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Public Chatter

The SEC’s Climate Proposal: Where Did We Wind Up With “Materiality”?

Leading up to the **recent issuance** of the SEC's climate disclosure proposal, there has been much debate regarding the definition of "materiality" – both outside the SEC and reportedly even within it. The **SEC's proposing release** deals with "materiality" in a variety of ways, including:

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1. Avoidance of "Double" Materiality: The SEC's proposing release first addresses "materiality" in the 3rd paragraph of the "Introduction" on page 7. It makes clear that the proposal targets disclosure based on financial materiality – "information can have an impact on public companies' financial performance or position and may be material to investors in making investment or voting decisions." Interestingly, the proposing release carefully avoids the debate over whether "double," "dynamic," "nested" materiality should be considered as an appropriate litmus test for disclosure. Those terms aren't mentioned a single time in the proposing release (see **this graphic** about what those terms mean). This likely is an effort to reduce the likelihood that the SEC would be successfully challenged in court over whether it has overstepped its authority in promulgating these rules. It also would keep the SEC's rule in line with the accounting literature.

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2. Line-Item Approach: The SEC's existing guidance relies heavily on the traditional definition of "materiality" to elicit climate disclosure. The **2010 interpretive release** uses a principles-based approach. The SEC's new climate proposal is much more line-item based. Just look at the text of the proposed rules that starts on page 457 of the **proposing release** and continues to page 490. The proposed rules cover detailed specifics, both for financial statements (including required disclosures of impacts of severe weather events, climate-related transition activities, and climate-related risks on financial statement line items) and narrative discussions of the business (including highly specific disclosure requirements regarding governance, strategy, business model, outlook, and risk management), in addition to the greenhouse gas (GHG) emissions disclosure requirements. In statements made at Monday's open Commission meeting, Commissioners expressed opposing views on this approach. **Commissioner Caroline Crenshaw noted** that the proposed rules are "carefully calibrated and the staff took great pains to ensure a thoughtful and balanced approach that provides investors with information that they have been seeking for years." From the other perspective, **Commissioner Hester Peirce expressed frustration** that the proposed rules stray from most existing SEC disclosure mandates. Commissioner Peirce summarized the principles-based approach: "Rather than simply ticking off a preset checklist based on regulators' prognostication of what should matter, companies have to think about what is financially material in their unique circumstances and disclose those matters to investors."

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3. Use of "Scenario Analyses" & the Resulting Forward-Looking Information: The proposal doesn't go as far as requiring companies to conduct scenario analyses (identifying and assessing a potential range of outcomes of future events under conditions of uncertainty). But it does call for certain disclosures when a company does use scenario analysis - regarding scenarios considered and projected principal financial impacts on business strategy under each scenario. See pages 83-88 of the proposing release. Scenario analysis is already recommended by the TCFD - and many companies are using it. Many companies may find that this process is helpful to determine "materiality" in assessing climate-related risks and climate-related business opportunities. In the climate context, scenario analysis envisions perhaps a more formal process than what in-house lawyers are accustomed to when making materiality judgments – and to what executives typically consider when making their strategic business decisions. Disclosure about scenario planning inevitably will wind up with companies making more forward-looking disclosure in their SEC filings. Although the SEC's proposal notes that the PSLRA forward-looking statement safe harbor would cover this type of disclosure, it still would require companies to be very careful about what they do – and disclose.

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4. Short-, Medium- and Long-Term Horizons: The SEC's proposing release digs into "Disclosure of Material Impacts" on strategy, business model and outlook starting on page 72. Once a company has described the climate-related risks reasonably likely to have a material impact on its business or financial statements – as manifested over the short-, medium-, and long-term as would be required by proposed Item 1502(a) of Regulation S-K – companies would have to describe the actual and potential impact of those risks. Scenario analyses could help companies make these short-, medium- and long-term evaluations.

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5. Disclosure of Climate Risk Assessment Processes: The SEC's proposing release – starting on page 100 – details how the SEC's proposal would require companies to describe any processes they have for identifying, assessing, and managing climate-related risks. This would elicit disclosure from companies about their processes to determine the "materiality" of climate-related matters, really drilling down into how companies make their disclosure determinations. A first for this type of disclosure rule. Under the SEC's proposal, a company specifically would be required to disclose: - How it determines the relative significance of climate-related risks compared to other risks; - How it considers existing or likely regulatory requirements or policies, such as GHG emissions limits, when identifying climate-related risks; - How it considers shifts in customer or counterparty preferences, technological changes, or changes in market prices in assessing potential transition risks; and - How it determines the materiality of climate-related risks, including how it assesses the potential size and scope of any identified climate-related risk.

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6. Materiality in the Scope 3 Emissions Context: Look for a blog soon about determining whether Scope 3 emissions should be considered "material"…

Here are our other blogs about the SEC's climate proposal so far: - **SEC Proposes Climate Disclosure Rules: 9 Things to Know** - **"How Much Is This Gonna Cost Us?" The SEC's Climate Economic Analysis**

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