What action, if any should the Canadian Securities Commission members take to address the lack of decision-useful climate risk information including greenhouse gasses in public company filings?

# Contents

# Executive Summary

Canada has seen a dramatic increase in physical climate risks from natural disasters and transition climate risks with increasing regulation in the transition to a low-carbon economy. Over half of Canadian businesses say profitability has suffered from climate-related events, however, only 4% of organizations report all climate risks recommended in the Task-Force on Climate-related Financial Disclosures framework[1]. This is a problem because the disclosures of climate-related risks and associated potential impacts of these risks for listed entities lacks decision-usefulness for investors; meaning, consistently measured and comparable over time and between entities, available in time to influence decisions, verifiable, and complete, having all necessary information to provide a thorough understanding. The financial markets are a key part of the economy and function effectively due to regulation that reduces information asymmetry (where one party to a transaction is more informed than the other) between buyers and sellers. In Canada, disclosure of climate risks has remained unregulated in the capital markets, making issuers more informed of the full scope of risks in their securities than an investor/buyer. When making a policy decision, the Canadian Securities Administrators should seek to balance implementation costs against the quality and amount of decision-useful information that reduces information asymmetry.

In the following analysis, two alternative policy options, mandating Canadian Sustainability Disclosure Climate Standard (CSDS 2) and allowing mandatory reporting flexibility under more vigorous jurisdictional rules are compared with the status quo of disclosing material information. Three goals are used to compare these policy options, capital market efficiency, implementation costs and political feasibility. This analysis concludes that mandating CSDS 2 is the best policy option as it will increase decision-usefulness of information with reasonable costs and better political feasibility given the influence of carbon intensive industries on regulatory policy in Canada. My recommendation from this analysis is therefore to mandate CSDS 2 with comply or explain exceptions to relive pressure for smaller issuers. Pending public consultation, the rule will be phased-in over a one-year period with a three-year period for venture issuers. Assurance requirements will be phased in for scope 1 and 2 greenhouse gas (GHG) emissions only, to encourage reporting of scope 3, over a three-year period and 5-year period for venture issuers.

# Introduction to the Importance of Climate Risk Information on the Economy

The stock market plays a substantial role in the economy [2]. A key function of capital markets is to price risk to support efficient capital decisions [3]. Without decision-useful information, capital will be misallocated. Decision-useful is defined for the purposes of this analysis as consistently measured and comparable over time and between entities, available in time to influence decisions, verifiable, and complete, having all necessary information to provide a thorough understanding [4].

Financial markets function effectively due to regulation that began with the introduction of the Securities and Exchange Commission (SEC) after the 1929 stock market crash demonstrated decision-useful information for investors to accurately price in risk was vital to market effectiveness [5].

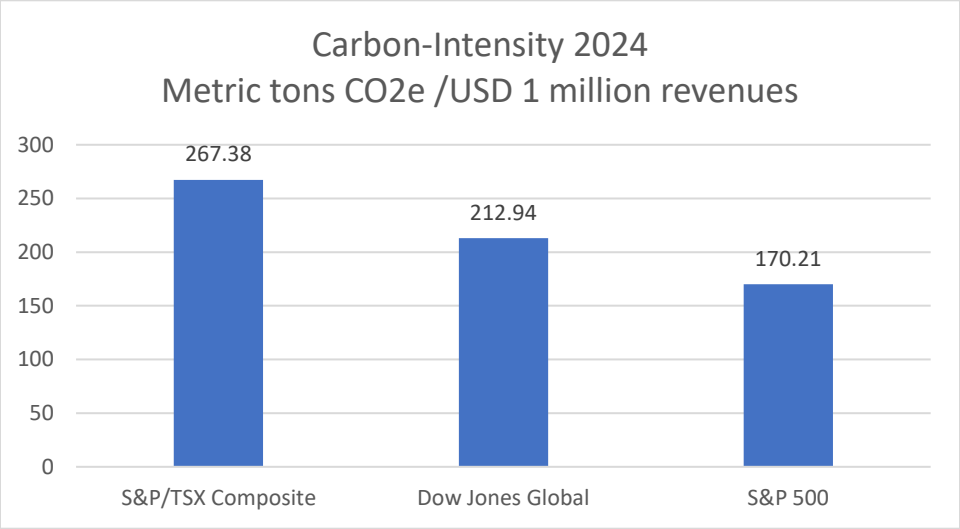
Climate change from global warming represents a significant economic risk. Although highly uncertain, a 2021 study indicated the world economy is on track to lose 10% of value by 2050 [6].

Canada has seen more prevalent and severe natural disasters and resulting damage in recent years[7]. Over half of Canadian businesses say profitability has suffered from extreme weather events and 92% fear that their businesses could be hit by climate-related events in the near-term [8]. Seventy-five percent of investors consider how a company manages sustainability risks (including climate) in their investment decisions[9].

There are physical and transition climate risks [3]. Physical risks represent actual and potential impacts from acute events like wildfires and chronic events like rising sea levels[3]. Transition risks represent risks in the transition to a low-carbon economy like increasing regulation[3]. These risks have important implications for Canada's economic performance, including impacts on asset valuations and financial stability[7]. With a high carbon-intensity index, Canadian exchanges are particularly vulnerable to climate risk as illustrated in the graph below.

**Carbon-intensity of the TSX/S&P composite index[1] compared with other indices**

*Adapted from* [10] *Data*[11–13]




Hundreds of standards and frameworks exist to provide climate risk information[14]. Although there has been a push to consolidate the reporting landscape, sustainability reporting remains fragmented and complex, hindering global interoperability compared to accounting standards. This makes reporting a complex process for organizations, particularly for entities reporting into several jurisdictions.

## Why the Lack of Decision-useful Climate Risk Information Leads to Mispriced Assets

With no legal requirement for disclosure, there is no incentive to disclose all recommended information, leading to inconsistencies. One of the most widely used disclosure frameworks, The Task-force on

[1] The benchmark index for Canada

Climate-related Financial Disclosures (TCFD) noted that only 4% of issuers provided all disclosure recommendations in the framework [1]. There is no consensus on how to best estimate unreported emissions. Methodologies used have low predictability and can be up to 200% inaccurate[15].

With climate risk found mainly in voluntary reports, prescribed timelines for disclosure in securities regulation do not apply, meaning the information is not provided at the same time or with the same reporting package as regulatory filings, affecting the usefulness of the information [16].

This causes Information asymmetry, where one party to a transaction is better informed than the other party and gives assets characteristics of post-experience goods, where asset quality is unknown even after purchase[17]. Without climate risks disclosed, a market failure exists from information asymmetry as sellers in exchanges are more informed about climate risks than investors/buyers. Asset mispricing evidence has been found through a study on physical risks specifically [18]. Although highly uncertain, this leaves potential for a financial crisis in Canada due to vulnerability of the economy to climate risks, accompanied by asset mispricing. Socially optimal share prices will likely differ from current market value when information asymmetry is reduced by providing decision-useful climate disclosures. Information asymmetry is a common rationale for policy intervention.

## Current Policy: Disclosure of Material Information

Securities issuers in Canada are required to disclose material information in regulatory filings. Information is material if it is likely to influence the decision of a reasonable investor to hold, sell or purchase securities. Issuers also provide qualitative descriptions of forward-looking information that will reasonably affect future performance. Materiality depends on organizational context and requires judgement [16]. High uncertainty and long timeframes of climate risks increase subjectivity in what to disclose [19]. The Canadian Securities Administrators (CSA), a voluntary group consisting of all provincial regulators across Canada, provides guidance on climate risk information which includes guiding principles, one of which being to err on the side of materiality if in doubt [16].

In 2021, 92% of issuers disclosed some form of climate risk in their regulatory filings[19], up from 85% in 2018 [20]. There is room for improvement in completeness, as many organizations report on a limited number of risks. Fifty-nine percent of the disclosures were detailed with the remainder being vague [19].

Investors continue to provide feedback on comparability and consistency of reporting and are interested in greenhouse gas (GHG) emissions to assess exposure to climate risk [20]. Emissions are divided into three scopes, scope 1 are emissions an organization directly owns or controls. Scope 2 are emissions from the purchase of energy. Scope 3 are emissions the organization is indirectly responsible for through it's value chain via outsourcing, product usage and disposal[21].

GHG emissions are rarely reported in regulatory filings[20], 72% of companies listed on S&P/TSX composite index accounting for 91% of the market size by dollar value report GHG emissions with scope 3 reported "infrequently"[22]. Without all three scopes, completeness of information is lacking, however, scope 3 is particularly challenging to obtain and subject to significant uncertainties and high costs to obtain the information.

In 2021, the CSA underwent a public consultation to require use of the TCFD recommendations with the exception of the two most complex disclosures 1) analyzing strategic resilience with various climate

scenarios and 2) allowing issuers to forego reporting GHG emissions by disclosing the reasons for not reporting (formally called comply or explain). The project was paused to monitor global developments and will be revisited upon finalization of Canadian sustainability standard consultations.

TCFD has now been integrated into the International Sustainability Standards Board (ISSB) standards, which Canada is consulting on adopting as Canadian Sustainability Climate Disclosure Standards (CSDS 2). Standards are voluntary until incorporated into a CSA rule.

The current policy continues to rely on identification of material information.

# Goals and Impacts of Policy

Three policy goals have been identified with impact categories to provide a balanced assessment.

The goals are designed considering the CSA authority which is limited to rule-making, which function as laws[23], and mission of the CSA to foster effective capital markets.

### Capital Market Efficiency

This goal aims to improve market efficiency by minimizing information asymmetry through organizations providing decision-useful information. This will allocate capital in the most economically efficient manner and decrease asset mispricing. The impact category is to maximize the number of listed organizations reporting decision-useful information on physical and transition climate risk and all three GHG emissions.

### Implementation Costs

The impact categories are to first minimize implementation costs for issuers so the costs of reporting climate risk information do not outweigh the benefits of providing the information to investors, which is difficult to measure. The second impact category is minimizing costs to investors. The last impact category is minimizing monitoring costs to the CSA.

### Political Feasibility

This is an instrumental goal, meaning it aims to maximize success of the policy put in place through political acceptance. The CSA members are crown corporations (owned by provincial governments but operated independently). This goal also seeks to minimize regulatory capture (which is when regulators are influenced by those they regulate) during public consultation and minimize the potential for judicial challenges.

# Policy Alternatives and Analysis of Alternatives Against Goals and Impacts

## *Current Policy: Disclosure of Material Information*

### Capital Market Efficiency

Reviews by the CSA members did not result in any type of corrective action for issuers, indicating material issues were reasonably identified [19]. Emissions disclosure is comparable with the USA and Japan but lags behind Europe (89%) and the UK (98%)[22], indicating room for improvement.

### Implementation Costs

Costs will continue to increase as investors demand more details on climate risks, however, without regulation issuers can gradually increase information up to their marginal private costs over time.

Costs to investors would remain high. Large institutional investors spend nearly $1,400,000 annually on obtaining climate analysis (expenses vary by investor type) [24].

Administration costs for CSA staff would remain stable under the status quo.

### Political Feasibility

Issuers are accustomed to providing material information in regulatory filings making political feasibility high.

## *Policy Option 1: Mandate the CSDS 2 Climate Standard*

The first policy option is to mandate listed organizations to use the CSDS 2 through a CSA rule. CSDS 2 focuses on financially material climate risk information, meaning the information will impact the organization's financials in some way. The standard incorporates the TCFD recommendations and several other globally recognized frameworks. CSDS 2 is prescriptive and mimics expectations of accounting standards. Unlike TCFD, CSDS 2 specifies that disclosures be made at the same time and with the same reporting package as the financial statements[25]. Issuers would therefore have to submit climate risk information with their securities filings, improving timeliness of information, however, not specifying where in the reporting package to disclose climate risk information gives flexibility to include information in a sustainability report. Many international jurisdictions including China and Brazil have adopted these standards for their indices[26].

Industry specific disclosure topics, all three emissions scopes throughout the value chain and business outcomes under different climate scenarios are required under CSDS 2. CSDS 2 does however have measures for proportionality specifying information reported should be "without undue cost or effort" to the company[25].

In alignment, the CSA would release guidance and adopt a comply or explain approach for the more complex measures in CSDS 2 including scenario analysis and scope 3 emissions to balance completeness with demands on issuers with varying resources[25].

It is recommended to phase in the rule over a one-year period with a three-year period for venture issuers[19]. Assurance requirements will be phased in for scope 1 and 2 GHG emissions only, to encourage reporting of scope 3, over a three-year period and 5-year period for venture issuers.

### Capital Market Efficiency

CSDS 2 requirements provide more decision-useful information on both climate risks and GHG emissions than the current policy. However, collecting the information required for completeness is costly given the complexity of scope 3 emissions in particular.

### Implementation Costs

Average compliance costs for issuers will be higher than the status quo. The initial costs of implementing previous international accounting standards are estimated between $750,000 and $1,600,000 [27] and should stabilize around $530,000 [24]. Although many organizations already report some climate risks, the

scope and verifiability (governance and controls) over information would need to increase to the level of financial information.

Initiatives organizations undertake to mitigate climate risks, such as reducing GHG emissions, will decrease operating costs and risks for organizations in the long-term.

The amount investors are paying to obtain information would decrease with better quality information. However, the comply or explain approach may leave gaps, continuing some reliance on third-party analysts.

Costs for CSA would increase with monitoring required for mandatory disclosures.

Given that mandatory climate disclosure is fairly new, information on economic effects is limited, however, the UK has had mandatory GHG reporting since 2013. A recent study found that firms reduced emissions and margins remained stable.[28]

### Political Feasibility

Regulatory capture is a risk as CSA members are crown corporations. Carbon intensive companies play a role in climate policy in Canada which could lead to less effective versions of the policy.

## *Policy Option 2: Allow Mandatory Reporting Flexibility Under More Vigorous Jurisdictional Rules*

The second policy option is creating a rule allowing the option to disclose under a jurisdiction of choice, providing the standards from that jurisdiction are equal to or more rigorous than CSDS 2, focusing on double materiality. The European Sustainability Reporting Standards (ESRS) is the most relevant point of comparison. ESRS focuses on a wider scope of materiality, asking organizations to report on both financially material climate risk and the impact the organization has on the environment, nature and communities which is defined as "double materiality"[29]. Organizations must make a disclosure if either type of materiality is met[29]. As with CSDS 2, ESRS is prescriptive and mimics expectations of accounting standards. Unlike CSDS 2, ESRS has specific considerations for materiality that must be followed which leaves less to the discretion of the organization[29]. Disclosures would be included in securities filings in a separate section of the management report[29].

Industry specific disclosure topics are coming and like CSDS 2, all three emissions scopes throughout the value chain and business outcomes under different climate scenarios are required under ESRS[29]. Therefore, there is interoperability between the standards, however ESRS has more comprehensive requirements under the double materiality lens.

This option would apply phase-in of the jurisdictional rules the entity will apply. If deciding to apply CSDS 2, the phase-in period will be over a one-year period with three years for venture issuers[19]. Assurance requirements will be phased in for GHG emissions over a three-year period and five-year period for venture issuers.

### Capital Market Efficiency

ESRS and other more rigorous standards provide the most decision-useful information of all policy options, allowing assessment of systemic risks from organizational impacts on the environment (such as

biodiversity impacts) as opposed to solely the effect climate risks pose to an organization. Scope 3 emissions are required as is assurance over all GHG emissions.

### Implementation Costs

Information collection under ESRS will be the costliest policy option. The estimated cost to issuers is over $1,000,000 annually with higher first year costs[29]. This is due to the wide scope and assurance costs of the information.

There will be some organizations in Canada that already fall under this regime and efficiencies could be had through this approach.

Monitoring costs for CSA would increase substantially with monitoring required for a wide scope of disclosures and familiarization with many jurisdictional rules. CSA would continuously need to monitor and determine which jurisdictional rules would be acceptable alternatives for issuers to use.

It is worth noting that social costs of emissions are estimated per tonne at $266 for Carbon Dioxide (CO2) [30]. A major Canadian Oil and Gas company emitted 17.2 million tons of CO2 equivalent emissions in 2021 which equates to social costs of $4,575,200,000 [31]. Therefore, increased information can help reduce the social costs of emissions.

### Political Feasibility

Risks are highest with this option, although it is flexible on which standard to use, issuers may feel pressure from investors by being benchmarked to peers to report using ESRS. Indication on regulatory movement towards mandatory double materiality disclosures will be strongly opposed as there are legal risks for organizations when information is disclosed in regulatory filings. However, judicial review such as what happened in the USA when the SEC released their final rule is unlikely as processes in Canada have several procedural barriers to overcome prior to application for review[32].

## Decision Matrix Comparing Policy Options

The goals and impacts from each policy are assessed as Poor, Fair, Good and Very Good based on the analysis above. Further details are in Appendix A.

## Conclusion

Based on the assessment, it is recommended to mandate listed organizations to use CSDS 2. This policy expands existing CSA work and aligns with its mission.

Although there is risk of regulatory capture from opposition by carbon-intensive industries, this is the most balanced solution in terms of implementation costs for the market failure of information asymmetry. By reducing information asymmetry, the additional details required in the standards will increase competition by providing incentive to achieve climate risk mitigation and adaptation.

Although some elements will be challenging for issuers such as scope 3 and scenario analysis, issuers are aware investors continue to demand further information to understand the systemic risks. The success of mandatory GHG reporting in the UK can be used to convince issuers. Most listed companies are already providing some information; however, a rule would ensure an improvement in processes and decision-useful information.

The next step is to release a detailed rule for public comment and ensure all perspectives can be heard before releasing final rules. The CSA needs to speak to their individual boards of directors about increased monitoring budgets. Systemic risks, asymmetric information and high social costs of emissions are a useful justification for mandating CSDS 2. To be successful, emphasizing the phase-in approach and proportionality elements is key, giving organizations with different resources time to adjust.

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# Appendix A – Detailed Decision Matrix

| Goal | Impact | Current Policy | Alternative Policy 1 | Alternative Policy 2 |
|---|---|---|---|---|
| Capital Market Efficiency | Decision-useful Climate risks | Fair – There is currently some climate disclosure of arguably the most material risks however, decision usefulness will not improve much with the status quo. | Good – Improved decision-usefulness of information, still risk of gaps with comply or explain option. | Very Good – Wider scope of materiality will provide the most comprehensive picture and encourage the market to adopt double materiality more widely. |
| | Decision-useful GHG reporting | Fair – Data is in-line with other countries but will not improve with the status quo. | Good – Improved decision usefulness of with timing of information much and scope 3 encouraged to be reported. | Very Good – Encourages scope 3 reporting for a wider range of entities. |

| | | | | |
|---|---|---|---|---|
| Costs of Implementation | Costs to issuers | Good – With disclosure being voluntary, companies choose the level that makes economic sense. | Fair – High costs of obtaining information. | Poor – Extremely high costs of obtaining information. |
| | Costs to investors | Poor –Some Investors current spending more than issuers would to comply. | Fair – Will improve costs, however, comply or explain for some requirements may require investors to continue to rely on third-party analysts. | Good – With issuers encouraged to report to more strict requirements, issuers will be encouraged to report more information, being benchmarked against peers. |
| | CSA monitoring costs | Very Good – Monitoring is incorporated into material risk disclosures already monitored by CSA. | Fair – Monitoring costs would increase. | Poor – Very high monitoring costs having to familiarize with many jurisdictions. |
| Political Feasibility | | Very Good – Issuers are accustomed to reporting material risks in regulatory filings. | Fair – Many issuers are already providing some climate information, however there remains discretion. The scope of the CSDS 2 may have opposition with some of the more complex reporting options. | Poor – Strong opposition expected given the scope of more stringent jurisdictions and assumed move towards that direction. |