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Insights

Environmental Practice Group

The California Effect: Visionary Climate Disclosure Laws Will Have Far-Reaching Impact

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On October 7, 2023, California Governor Gavin Newsom signed into law two groundbreaking climate disclosure bills, SB253 (The Climate Corporate Data Accountability Act) and SB261 (The Climate-Related Financial Risk Act) (together, the "Laws"), which require major corporations doing business in the state to disclose their greenhouse gas ("GHG") emissions and certain other climate-related risk data. These landmark Laws could form the latest chapter of the "California effect," the phenomenon where strict environmental regulations passed by California ripple outward, spreading to other states and beyond. Although the U.S. Securities and Exchange Commission ("SEC") proposed a final rule ("SEC Proposed Rule") on March 21, 2022 that would require certain public companies to make certain climate-related disclosures,[1] the Laws have a more expansive reach, applying to most large U.S. companies doing business in California, both private and public, so long as they exceed certain revenue thresholds.

The Skinny on SB253

SB253, the Climate Corporate Data Accountability Act, requires "reporting entities" that have annual revenues in excess of $1 billion, do business in California, and were formed in the United States to disclose their Scope 1, 2, and 3 GHG emissions for the prior fiscal year to an "emissions reporting organization." The California Air Resources Board ("CARB") is tasked with developing implementing regulations by January 1, 2025, and the "emissions reporting organizations" is a to-be-determined non-profit reporting organization to be contracted with by CARB to develop the reporting program to receive and make public the disclosures.

A key difference between SB253 and the SEC Proposed Rule is that SB253 requires mandatory Scope 3 GHG emission disclosures for all companies subject to the law, while the SEC Proposed Rule only imposes a Scope 3 GHG emissions reporting requirement on companies that have set a Scope 3 GHG emission reduction target or that have material Scope 3 GHG emissions; smaller companies would be exempt from Scope 3 GHG emissions reporting under the SEC Proposed Rule.

[1] The SEC Proposed Rule has experienced a series of delays. While the SEC rulemaking agenda indicates that the SEC Proposed Rule should be finalized in Fall 2023, remarks made by SEC Chair Gary Gensler in September 2023 indicate that there could be further delays as the SEC considers how to handle Scope 3 GHG emissions reporting.

Under SB253, companies must begin reporting Scope 1 and 2 GHG emissions in 2026, and Scope 3 GHG emissions in 2027. Companies will also need to obtain an “assurance” report from a third-party provider. Scope 1 and 2 GHG emissions must be assured at a “limited assurance” level in 2026, and a “reasonable assurance” level starting in 2030, and Scope 3 GHG emissions may require a “limited assurance” level beginning in 2030 (depending on CARB’s review and evaluation in 2026), which requires less evidence than a “reasonable assurance” analysis.

Companies will need to pay an annual fee to a newly formed Climate Accountability and Emissions Disclosure Fund, which will be used to cover the costs of administering and implementing the law. Companies that fail to comply could be subject to an administrative penalty of up to $500,000 in a reporting year. The penalties are more limited for Scope 3 GHG emissions to account for the difficulties in obtaining the data and potential errors in reporting; companies will not be subject to penalties for inaccuracies in Scope 3 GHG emissions reporting data between 2027-2030, so long as the disclosures were made with a reasonable basis and in good faith. Companies can still be subject to penalties for failing to file Scope 3 GHG emissions data.

The 411 on SB261

SB261, the Climate-Related Financial Risk Act, requires “covered entities” – companies with annual revenues in excess of $500 million, do business in California, and were formed in the United States – to prepare and publish a publicly available report on the company’s website that discloses climate-related financial risks in accordance with the Final Report Recommendations of the Financial Stability Board’s Task Force on Climate-related Financial Disclosures (“TCFD”) and the measures the company is taking to mitigate those risks. Companies must publish their first report on or before January 1, 2026, and every two years thereafter. If a company cannot provide all the required disclosures, it is required to provide the most complete information it can, discuss any reporting gaps, and identify steps the company will take to provide all required disclosures.

The law defines “climate-related financial risks” as “material risk of harm to immediate and long-term financial outcomes due to physical and transition risks, including, but not limited to, risks to corporate operations, provision of goods and services, supply chains, employee health and safety, capital and financial investments, institutional investments, financial standing of loan recipients and borrowers, shareholder value, consumer demand, and financial markets and economic health.”

A company can satisfy its requirement under the law if it prepares a publicly accessible biennial report that includes climate-related financial risk disclosure information either under a law, regulation or listing requirement issued by a regulated exchange, national government, or other government entity incorporating similar disclosure requirements (which would likely include the SEC Proposed Rule after issuance thereof), or by voluntarily using a framework that provides for a similar type of disclosure. The law also specifically states that compliance with the International Financial Reporting Standards would meet the reporting obligations, because the International Sustainability Standards Board has taken over the monitoring activities of the TCFD and its sustainability disclosure standards build on the TCFD framework and consolidate various other sustainability-related frameworks and standards. Another possibility for satisfying requirements of the law, for companies that operate within the European Union, is to show compliance with the EU Corporate Sustainability Reporting Directive (“CSRD”), which also has the TCFD recommendations as its backbone.

Although the law is self-implementing, CARB has been tasked with determining an appropriate annual fee to be paid by all “covered entities” that pays for CARB’s actual and reasonable costs to administer and implement the law. Companies that fail to comply with the law will be subject to an administrative penalty not to exceed $50,000 in a reporting year.

Climate-related Disclosures Aren't Just California Dreamin' – They're the New Global Reality

There are still a number of unknowns regarding implementing regulations and timing of the Laws. Governor Newsom remarked, when signing the bills into law, that their implementation deadlines are "likely infeasible" (SB253) and would "not provide CARB with enough time to adequately carry out the requirements of the bill" (SB261). Governor Newsom also expressed concerns about the cost impacts of the Laws to businesses. Additionally, neither of the Laws define what it means to "do business" in California, or how the revenue thresholds should be calculated. However, based on a memorandum prepared by the nonpartisan Office of Senate Floor Analyses for SB253, the intent appears that "doing business" for purposes of the Laws means "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit" in California, being "organized or commercial domiciled" in California, or having California sales, property, or payroll exceeding certain amounts. Another question that will require further clarification is whether a company meets the revenue thresholds based on all revenues generated at a company-wide level, or only from those generated from business it conducts within California. Relatedly, the Laws are also silent on whether a "company" includes a parent and all of its corporate entities, or whether the Laws apply on an entity-by-entity basis.

Many questions remain concerning the scope, timing and implementation of the Laws, especially the legal challenges against the Laws that are extremely likely to be filed soon. Further, Governor Newsom has stated that the Laws will need some "clean up". CARB's implementing regulations and this "clean up" will answer these questions, although the regulations themselves could also become subject to inevitable litigation. Despite these uncertainties, the rising tide of governmental requirements for climate-related reporting cannot be denied. With the tight timeline of beginning to report Scope 1 and 2 GHG emissions under SB253 and publishing a report on climate-related disclosures under SB261 beginning in 2026, U.S. companies doing business in California should not wait for CARB's rulemakings to begin preparing for compliance with the Laws. This is especially pressing for public companies that are subject to the SEC Proposed Rule, and/or companies that operate within the EU who are subject to the CSRD. If you have questions about the potential impacts of the Laws, please reach out to any member of our ESG & Sustainability team or your regular Milbank contacts.

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