Is Your Company Ready For the SEC's New Climate Disclosure Rules? We Break Them Down.

Sam Gandhi, Sonia Barros, and Heather Palmer
April 2024

View our related update on this subject

Sam Gandhi:
The SEC had planned to usher in a new era of corporate disclosure, but now it may be on hold. The new rules will require public companies to report extensive climate-related information, including the amount of their greenhouse gas emissions. The rules are intended to improve the consistency of climate-related information available to investors. But some states and business groups have mounted legal challenges.

They argue the rules exceed the SEC's authority and violate the First Amendment. Environmental advocates are also suing, claiming the rules don't even go far enough. Now in the wake of that litigation, the SEC has just issued a voluntarily stay of the rules, hoping it will speed resolution of the case.

Sonia Barros:
They really should start working on their compliance now. Waiting until the lawsuits get figured out could put a lot of strain on a company's resources. It may not give them a lot of time.

Sam Gandhi:
That's Sonia Barros, a partner in Sidley's Capital Markets practice and the co-leader of the firm's Public Companies and ESG practices.

Heather Palmer:
So, companies should begin assessing the gaps between the climate-related information that they currently disclose, both inside and outside of SEC filings, and consider what would be required under the final rules. A thorough review of all public-facing materials should be included, so you're not just looking at what's been set in your Form 10-K or your proxy.

Sam Gandhi:
And that's Heather Palmer, an Environmental and Energy partner, and a co-leader of the firm's ESG and Climate Change practices. In today's podcast, we'll discuss the SEC's newly-adopted climate disclosure rules, the status of legal challenges, and how companies should prepare to comply with the new requirements.

From the international law firm Sidley Austin, this is *The Sidley Podcast*, where we tackle cutting-edge issues in the law and put them in perspective for businesspeople today. I'm Sam Gandhi.

Hello, and welcome to this edition of *The Sidley Podcast*, episode number 40.

In March, the SEC adopted final rules requiring companies to disclose certain climate-related information in emissions. It's a watered-down version of the original proposal from two years ago after a successful lobbying effort by businesses, trade groups, and some lawmakers. Even so, no sooner had the proverbial ink dried on the new rules when the agency was hit with expected litigation.

Now on March 29, I sat down with Sonia Barros and Heather Palmer to discuss the implications of the new rules. And then on April 4, the U.S. Securities and Exchange Commission (SEC) announced it was voluntarily delaying implementation of the client disclosure regulations while it fights an Eighth Circuit challenge seeking to vacate the rules.

In its order, the SEC said it continued to vigorously defend the rules, and there was no mention of changes of the compliance dates in the SEC order. Despite these latest developments, we still think our conversation with Sonia and Heather stands on its own, so we present it to you now.

Sonia, Heather, great to have you on the podcast today.

Sonia Barros:
Thank you, Sam, good to be here.

Heather Palmer:
Thank you, Sam, it's great to be here.

Sam Gandhi:
Sonia, the burning question today is, what's the status of these legal challenges?

Sonia Barros:
A number of lawsuits have been filed, and they have currently all been consolidated into the Eighth Circuit. Now we're waiting to see how the Eighth Circuit will decide these cases, and I think it's important to understand a little bit of history of how we got here. Over 20 states had filed lawsuits challenging the rule. Most of the states were red states, a few of them were not.

Other groups, like the Chamber of Commerce, and special interest groups, and some companies also filed lawsuits. They were filed in various different circuits, Fifth, Sixth, Eighth, and Eleventh Circuits, which are all viewed as more conservative and business-friendly. One lawsuit, which you may have heard of, was filed by Liberty Energy. In this lawsuit, the company applied for a temporary administrative stay of the rule, and this was actually granted, back on March 15.

But then, it was later vacated because of this process of selecting the Eighth Circuit. There were also a couple cases arguing that the SEC rules scaled back too much. These were filed by the National Resource Defense Council and the Sierra Club, filed in the D.C. Circuit and the Second Circuit. Those would be circuits that would be viewed as more friendly to perhaps upholding the rule.

So, because you have these six different circuits, the SEC then requested the cases be consolidated, and that one circuit was selected. So, that's how we got to this process, of all the cases being decided by the Eighth Circuit. The process is a random lottery drawing. Each circuit gets one name in the random lottery, and the Eighth Circuit was selected.

Now, the panel of Eighth Circuit judges, it's mostly composed of a conservative majority, and only one of the court's judges was appointed by a Democratic president. So, we'll have to wait and see how that fares out, but that's where we stand on the litigation.

Sam Gandhi:
So, while we're waiting to see how the litigation stands out, and given that the legal challenges are sitting with what's considered to be the conservative Eighth Circuit, should companies be waiting out? Or should they be starting their compliance programs, notwithstanding the court challenges that are out there?

Sonia Barros:
They really should start working on their compliance now. Waiting until the lawsuits get figured out could put a lot of strain on a company's resources. It may not give them a lot of time. Another thing to keep in mind is that on March 28, 2024 the rules were actually published in the Federal Register, which means the rules will be effective 60 days after that, on May 28, 2024. So, companies don't need to comply on May 28.

There are extended transition dates for compliance, and our Sidley Alert has a detailed table of those dates, and I encourage you to look at that. But the significance of this effective date is that now there is a very remote chance that a change in presidential administration would result in an undoing of the final rules. And so, this would be through the process known as the Congressional Review Act.

So, that's likely not to lead to an overturning of the rule. So, that's one reason companies should start working on compliance now. The new rules, you know, they're very extensive. It's going to take a lot of work. There are also a number of materiality qualifiers that companies should go through beforehand, to think about whether certain disclosures are triggered in the rule or not.

And it's also possible that only part of the rule gets vacated down the road. Think about, back to Conflict Minerals. Ultimately, in the end, only part of that requirement was gutted. So, a real possible outcome is that only a portion of the rule gets vacated, and a portion of it ends up staying, which companies would have to comply with.

A final reason that companies should start working on compliance now is that the SEC final rules are based on the TCFD disclosure framework. That's the Task Force on Climate-Related Financial Disclosures. A lot of companies already provide voluntary disclosures in line with the TCFD, and by working on SEC disclosures, even if companies don't ultimately need to provide those in their SEC filings, they could use that work that they've done to enhance their TCFD and voluntary disclosures.

Sam Gandhi:
So, Sonia, underlying a lot of the climate rules, and the basis for the climate rules, was to disclose the material risks that climate and greenhouse gas emissions are really having on the business. But in her dissent from the SEC's decision, Republican commissioner Hester Peirce said, while the commission has decorated the final rule with materiality ribbons, the rule embraces materiality in name only.

What does that mean, and how do companies in the context of that comment think about the materiality issue?

Sonia Barros:
There are a lot of materiality qualifiers throughout the rule, and I would give companies three kind of main points to think about materiality, and I'll address Commissioner Peirce's comments as well. So, the first is that the SEC made it clear that the traditional definition of materiality under the U.S. Securities' laws would continue to apply. The SEC did not adopt a concept of double materiality, which is a standard that exists in the EU.

The SEC made it clear that materiality here would be the importance of information to investment and voting decisions about a particular company, not to the importance of the information outside of those decisions. So, double materiality is where you look at the importance of an issue outside the company or to others outside the company. The SEC said, we're not adopting that concept.

They also made it clear that it's a standard definition that we're all familiar with, that something's material if there's a substantial likelihood that a reasonable investor would consider it important when determining whether to buy or sell securities, or how to vote, or such a reasonable investor would view omission of the disclosure as having significantly altered the total mix of information made available, and that the determination is fact-specific and requires both quantitative and qualitative considerations.

So, that’s the first point. It’s the standard definition of materiality. The second key take-away on materiality is that there are materiality qualifiers all throughout the new rules, except in a few notable places. The first one I wanted to highlight is in the new financial statement footnote disclosures, and these draw out disclosures and items that are capitalized cost, expenditures expensed, charges, and losses incurred as a result of severe weather events or other natural conditions.

These are not subject to any materiality qualifiers. Here, the SEC justified not having a materiality qualifier, because it indicated that there are other thresholds to these financial statement disclosures. There’s the one-percent threshold, and this is measured in a very different way than the SEC had proposed. For income statement items, it’s one percent of the absolute value of income or loss before income tax expense or benefit. For balance sheet items, it’s one percent of the absolute value of stockholders’ equity or deficit.

A second reason the SEC gave for not adopting a materiality qualifier here was that there’s de minimis thresholds. No disclosure’s required here, if amounts in the aggregate are less than $100,000 for the income statement, or less than $500,000 for the balance sheet. A third reason is that the requirement doesn’t apply to all financial statement line items. It only applies to items that reflect capitalized cost, expenditure’s expense, charges, and losses.

And then, there’s also an attribution principle, that the disclosure is limited to only where you have a severe weather event or other natural condition that was a significant contributing factor to those items that require disclosure. So, that’s the financial statement footnote disclosures. No materiality qualifier.

A second item where there’s no materiality qualifier is for disclosure on the board’s oversight of climate-related risks. So, the SEC specifically noted that they’re not adopting materiality qualifier here. What they said is that if the board determines to oversee a particular risk, the fact of that oversight is material to investors. The SEC had made a similar argument with the new cyber-disclosure rules that recently went into effect.

And the requirement here for board oversight of climate-related risks is fairly similar to the comparable requirement in the new SEC cyber-disclosure rule. The third key point on materiality qualifiers, and this is the point that Commissioner Peirce was making in the comments, that even though various aspects of the rules have materiality qualifiers, the disclosure will draw out disclosures that may not be material overall.

And I'll just highlight a couple examples of where this happens. One is under Item 1501(b), this is disclosure of management oversight of climate-related risks. So, here companies will need to describe how management handles material climate-related risks. Once a company determines it has a material climate-related risk, it will need to provide disclosure on management's oversight of that risk, even if that additional disclosure on management oversight is not material information overall.

Similarly, in Item 1503, disclosure on risk management, companies will need to describe the process for identifying, assessing, and managing material climate-related risks. The requirement is not limited to the material processes the company has. So, once a company has identified a material climate-related risk, the disclosure is triggered, even if those risk-management processes themselves are not material information overall.

Sam Gandhi:
You're listening to *The Sidley Podcast*. We're speaking with Sidley partners Sonia Barros and Heather Palmer about the parameters of the SEC's climate disclosure rule, and how companies should prepare to comply, even with the ongoing litigation against the rule. Beginning in 2026, businesses who deem the information material will be required to disclose both their direct and indirect greenhouse gas (GHG) emissions.

Heather, let's talk about the requirements related to GHG emissions and third-party assurance. Just give us an overview of those requirements.

Heather Palmer:
Sure, Sam. So, large accelerated filers and accelerated filers are required under the final rules to disclose their Scope 1 and Scope 2 greenhouse gas emissions, if material to the company. And so, this is a significant change from the proposed rules that would've required disclosure of Scope 1 and Scope 2 emissions from all registrants, regardless of materiality, and Scope

3 emissions if material or if the company had set a target or goal with respect to Scope 3.

And when we’re talking about these different Scopes of emission, Scope 1 emissions are direct GHG emissions from operations that are owned or controlled by a company. When you talk about Scope 2 emissions, you’re talking about indirect greenhouse gas emissions from the generation of purchased or acquired electricity, steam, heat, or cooling that’s consumed by the operations, owned, or controlled by a company.

And then, when you talk about Scope 3 emissions, really, you’re talking about almost everything else. Scope 3 emissions are indirect emissions from the company’s value chain, and one of the developments in the rule that’s been talked about a lot is the fact that the decision by the SEC not to require disclosure of Scope 3 emissions.

So, the addition of the materiality qualifier in the final rules for Scope 1 and Scope 2 emissions actually is going to be helpful, because you have to meet that materiality standard in order to have to disclose either your Scope 1 or Scope 2 emissions. And it could be a situation in which Scope 1 might be material to you, but Scope 2 is not, or it could be where Scope 2 is material, but Scope 1 is not.

And the rules are set up in such a way that you only have to disclose one or the other, or if they’re both material, you disclose both of them. And so, while the addition of the materiality qualifier’s going to be helpful, even companies that determine that their Scope 1 and Scope 2 emissions are not material, will still be required to go through an exercise to make that determination, and then will need to be able to show their work to substantiate how they determine those emissions are not material.

And even companies that are already tracking their emissions could have to invest in systems or technologies to better measure their Scope 1 and Scope 2 emissions, to improve their data and prepare for assurance, because one of the interesting aspects of the rule is with respect to assurance. So, the final rules recognize two assurance levels of limited and reasonable, although the SEC did not define those terms in the final rules.

And so, the way to think about the difference between limited assurance and reasonable assurance is that limited assurance is the work an auditor does on a Form 10-Q, and reasonable assurance is similar to an audit of the financial statements in a Form 10-K. And so, under the final rules, large accelerated filers and accelerated filers are required to obtain limited assurance of their material Scope 1 and/or Scope 2 emissions. There's an initial phase-in period for that. So, after that initial phase-in period, you have to obtain that limited assurance.

And then, for large accelerated filers, there's going to be the additional requirement of getting reasonable assurance after a second phase-in period. One of the things that's interesting to note as well, that I haven't seen a lot of attention called to, is the fact that during the phase-in period, even before large accelerated filers and accelerated filers had these requirements to obtain limited assurance on their Scope 1 and Scope 2 emissions, actually, to the extent that they are already obtaining voluntary assurance over those greenhouse gas disclosures.

Even before the mandatory assurance requirements kick in, the company would be required to provide disclosures about that voluntary assurance in its annual report for the fiscal year in which voluntary assurance was obtained.

Sam Gandhi:
Heather, let's talk about targets and goals, because a number of issuers have come out there, especially the large ones, about certain targets of reducing emissions by a certain date, certain…some of those companies have come back and rolled some of those dates forward, because they weren't going to hit there, and they'd be under some scrutiny from institutional investors and otherwise. So, what about targets and goals? Do companies have to disclose those?

Heather Palmer:
Yes, under the rules, if a company has a climate-related target or goal that has materially affected or is reasonably likely to materially affect the registrant's business, results of operations, or financial condition. They are going to be required to disclose those targets and goals. And if a target or goal is material, they determine that it is material, then additional information must be provided.

And there's a lot of granularity in that. You're going to have to provide a description of the scope of activities included in the goal, the defined time horizon for achievement of the goal, a qualitative description of how the company plans to meet that goal. In addition, there's a requirement to update that information. So, you have to update your disclosures each year, and have to describe in that update the actions that were taken during the year to achieve the goal, and any progress made toward reaching the goal.

Disclosure also has to include not only that qualitative description about the goal, et cetera, but you also have to disclose any material expenditures or material impacts on your financial estimates and assumptions as a direct result of the target or goal, or the actions that you've taken to make progress towards meeting the target or goal. And that description and disclosure, with respect to material expenditures and material impacts, needs to be expressed both qualitatively and quantitatively.

And to the extent that carbon offset to renewable energy credits, or RECs, are a material component of the company's plan to achieve its material targets or goals. Detailed information would have to be provided about those offsets and RECs. So, questions for a company to ask when you're talking about targets and goals is, first, have I set a target or goal? And it's important to keep in mind that it doesn't even have to be something that's publicly announced.

It can be something that internally, the company has established on its own. It doesn't even have to be something that was a target or goal that was approved by the board, or signed off on by the CEO. It doesn't have to be as formal as that. So, you really need to take a look at determining whether your company has set a target or goal, even if not publicly announced.

The second question to ask, then, is that, is that target or goal reasonably likely to be material to the company, and if material, you also have to ask, okay, so, does the company intend to use carbon offsets or RECs to meet that goal, and then, what expenditures and impacts are expected on the company's financial estimates and assumptions, as a direct result of those targets and goals.

And if material, right, if you think that those expenditures and impacts are going to be material, or reasonably expect it to be material, then those expenditures and impacts will have to be disclosed, both quantitatively and qualitatively.

Sam Gandhi:
We keep talking about whether a target or a goal is material to the companies, or it's reasonably likely to materially affect the company's business results of operations or financial condition. Why do we need new rules to dictate that? Isn't that effectively the disclosure requirement that we have now? Let's talk about why we think that the rules are actually new rules or new requirements, if they're phrased that way.

Sonia Barros:
In the last few years, you know, we have seen the SEC indicate increasingly that climate-related disclosures are likely material. SEC officials have made a number of public statements, in speeches, and on the SEC's web sites about this. Chair Gary Gensler has been talking about it in his confirmation hearings, a number of speeches. And the way that the SEC looks at it is because investors are asking for this information, then it must be material.

And the SEC has really been pressing companies on that materiality determination. CorpFin has done a comment letter, blitzed to a number of public companies, asking them about whether they view certain climate items as material. But the bottom line is, all public companies are not providing these disclosures in their SEC filing. Some do, but others don't, and by adding the requirement, it will force companies to think about it in a more focused manner.

Sam Gandhi:
Are we transitioning to a world in which the SEC is prescribing what is material, as opposed to the standard as to what is material?

Sonia Barros:
Some would say that is the case, but the SEC has also made it clear that it's the same definition of materiality that has historically applied, from the Securities laws. So, I think one of the first steps a company should do in

thinking about compliance with the new rules, is to do a thorough materiality assessment, and to look at everything they're saying on their web site, and their corporate sustainability report, and make sure that that materiality assessment aligns with the messaging that they have out there in their public disclosures, those outside of their SEC filings.

For example, a company may have a lot of disclosures about targets, and goals, and climate-related initiatives in its corporate sustainability report. But they may not really view those as material to the overall business of the company, and if that's the case, perhaps the company wants to make that clear in those public disclosures, that they're providing these disclosures to inform investors, to provide additional information to the marketplace, but that perhaps it's not material.

And that's something that companies could start doing now. A lot of companies now are working on updating their corporate sustainability reports. I think now is a really good time to look carefully at what you're saying about climate, is it really material to your business, and how will that impact disclosures that you may need to provide under the new SEC rules.

Sam Gandhi:
And so, Heather, in your view, what else should a company be thinking about as they prepare to comply?

Heather Palmer:
One of the things that we suggest is to start with a gap analysis. So, companies should begin assessing the gaps between the climate-related information that they currently disclose, both inside and outside of SEC filings, and consider what would be required under the final rules, what kind of resources are they going to need, to the extent that there are gaps, so that they can go back to the board or management to get those resources in place, to be able to ensure compliance.

A thorough review of all public-facing materials should be included. So, you're not just looking at what's been said in your Form 10-K or your proxy. You do need to go back through your ESG reports, or corporate sustainability reports, look at your web pages, to the extent you've had disclosures that are made on climate-related information there. Also, a lot of companies report to the CDP, or what was formerly known as the Carbon Disclosure Project.

So, it's also very important to review your CDP reports and the disclosures that you made around your climate-related risks in those reports, as you're sort of doing your overall gap analysis, of putting together, gathering the information that you're going to need, and the gaps could actually be significant for many companies. And then, Sonia had mentioned earlier around TCFD, or the Task Force on Climate-Related Financial Disclosures, in terms of…some companies have already been complying to some extent, right, with those, in making their voluntary disclosures.

But most to date have been sort of partially compliant with the recommendations of the TCFD. And so, it is important for companies, even who think, okay, you know, we feel good about our disclosures or our position, because we've already been making some of these disclosures in accordance with those TCFD recommendations, but they may have to actually rework their approach, or disclose more information, to satisfy the SEC's requirements.

So, it's something where, by doing that gap analysis, it can really help companies focus on the areas in which they may need to enhance those disclosures, or maybe their processes in controls, their data collection, perhaps having to upgrade their software. It'll help them as they're preparing for compliance.

Sonia Barros:
Just to add onto Heather's comments there, is, some of the voluntary disclosures are also couched as questions and answers, right, which is not going to work for the SEC disclosures and the Form 10-Ks. So, companies may find themselves in a situation where they're drafting Folsom disclosures for the first time.

Sam Gandhi:
The last thing for this discussion is really the fact that there's a lot of disclosure requirements in various other jurisdictions, both within the United States and the various states, but also in the EU and the UK, et cetera. And so, how do these new SEC rules intersect with those disclosures in other regimes around the world?

Heather Palmer:
You’re absolutely right. The considerations in thinking about compliance with the SEC rules, also, you have to consider and give consideration to the regulatory requirements in other global jurisdictions. And as you mentioned, the EU and the UK have adopted mandatory disclosure requirements for corporations that will apply to EU or UK subsidiaries of many US companies.

California has enacted a package of three climate bills, that will require disclosure of Scope 1, Scope 2, and Scope 3 greenhouse gas emissions, also requiring disclosure of climate-related financial risks, information related to carbon offsets, or emissions marketing claims, such as being net zero by a date certain. So, in many of these cases, these requirements are actually some of the global requirements.

And California’s requirements are actually broader than the disclosure requirements in the SEC’s final rules. And so, companies need to be thinking now and developing a strategy for compliance with all of the applicable disclosure regimes, right? And so, part of that exercise is just, once again, just identifying and determining applicability for both at the enterprise level, and then for their various subsidiaries, or an evaluation of their operations globally, to help determine whether these different regulatory regimes will be applicable to them.

And then, you have to start thinking through what processes and controls need to be put in place to gather and report out on the required information for all of these different regimes. And when you’re thinking as a U.S. company, and you have subsidiaries in other jurisdictions, like in the UK or the EU, consideration should be given to whether, when you are making disclosures under those separate regimes, whether to report at the enterprise level, for example, under Corporate Sustainability Reporting Directive (CSRD), or at the regional level, and determining which entities are required to disclose.

There’s Scope 1, Scope 2, and Scope 3 emissions to the state of California, which, unlike the SEC rules, do not have a materiality qualifier with respect to those disclosures. And they also currently, we’re still waiting for the regulations in California, but as initially drafted, the threshold for disclosure was based on total annual revenue. But there was nothing in the bill itself that would say that all the disclosures could be consolidated at the enterprise level.

So, you could have a situation in which you have U.S. subsidiaries that actually trigger it as well, so we're going to have to wait and see when the California regulations are promulgated to see whether that consolidation is allowed. But it is important as an initial matter to start thinking through, which entities are going to be subject to all the different regulatory regimes. And then, in the end, it's really, the key issue is going to be consistency, is having consistent disclosures across all reporting regimes, because the failure to provide those consistent disclosures could result in potential claims of greenwashing, or that statements made were false or misleading.

And that could actually lead to litigation or regulatory enforcement actions in various jurisdictions. And so, one of the challenges and why it's important to start thinking about all of this now, and putting things in place, regardless of what ultimately happens in the litigation involving the SEC rules, is that you need to start thinking now in terms of how these disclosures fit together, where the disclosures might need to be different, where the methodologies to calculate your greenhouse gas emissions, for example, may be different.

And so, you have to take, as a company, a very holistic approach to all of it, because we have now moved from a place where it used to be voluntary, right? You could do this on your own. You could do it based on what you would like. You can pick and choose from different voluntary disclosure standards. Now, we've moved from the voluntary realm into the mandatory, and not all of these different regimes had the same requirements. Some of them are different.

Some of them have different materiality standards, as Sonia was pointing out. And so, it is important for companies as we're moving into this era of compliance and focus on compliance, to really take stock of where they are, where they're going to be subject to regulation, what the timelines are for that, and to really start thinking through and developing a strategy, and how they're going to manage that internally from a data standpoint, from a legal standpoint, and from a governance standpoint moving forward.

Sonia Barros:
One additional point I'll mention, I encourage you to look at a detailed summary we have of the rules in our Sidley Update. It's 18 pages, which may seem long, but in comparison to the 886-page SEC rule release, it'll give you a nice, comprehensive update and summary of all the key provisions, and we also have a table that highlights key changes in the final rules from the proposed rules.

Sam Gandhi:
We've been speaking with Sidley thought-leaders Sonia Barros and Heather Palmer about the intricacies of the SEC's newly-adopted climate disclosures rule, and the challenges and risks for businesses seeking to comply with it. Sonia, Heather, this has been a real interesting look at the landscape regarding climate disclosure rule, and thanks for sharing your insights on the podcast.

Heather Palmer:
Thanks, Sam, happy to be here.

Sonia Barros:
Thanks, Sam.

Sam Gandhi:
You've been listening to *The Sidley Podcast*. I'm Sam Gandhi. Our executive producer is John Metaxas, and our managing editor is Karen Tucker. Listen to more episodes at Sidley.com/SidleyPodcast, and subscribe on Apple Podcast, or wherever you get your podcasts.