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Insights

The SEC Proposes Enhanced Climate Disclosure Rules

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On Monday, March 21, 2022, the U.S. Securities and Exchange Commission ("SEC") released its long-awaited proposed rules on climate-risk disclosures. The proposed rules would amend and build upon existing climate-change disclosure rules and guidance (collectively, the "Proposed Rules"). Under the Proposed Rules, publicly traded companies and other issuers of securities that are required to file a registration statement with the SEC (collectively referred to by the SEC as "Registrants") would be required to make climate-related disclosures to investors in their registration statements (Forms S-1, S-3, F-1, and F-3) and periodic reports (Forms 10-K, 10-Q, and 20-F).

The Proposed Rules aim to enhance and standardize disclosures on climate-related risks that are likely to have a material impact on a company's business and financial performance over the short-, medium-, and long-term. The release of the Proposed Rules has triggered impassioned debate, illustrating both strong support for, and fervent opposition to, the proposed climate-related disclosure framework. Thus, any final rules adopted following the comment period could vary significantly from the proposals by the SEC discussed herein.

Background

The Proposed Rules come as investors—including shareholders, investment advisers, and investment management companies—have increasingly sought clear guidelines for assessing and understanding the climate-related risks associated with current and potential investments, and they reflect a growing interest in environmental, social, and governance ("ESG") issues more broadly.

Climate- and ESG-related risks can affect a company's business in several ways—extreme weather events can damage assets and disrupt operations, and changes in regulations, consumer preferences, and financing options can affect the soundness of a company's business strategy. "Physical and transition risks from climate change can materialize in financial markets in the form of credit risk, market risk, insurance or hedging risk, operational risk, supply chain risk, reputational risk and liquidity risk," observed SEC Commissioner Allison Lee, who voted in favor of the Proposed Rules.

Yet, prior practice for climate- and ESG-related disclosures has been limited and inconsistent, and in some cases vulnerable to "cherry picking" or "greenwashing." A proliferation of third-party ESG reporting frameworks over recent years has only served to increase fragmentation of climate-related reporting.

SEC Rulemaking

To address these challenges, the SEC has long been working to set forth a consistent, comparable, and reliable disclosure requirement that would allow investors to make informed investment and voting decisions. With these Proposed Rules, SEC Chair Gary Gensler believes investors will benefit from "consistent and clear reporting obligations for issuers" and issuers will be able to "more efficiently and effectively disclose these [climate] risks and meet investor demand, as many issuers already seek to do."

The Proposed Rules build off of the SEC's prior rules and guidance on climate-related disclosures, which date back to the 1970s, and which more recently have included the SEC's 2010 Climate Disclosure Guidance and September 2021 Sample Letter to Companies Regarding Climate Change Disclosures. The Proposed Rules incorporate concepts and frameworks for climate-related reporting set forth by the Task Force on Climate-Related Financial Disclosures ("TCFD") and standards for accounting and reporting on greenhouse gas ("GHG") emissions established by the Greenhouse Gas Protocol ("GHG Protocol"). Both the TCFD and GHG Protocol have developed concepts that are widely accepted and used by companies when providing climate-related disclosures.

Disclosure and Audit Requirements for All Registrants

The Proposed Rules provide that Registrants must make disclosures that are designed to foster greater consistency, comparability, and reliability of available information for investors. In particular, the Proposed Rules would require Registrants to disclose information related to climate-related risks and GHG emissions.

- **Climate-related risks; impact on strategy, business model, and outlook; governance and risk management.** Climate-related risk disclosures under proposed Regulation S-K amendments would entail climate-related risks identified by a Registrant that are likely to have a material impact on its business and consolidated financial statements, as well as the financial estimates and assumptions used in the financial statements, over the short-, medium-, and long-term. Climate-related risks would include physical climate-related risks (such as shorter-term severe weather events and longer-term weather patterns and higher temperatures) and risks related to a potential transition to a lower carbon economy (such as regulatory changes and changes in market demand). A Registrant would also be required to disclose how identified climate-related risks have affected, or are likely to affect, its strategy, business model, and outlook. Disclosures would also include climate-related governance information, including as to a Registrant's processes for board and management oversight and governance over climate-related risks, assessing and managing climate-related risks, and integrating climate-related risks into an overall risk management system or process.

- **Financial statement metrics**. In addition to the proposed narrative disclosure under Regulation S-K, the Proposed Rules also contemplate adding requirements under Regulation S-X to include climate-related financial metrics and related disclosures in a note to the Registrant's audited financial statements, which would not only be included in the scope of any required audit by an independent registered public accounting firm but also would be included in the scope of the Registrant's internal control over financial reporting. Subject to specified thresholds, the Proposed Rules would require the Registrant to report three categories of financial statement metrics: financial impact metrics (which would require a Registrant to present disaggregated information about the impact of climate-related risks, events, and transition activities on its financial statement line items), expenditure metrics (which would disaggregate expenses and costs associated with climate-related events and transition activities), and financial estimates and assumptions (including whether the estimates and assumptions used to produce the financial statements were impacted by climate-related risks and uncertainties). For each type of financial statement metric, the Registrant would be required to describe how it derived the metric, significant inputs and assumptions used, and, if applicable, policy decisions made by the Registrant to calculate the specified metrics.

- **GHG emissions**. GHG emission disclosures would include a Registrant's direct GHG emissions (Scope 1) and indirect GHG emissions (Scope 2). Scope 1 and Scope 2 emissions would be disclosed on a disaggregated constituent GHGs basis and aggregated basis, and would be expressed both in absolute terms (not including offsets) and in terms of intensity (*i.e.*, per unit of economic value or production). Registrants, with the exception of smaller reporting companies, would also be required to disclose GHG emissions stemming from sources not part of their operations or under their direct control, but within the upstream and downstream activities relating to their operations (Scope 3). Scope 3 emissions are often the largest source of a company's

emissions, at least double or triple (or more) than a company's Scope 1 and Scope 2 emissions. However, because Scope 3 emissions are outside a company's direct ownership or control, the SEC has recognized that Registrants may face significant costs and difficulties when attempting to accurately disclose Scope 3 emissions.[1] To strike a balance, the SEC has proposed that Scope 3 emissions disclosures would enjoy a safe harbor from liability (unless the disclosures are made without a reasonable basis or in bad faith), and smaller reporting companies would be exempt from Scope 3 emissions reporting as they may not be able to shoulder the costs or complexities of accurate Scope 3 emission reporting.

Disclosure Requirements for Registrants Setting Climate-Related Strategies

Certain elements of the Proposed Rules only affect Registrants that have adopted or employed certain climate-related strategies.

- **Climate-related targets**. If a Registrant has publicly set climate-related targets or goals, then the Registrant would have to disclose information about the scope of activities and emissions included in the target, the defined time horizon by which the target is intended to be achieved, and any interim targets. The Registrant would also have to disclose how it intends to meet its climate-related targets or goals, as well as relevant data that indicates whether the Registrant is progressing toward its target and how such progress has been achieved, with updates each fiscal year. If carbon offsets or renewable energy credits or certificates ("RECs") have been used as part of the Registrant's plan to achieve a target, disclosures would include certain information relating to the carbon offsets or RECs, including the amount of carbon reduction represented by the offsets or the amount of generated renewable energy represented by the RECs.

- **Carbon pricing**. Additionally, if a Registrant uses an internal carbon price, then the Registrant would have to disclose information about that price, including how it is set.

- **Transition plan**. If a Registrant has adopted a transition plan as part of its climate-related risk management strategy, the Registrant would have to describe the plan, including the relevant metrics and targets used to identify and manage any physical and transition risks.

- **Scenario analysis.** If a Registrant uses a scenario analysis to assess the climate resilience of its business strategy, the Registrant would have to disclose the scenarios used, as well as the parameters, assumptions, analytical choices, and projected principal financial impacts.

Third-Party Attestation Requirements

Accelerated filers and large accelerated filers would be required to include in the relevant filing an attestation report for their Scope 1 and Scope 2 emissions, as well as certain related disclosures about the service provider. Both accelerated filers and large accelerated filers would have time to transition to these attestation requirements, with the proposed transition periods allowing for one additional year to transition to providing "limited assurance" reports and two additional years to transition to providing "reasonable assurance" reports (see table below).

Phase-In Periods and Accommodations

[1] There are 12 categories of Scope 3 emissions, not all of which may be relevant depending on the operations of each Registrant. "Upstream" Scope 3 emissions include purchased goods and services, capital goods, fuel and energy related activities, transportation and distribution, waste generated in operations, business travel, employee commuting, and leased assets. "Downstream" Scope 3 emissions include transportation and distribution, processing of sold products, use of sold products, end-of-life treatment of sold products, leased assets, franchises, and investments. *See* Environmental Protection Agency, Scope 3 Inventory Guidance, https://www.epa.gov/climateleadership/scope-3-inventory-guidance.

The Proposed Rules also include a number of elements that are designed to mitigate burdens on Registrants, such as phase-in periods for the proposed climate-related disclosure requirements and accommodations for smaller reporting companies. Specifically, these include:

- **Phase-in periods**. There would be phase-in periods for all Registrants, with the compliance date dependent on the Registrant's filer status—as a large accelerated filer, accelerated or nonaccelerated filer, or smaller reporting company—and the content of the item of disclosure. There would also be phase-in periods for reporting Scope 3 emissions.

- **Safe harbors.** The Proposed Rules include a safe harbor for liability for Scope 3 emissions disclosures (unless they are made without a reasonable basis or in bad faith). To the extent that the proposed disclosures constitute forward-looking statements, the forward-looking statement safe harbors pursuant to the Private Securities Litigation Reform Act would apply.

- **Scope 3 disclosure exemptions.** The Proposed Rules provide exempt Registrants meeting the definition of smaller reporting companies from the Scope 3 emissions disclosure requirements.

Assuming the Proposed Rules are adopted by the end of 2022, a Registrant with a December 31 fiscal year-end would be subject to the requirements based on its filer status as follows:

	All proposed disclosures (excluding Scope 3 GHG emissions)	**All proposed disclosures (including Scope 3 GHG emissions)**	**Limited assurance report**	**Reasonable assurance report**
Large accelerated filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)	Fiscal year 2024 (filed in 2025)	Fiscal year 2026 (filed in 2027)
Accelerated filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	Fiscal year 2025 (filed in 2026)	Fiscal year 2027 (filed in 2028)
Non-accelerated filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	Exempted	Exempted
Smaller reporting company	Fiscal year 2025 (filed in 2026)	Exempted	Exempted	Exempted

Comment Period

The comment period on the Proposed Rules will remain open for 30 days after its publication in the Federal Register or until May 20, 2022 (whichever is longer).

Comments and Reception by Investors, Companies, and Other Interested Parties

In what could be interpreted as an attempt to get ahead of the anticipated debate surrounding the Proposed Rules, the SEC has stressed that it considered feedback from a range of commenters in developing these proposals. Highlighting the wide-ranging support for climate-related disclosures, the SEC included letters of support received from academics, accounting firms, individual and institutional investors, and government officials. The SEC also noted that its Proposed Rules incorporate many concepts from the TCFD, one of the most established ESG frameworks, which has more than 2,600 supporters, including over 1,000 financial institutions.

Arguments in support of the Proposed Rules posit the following.

- **Consistency, comparability, and reliability.** The SEC has stressed that the Proposed Rules would facilitate the provision of consistent, comparable, and reliable information to investors that

would inhibit the ability of a Registrant to "greenwash" and would facilitate investors' determinations of the true impacts of climate-related risks on a Registrant's business.

- **Decreased costs.** The Proposed Rules, proponents argue, would provide consistent and clear reporting obligations to Registrants, therefore making unforeseen costs less likely. Also, the Proposed Rules would streamline research regarding sustainable companies—a now difficult and time-consuming task for investors who want to build a sustainable portfolio.

- **Market confidence.** Supporters also highlight that increased climate-related disclosure would increase confidence in the capital markets and promote efficient valuation of securities and capital formation.

- **Resiliency to climate-related risks.** Registrants might feel compelled to announce and advance climate-related goals and targets in order to attract investments. The increased availability of disclosures on climate-related risks could serve to increase investor focus and reliance on such disclosures, and in turn prompt Registrants to monitor climate-related risks and manage and mitigate such risks. Indeed, one of the metrics that investors use to make investment decisions is whether that company is part of the solution to climate change, or part of the problem.

On the other hand, critics of the Proposed Rules, including Commissioner Hester M. Peirce (who has written in opposition), have raised a myriad of objections ranging from impracticality to unconstitutionality. Opponents have pointed to the following in making their case against adoption of the Proposed Rules in their current form.

- **Susceptibility to inaccuracy and variability.** Opponents argue that the Proposed Rules would invite speculation and reliance on data points that would not lead to the sought after comparable, consistent, and reliable disclosures. The extended time horizon, nonlinear behavior, and uncertain translation of climate change data to financial models renders assumptions about the impact of climate change on company performance highly susceptible to inaccuracy and variability.

- **Increased costs.** Opponents maintain that the adoption of the Proposed Rules would increase costs, even for Registrants that already volunteer climate-related information, because of the stricter requirements and higher level of liability involved with SEC filings.

- **Market effects.** Some worry that the increased cost of compliance with the Proposed Rules might dissuade companies from remaining in or entering the public markets. In turn, retail investors might be further limited in their investment options.

- **Legality.** The Proposed Rules could face legal challenges. Lawsuits might include allegations that the Proposed Rules run afoul of the First Amendment limitations on compelled speech and fall outside the SEC's statutory authority. Notably, Commissioner Hester M. Peirce's statement, titled "We are Not the Securities and Environment Commission," argues that the SEC should not be involved in political and social issues.

While the Proposed Rules have made the issue of climate-related disclosures more salient, it is unlikely the discussion and debate surrounding the Proposed Rules will subside in the near-term. The SEC appears determined to issue final rules on climate-related disclosures, but even if some form of the Proposed Rules is adopted, lawsuits challenging the validity of any final rules could delay or forestall their implementation.

Moving Forward

The range of commentary surrounding the Proposed Rules, and anticipated legal challenges, bring uncertainty around the substance of any final rules that may be issued by the SEC. In the interim, Registrants should continue to be mindful of their current disclosure obligations under existing SEC climate disclosure guidance. Also, with investors increasingly demanding climate-related disclosures, and with the

momentum that has been building around these Proposed Rules, Registrants may wish to proactively review their climate-related governance and compliance mechanisms and assess and, as appropriate, implement any changes that would be necessitated by the Proposed Rules' disclosure requirements.

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