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The New York Environmental Lawyer

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The Environmental Justice Issue

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An Overview of the SEC's Proposed Climate-Related Risk Disclosure Rules

By Allison E. Sloto, Pinky P. Mehta and Matthew H. Ahrens

On March 21, 2022, the U.S. Securities and Exchange Commission (SEC) released its long-awaited proposed rules on climate risk disclosures, which amend and build upon existing climate-change disclosure rules and guidance (collectively, the "proposed rules").[1] 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. Under the proposed rules, publicly traded companies and other issuers of securities that are required to file a registration statement with the SEC ("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 release of the proposed rules has triggered impassioned debate between proponents and opponents of standardized regulations for climate disclosures in particular and disclosures related to environmental, social, and governance (ESG) more generally. In fact, there is such a high level of interest in commenting on the proposed rules that the SEC has extended the initial comment period from May 20, 2022, to June 17, 2022.[2] Considering the likely volume and variety of comments, the final rules adopted after closure of the comment period could vary significantly from the proposed rules discussed in this article.

Background on SEC Climate-Related Disclosure Regulation

The SEC's prior rules and guidance on climate-related disclosures date back to the 1970s.[3] More recently they have included the SEC's 2010 Climate Disclosure Guidance[4] and September 2021 Sample Letter to Companies Regarding Climate Change Disclosures.[5] Since the beginning of the Biden administration, the SEC has been honing its focus on climate change disclosures[6] in line with Biden's policy agenda to prioritize combating climate change.[7]

In the past year, the SEC has increased scrutiny of companies' voluntary climate change disclosures. In late 2021, the SEC sent letters to subsidiaries of Morgan Stanley, Verizon Communications, Ford Motor Co. and Toyota Motor Corp. to report any risks they faced from climate change in 2021, or to better describe those risks.[8] On Feb. 14, 2022, the SEC also released the first of its climate-risk exchanges with operating companies, including Matson[9] and Cintas.[10]

The proposed rules build off these earlier efforts and incorporate concepts and frameworks for climate-related reporting set forth by the Task Force on Climate-Related Financial Disclosures (TCFD)[11] and standards for accounting and reporting on greenhouse gas (GHG) emissions established by the Greenhouse Gas Protocol (GHG Protocol).[12] Both the TCFD and GHG Protocol have developed concepts that

are widely accepted and used by companies when providing climate-related disclosures.

The SEC released the proposed rules in response to increasing investor pressure for clear guidelines to assess and understand the climate-related risks associated with current and potential investments, and they reflect a growing interest in ESG issues more broadly. Prior practice for climate-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.

Climate-related risks can affect a company's business in several ways that would be material for investors. Specifically, 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.[13]

Disclosure and Reporting 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.

A. 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.

B. Financial statement metrics

In addition to the proposed narrative disclosure under Regulation S-K, the proposed rules 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.

C. 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 (e.g., 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, often double or triple (or more) than that of a company's Scope 1 and Scope 2 emissions.[14] 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.[15] 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). The SEC has also proposed exempting smaller reporting companies from Scope 3 emissions reporting obligations 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. First, 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. 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. Further, 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. Finally, 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.

Phase-In Periods and Accommodations

The proposed rules include several elements designed to mitigate burdens on registrants. Specifically, these include phase-in periods, safe harbors, and Scope 3 disclosure exemptions and accommodations for smaller reporting companies. The phase-in periods would be applicable to all registrants, with the compliance date dependent on the registrant's filer status and the content of the item of disclosure. There would also be phase-in periods for reporting Scope 3 emissions. 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. Finally,

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the proposed rules exempt registrants meeting the definition of smaller reporting companies from the Scope 3 emissions disclosure requirements.

What Comes Next?

The SEC appears determined to issue final rules on climate-related disclosures, but at this point it is unknown to what extent changes will be made from the rules as proposed, or the timing for final rule issuance. Even if some form of the proposed rules is ultimately adopted, lawsuits challenging the validity of any final rules could delay or forestall their implementation. Yet it is unlikely investor interest in transparency around companies' ESG claims will subside, and climate change impacts present increasingly urgent risks to companies' supply chains and operations.[16] Also, the SEC has been focusing more resources and attention to identifying material gaps and misstatements in ESG disclosures under its existing regulations and guidance, including by forming the Climate and ESG Task Force.[17] In fact, shortly after the release of the proposed rules, the SEC's Climate and ESG Task Force investigated and charged Vale S.A. in the U.S. District Court for the Eastern District of New York with violating anti-fraud and reporting provisions of federal securities laws after it allegedly misled investors about the integrity of Vale-owned dams in ESG disclosures and regulatory filings.[18] Therefore, registrants should proactively review their climate-related governance and compliance mechanisms and prepare to implement the changes that will be necessitated by the final form of the proposed rules.

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