized and there is no longer a need to meet and audit overlapping metrics across multiple standards/frameworks. Regardless, should these rules go through as stated, it would be a huge windfall for auditors and consultants, as well as ESG related data management services.

One of the chief benefits cited by the SEC is reduced information asymmetry. For instance, with cyber, there is the concern of insider trading. The SEC found that the length of time between when a breach is discovered and when it actually occurred is often 44 days. Then it is another 37-54 days before it is possibly reported. In that time, the SEC feels that there is an opportunity for mispricing and exploitation of it by malicious actors or insiders.

Further Resources

SEC Cyber Disclosure: https://www.sec.gov/rules/proposed/2022/33-11038.pdf

SEC Climate Disclosure: https://www.sec.gov/rules/proposed/2022/33-11042.pdf

IFRS Sustainability: https://www.ifrs.org/content/dam/ifrs/project/general-sustainability-related-disclosures/exposure-draft-ifrs-s1-general-requirements-for-disclosure-of-sustainability-related-financial-information.pdf

IFRS Climate Change: https://www.ifrs.org/content/dam/ifrs/project/climate-related-disclosures/issb-exposure-draft-2022-2-climate-related-disclosures.pdf

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