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Buckle Up for the SEC's Mandatory Climate Change Reporting Ride

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On March 21, 2022, the US Securities and Exchange Commission (the "SEC") proposed rules governing the "Enhancement and Standardization of Climate-Related Disclosures for Investors."

What you need to know:

- Disclosing climate-related risk and greenhouse gas emissions disclosures will require substantial effort.
- For the first time companies will need to explain how they manage climate risks.
- The proposed rules may be challenged, but companies need to pay attention now.

The proposed rules arrive after many months of speculation about their contents, which reflect the SEC's first major foray into climate-change regulation of publicly traded companies. The proposed rules run over 500 pages, providing plenty of fodder for comments by interested parties, which are due 30 days after the date the rules are published in the Federal Register or May 20, 2022 (60 days after issuance), whichever is later.

The SEC issued the proposed rules, which broadly reflect a global trend toward regulation of Environment, Social, and Governance (ESG) performance by companies in virtually all industry sectors. The agency issued the rules by a 3-to-1 vote, with Commissioner Hester Peirce voting against them, see below.

According to the SEC, the proposed rules would require registrants to include climate-related disclosures in their registration statements and periodic reports, including information about “climate-related risks” that are “reasonably likely to have a material impact on their business, results of operations, or financial condition.” Publicly traded companies would also be required to report their “greenhouse gas emissions” (GHG). Importantly, the proposed rules apply to domestic and foreign companies that file periodic reports or registration statements with the SEC.

Summary of Highlights from the Proposed ESG Rules

While the final rules that no doubt will be challenged in court, especially with respect to the scope of SEC's authority to promulgate climate change regulations, we believe that publicly traded companies should pay close attention to four aspects of the proposed rules as they prepare for the possible regulatory burdens the final rules would impose, and as they



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consider commenting on the draft. These four components also highlight critical benchmarks that other companies and organizations considering voluntary compliance with these or other ESG reporting frameworks should keep in mind. Finally, we also mention global developments that should be considered as companies respond and adapt to the future of increased ESG reporting and formal regulation worldwide.

1. Disclosure of Climate Related Risks

The proposed rules require disclosure of “climate related risks” that are “reasonably likely to have a material impact on the registrant … which may manifest over the short, medium and long term.” See proposed 17 C.F.R. § 229.1502(a). The new climate-risk definitions to be added to 17 C.F.R. § 229.1500 track the guidance of the Task Force on Climate-Related Financial Disclosures (TCFD), which is already widely used by many companies and includes “physical risks” and “transition risks.” “Physical risks” include acute risks (i.e., short-term extreme-weather events such as floods and hurricanes), and chronic risks (i.e., long-term changes in weather patterns such as droughts, rises in sea level, increased wildfires, decreased freshwater supplies, etc.). “Transition risks” include impacts on a company's financial statements, business operations, or value chains attributable to regulatory, technological, and market changes to address, mitigate, or adapt to climate-related risks. The expansive disclosure of climate risks includes both “actual and potential risks” to not only the company's business operations and products and services, but also to “suppliers and other parties in [the company's] value chain.” See proposed 17 C.F.R. § 229.1502(b).

2. Climate Risk Management

The preamble to the proposed rules summarizes the extensive disclosure requirements relating to climate-related risk management found at proposed 17 C.F.R. § 229.1503, set out here in full:

When describing the processes for identifying and assessing climate-related risks, the registrant would be required to disclose, as applicable:

- 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.

When describing any processes for managing climate-related risks, a registrant would be required to disclose, as applicable:

- How it decides whether to mitigate, accept, or adapt to a particular

risk;

- How it prioritizes addressing climate-related risks; and
- How it determines how to mitigate a high[-]priority risk.

Together, these proposed disclosures would help investors evaluate whether a registrant has implemented adequate processes for identifying, assessing, and managing climate-related risks so that they may make better informed investment or voting decisions.

3. Climate-Related Risk Governance

Under proposed 17 C.F.R. § 229.1501, companies would need to disclose board members or committees responsible for the oversight of climate-related risks; their expertise in climate-related risks; how management provides the board with information regarding climate-related risks; frequency and process for board or committee consideration of climate-related risks; “how the board of directors or board committee considers climate-related risks as part of its business strategy, risk management, and financial oversight,” including establishing “risk management policies, performance objectives, budgets, and major purchases, sales, and expenditures”); “how the board of directors sets climate-related targets or goals,” and “how it oversees progress against those targets or goals, including the establishment of any interim targets or goals.”

4. Greenhouse-Gas Emissions and Metrics

The proposed rules also require disclosure of annual and historic Scope 1 GHG emissions (i.e., direct GHG emissions from operations that are owned or controlled by a company) and Scope 2 emissions (i.e., indirect GHG emissions from the generation of purchased or acquired electricity, steam, heat, or cooling that is consumed by operations owned or controlled by a company). SEC is proposing a materiality threshold for Scope 3 emissions, which are all indirect GHG emissions not otherwise included in a company's Scope 2 emissions that occur in the upstream and downstream activities of a company's value chain, including emissions attributable to goods and services that a company acquires, the transportation of goods to the company, and employee business travel and commuting; and downstream emissions from use of the company's products, transportation of products to customers, and investments made by the company. Under the proposal, Scope 3 emissions must be disclosed if material to the company or the company set a GHG emissions reduction target or goal that includes these emissions. Companies must describe the methodology, significant inputs, and significant assumptions used to calculate their GHG emissions metrics, and any material change to the methodology or assumptions underlying GHG emissions disclosures from the prior fiscal year. See proposed 17 C.F.R. § 229.1504.

Under 17 C.F.R. § 229.1505, larger companies (e.g., large accelerated filers) must provide an attestation report from an independent attestation service provider that verifies the disclosure of their Scope 1 and Scope 2 GHG emissions. They must also disclose information about the attestation service provider to demonstrate that such provider satisfies certain minimum qualification and independence requirements. The proposed

rules do not require third-party assurance pertaining to Scope 3 emissions.

Potential Concerns

We encourage companies to consider the potential impact of the rules on their organization and strategize a thoughtful approach to crafting comments with the greatest potential to influence SEC's final rules.

There are a few issues that immediately come to mind that we believe could apply to most, if not all, regulated companies potentially subject to the new rules. First, it is unclear whether the SEC has the regulatory authority to mandate climate-related disclosures—many of which can only arise from technology- or science-heavy internal analyses that companies will be forced to perform (e.g., related to GHG reporting) both on themselves and on supply-chain partners. This is especially true since other agencies (such as the Environmental Protection Agency, which reviews GHG emissions under the Clean Air Act) have overlapping regulatory purviews.

Second, the proposal raises questions regarding what standards will govern the disclosures once made, and whether the SEC has the administrative capacity to evaluate whether the disclosures meet those standards. Although the proposed rules give credence to the TCFD guidance, it is unclear how the SEC, an agency imbued with financial-integrity mandates, will govern climate-related reporting, much less understand the information and data it collects and how to react to it.

Third, it is not clear whether and how the agency will enforce the rules once finalized. Even a cursory review of the agency's 500-page proposal leads to the conclusion that the rules will create a plethora of regulatory challenges for public companies. It will be hard enough for companies to carefully design internal climate-related reporting programs if they don't already have them, and to make sure whatever program they have fits the rules. By layering on the possibility of enforcement to the already daunting compliance lift, in a relatively short time and the regulatory pressure increases dramatically.

SEC Commissioner Peirce Dissent

Commissioner Hester Peirce voted against them, asserting in her dissent, among other things, that (1) existing disclosure rules already cover climate-related risks; (2) the proposed rules likely will not result in “comparable, consistent, and reliable disclosures”; (3) the SEC lacks authority to require companies “to disclose information that may not be material to them and recasts materiality to encompass information that investors want based on interests other than their financial interest in the company doing the disclosing”; and (4) that compliance will be expensive and burdensome.

Inevitable Global Reach of ESG Reporting

Although the future of the SEC's proposed climate-change rules remains unclear pending notice-and-comment rulemaking, issuance of the final rules, and anticipated judicial review, it is apparent that regulatory interest

in both mandatory and voluntary ESG reporting will only increase with time. Even without the SEC's mandatory climate-related reporting, in 2021, approximately 92% of S&P 500 companies published a sustainability report of some kind. Markets and investors now demand it. And non-publicly traded companies and service providers increasingly receive pressure from lenders, private equity firms, and insurers to provide ESG reports as well. Moreover, over the objection of the American Chamber of Commerce, on February 23, 2022, the European Commission announced that its proposed directive on comprehensive “corporate sustainability due diligence” will apply to foreign subsidiaries of non-EU companies so that companies will be incentivized to “take into account the human rights, climate change and environmental consequences of their decisions.” This new directive, along with last year's EU-proposed Corporate Sustainability Reporting Directive, and now the forthcoming applicability of the SEC rules to foreign companies, essentially make ESG and other climate-related reporting a global practice.

We recommend that all companies, especially those with significant operations in domestic and international markets, evaluate their capacity to engage in climate-related and wider ESG reporting, voluntary or otherwise, if they have not already done so. This is especially true due to the significant lead time needed to develop internal compliance programs and the structural buildouts to manage and implement them, compile ESG information, and develop ESG metrics to measure performance relating to climate-related risks and opportunities.

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