SEC's Climate Disclosure Proposal May Overburden Cos.

By Heather Palmer and Sonia Barros (April 5, 2022)

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On March 21, the U.S. Securities and Exchange Commission proposed rules that would require public companies with periodic reporting obligations and companies filing registration statements to provide granular disclosures regarding greenhouse gas emissions, climate-related risks and impacts, oversight of climate-related risks, climate-related goals and climate-related financial statement metrics.

It is one of the most significant developments in U.S. securities law in recent decades.

Certain aspects of this information would also be subject to attestation or independent audit requirements. The proposed rules are intended to satisfy significant investor demand for climate-related disclosures that are consistent, comparable and reliable.

However, the proposed rules, if adopted, would compel companies to incur significant costs of compliance and to put in place robust monitoring, accounting, auditing, planning and governance practices to satisfy the extensive disclosure requirements.

Greenhouse Gas, or GHG, Emissions Disclosures — A New Frontier for SEC Filings

The proposed rules would mandate disclosures concerning a company's direct GHG emissions — Scope 1 — and indirect GHG emissions from purchased electricity and other forms of energy — Scope 2.

In addition, registrants would also be required to disclose indirect GHG emissions from the company's value chain, known as Scope 3 emissions, if material or if the company has set Scope 3 emissions targets or goals.

The proposed rules, if adopted, would go well beyond the statutory or regulatory requirements of any other federal agency, including the U.S. Environmental Protection Agency, in requiring the quantification and mandatory reporting of Scope 1, Scope 2 and, under certain circumstances, Scope 3 GHG emissions.

Many of the proposed emissions disclosure requirements would create new challenges for public companies that have not made these disclosures in the past, including the new attestation requirements applicable to disclosures of Scope 1 and Scope 2 emissions by large accelerated filers and accelerated filers.

The proposed rules would require the attestation report to be included in a new separately captioned climate-related disclosure section in the relevant filing and include detailed disclosures about the experience, expertise and independence of the GHG emissions attestation provider.

Among the most controversial aspects of the proposed rules is the proposed requirement that certain registrants disclose Scope 3 emissions.

It is widely recognized, including by the SEC in its proposing release, that Scope 3 emissions are challenging to calculate, most notably because of the need to rely on third-party data. That data may not be accessible for all of a company's supply chain and, to the extent it is accessible, it may not be sufficiently verifiable for SEC filing purposes.

Moreover, methods for obtaining, calculating and disclosing Scope 3 emissions are also still evolving. Even companies regarded as high performers in climate-related operations and disclosures may not yet have in place adequate infrastructure to track the emissions of third-party distributors, suppliers and customers to give them comfort that their disclosures are sufficiently complete and reliable for SEC filing purposes.

And, a company choosing not to disclose all or certain Scope 3 emissions on the basis that they are not material may be expected to explain the basis of its determination to the SEC.

In addition, because the proposed rules would treat a company's GHG emissions disclosures as filed for purposes of SEC regulations, such disclosures could potentially subject the company to strict liability under the federal securities laws, although the proposed rules provide a safe harbor for disclosure of Scope 3 emissions.

Specification of Material Climate-Related Risks and Their Actual and Potential Impacts

The proposed rules would require companies to make disclosures about climate-related risks from three angles. First, companies would be required to disclose any climate-related risks reasonably likely to have a material impact on the registrant's business or consolidated financial statements over the short, medium and long term.

Climate-related risks are the actual or potential negative impacts of climate-related conditions and events on a registrant's consolidated financial statements, business operations or value chains — i.e., upstream and downstream activities related to a registrant's operations.

The inclusion of value chains within the definition of climate-related risks would require registrants to capture the full extent of their potential exposure to climate-related risks beyond their own operations. Registrants would need to specify whether an identified climate-related risk is related to the physical impacts of climate — i.e., physical risks — or to a potential transition to a lower carbon economy — i.e., transition risks.

Second, the proposed rules would require that the company describe the actual and potential impacts of its material climate-related risks on its strategy, business model and outlook.

Third, the proposed rules would also require companies to describe processes for identifying, assessing and managing climate-related risks, which the SEC acknowledges that only a minority of registrants currently include in voluntary climate reports. If a company has a transition plan, the proposed rules would require detailed disclosure regarding such plan.

Identifying climate-related risks and their actual and potential impacts involves accounting for occasional weather events — such as severe weather — as well as for chronic risks — such as long term weather patterns, higher temperatures and sea level rise. More challenging for companies, particularly from a legal angle, is specifying transition risks and their potential impacts.

Projecting transition risks involves speculating on the potential impacts on a company's financial statements, operations and value chains on account of a possible future change in legislation and regulation — e.g., carbon taxes, emissions trading systems — technology and changes in customer demand.

Although it may be challenging to project these types of changes in the future with enough certainty to regard them as material for SEC filings purposes, a company could face consequences down the road if it is perceived in hindsight to have under or overdisclosed its physical or transition risks.

Governance of Climate-Related Risks

The proposed rules require that registrants disclose certain information concerning a board's oversight and management's governance of climate-related risks. Such disclosures would include information regarding the processes by which the board and management oversee and account for climate-related risks and how management reports to the board on these issues.

Although public companies already established in recent years high-level protocols for overseeing environmental, social and governance issues, these practices can be expected to evolve relatively quickly if the proposed rules are adopted. About 30% of boards in the S&P 500 delegate ESG responsibility to a board committee, often to the nominating and governance committee.

Relatively few S&P 500 companies have stand-alone committees responsible for environmental and sustainability matters. And while there are many reasons to delegate certain ESG matters to audit committees, the practice has not been widespread.

If the proposed rules are adopted, companies will need to take another in-depth look at how both the board and management oversee ESG matters to ensure the company will be able to keep pace with its peers in terms of standards in oversight. In particular, audit committees will need to play a greater role in the oversight of controls and disclosures related to climate-related factors.

Given the rigorous methods and standards elaborated by the SEC in the proposed rules and the granular level of disclosure expected, companies would be compelled to enhance their existing information and reporting structures and controls to comply with the extensive disclosure requirements.

Climate-Related Goals and Financial Metrics

Under the proposed rules, if a registrant has previously set climate-related targets or goals, the registrant would be responsible for including a robust set of disclosures outlining the methodology and assumptions used for setting such goals and targets. A registrant would also be required to update this disclosure each fiscal year by describing the actions taken during the year to achieve its targets or goals.

As a result, companies should begin to carefully review their climate-related goals, such as net-zero emissions pledges, including a comprehensive understanding and review of all internal processes and assumptions that go into these goals, in anticipation of the final rules.

The proposed rules would also amend Regulation S-X to require a registrant to disclose in a note to its financial statements certain disaggregated climate-related financial statement metrics.

Companies would be expected to disclose the financial impacts of weather events, transition activities, and climate-related risks and related expenditure metrics and provide a discussion of whether estimates and assumptions used to produce the consolidated financial statements were affected by exposures to risks and uncertainties associated with climate change and weather.

As these proposed financial statement metrics would be required in a registrant's financial statements, they would be included in the scope of any required audit of the financial statements, subject to audit by an independent registered public accounting firm, and within the scope of the registrant's internal control over financial reporting.

Next Steps for Public Companies

It is not known what the final form of the proposed rules will be. The SEC will take into account feedback from companies and other interested parties when drafting its final rules.

It is also anticipated that the proposed rules, if adopted, will face litigation that could potentially delay implementation. In the sole dissenting statement objecting to the proposed rules, Commissioner Hester Peirce set out a road map for such litigation, arguing, among other things, that the proposed rules are beyond the scope of the SEC's legal mandate.[1]

Based on the far-reaching scope of the proposed rules, companies should consider taking steps now to evaluate how the rules, if adopted, would affect future operations as well as disclosures in SEC filings.

On the disclosure front, public companies should begin assessing the gaps between climate-related information they currently disclose, inside and outside of SEC filings, and what would be required under the proposed rules, if adopted.

Companies should also review their climate-related goals, such as net-zero emissions pledges, as well as the internal processes and assumptions that go into these goals. If a company has not yet identified climate-related goals, it may be time to begin exploring options.

Finally, in light of the significant new burdens the proposed rules would impose on companies directly and indirectly, companies should consider submitting comments to the SEC during the comment period. The proposed rules will be open for public comment until whichever is later — May 20 or 30 days after their publication in the Federal Register.

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[1] See Commissioner Hester M. Peirce (SEC), "We Are Not the Securities and Environment Commission – At Least Not Yet," Mar. 21, 2022, https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321.