A Brief Summary of the SEC's Proposed Climate-Related Rules

Article By:

Jacob H. Hupart

Megan N. Gates

William F. Weld

Douglas P. Baumstein

Jennifer B. Rubin

Courtney O. Taylor

On March 21, 2022, the Securities and Exchange Commission ("SEC") unveiled its long-anticipated proposed rules on climate disclosures, entitled "The Enhancement and Standardization of Climate-Related Disclosures for Investors." The SEC proposal is an attempt to "advance consistent, clear, intelligible, comparable, and accurate disclosure of climate-related financial risk," an identified political priority for the Biden Administration's environmental agenda. Indeed, one of the first public statements issued by the SEC under the Biden Administration was directed squarely at this issue, when Acting Chair Allison Herren Lee stated on February 24, 2021 that the SEC would "enhance its focus on climate-related disclosure in public company filings." The SEC requested public comment on these proposed disclosures on March 15, 2021. Yet, despite various (and relatively non-specific) statements by the SEC over the past year, the publication of these proposed rules last week was the first opportunity for the public to view these proposed rules relating to climate disclosures.

Briefly, the proposed new disclosures include the following:

First, as reflected by the fact that these disclosures will be incorporated into key SEC filings, such as the Form 10-K, this proposed rule will effectively apply broadly to all issuers with registered classes of securities in the public U.S. capital markets. Specifically, as stated by the SEC, the "proposed climate-related disclosure rules would apply to a registrant with Exchange Act reporting obligations pursuant to Exchange Act Section 13(a) or Section 15(d) and companies filing a Securities Act or Exchange Act registration statement."

Second, climate-related disclosures would be incorporated directly into existing SEC filings (including Forms 10-K and 10-Q), rather than as a separate document. This increases both the prominence of the proposed climate disclosures, and the prospect for potential liability for any misleading or inaccurate disclosures.

Third, climate-related disclosures, including "certain disaggregated climate-related metrics," will be incorporated into companies' audited financial statements, which also expands the potential liability for such disclosures.

Fourth, climate-related disclosures would be "filed," rather than "furnished," under the proposed rules, which, again, has the potential to lead to heightened liability for registrants.

Fifth, as described more fully below, these disclosures are subject to a "phase-in" period over the next five years, and safe harbors will apply to certain types of climate disclosures.

Certain key aspects of the content of the mandatory disclosures are discussed more fully below.

Background

The overall content of these rules is in accordance with what many industry professionals had anticipated. The SEC has used the guidelines issued by the Task Force on Climate-Related Financial Disclosures ("TCFD") as the basis for the proposed regulations. It has also relied upon the Greenhouse Gas Protocol ("GHG Protocol") for a reporting framework with respect to greenhouse gas emissions. Yet even though the general contours of the SEC's approach were anticipated, these proposed rules nonetheless represent a significant potential change that will have a substantial impact on market participants. If the rules are adopted as proposed, key SEC filings—including the Form 10-K—would now require statements about greenhouse gas ("GHG") emissions and climate change. Public companies will have to report on how their boards of directors are responding to the challenge of climate change, and identify whether any of their directors possess expertise on the issue. Even though the SEC's proposed rules are not yet final, and will likely be subject to legal challenge, this publication of proposed climate disclosures (which brings the United States into alignment with other advanced economies) reflects a paradigm shift in the content of financial disclosures. Many may also argue that these proposed rules also represent a shift that enables the political use of SEC reporting requirements.

The SEC's proposed climate-related disclosures are not entirely novel. In February 2010, the SEC issued a letter "to provide guidance to public companies regarding the Commission's existing disclosure requirements as they apply to climate change matters." (Indeed, the SEC's new proposed rules explicitly reference this 2010 Guidance as a precedent.) But the 2010 Guidance did not mandate additional disclosures—as the SEC's new proposed rules do—nor did it ultimately have a significant impact on the disclosures issued by public companies, as noted by various commentators and the government itself.

Still, the SEC's guidance under the Obama Administration encouraged those that sought to use climate-related financial disclosures as a tool to address climate change. This was further encouraged by the proliferation of international and transnational reporting standards for climate-related financial disclosures, which were adopted by a number of advanced economies (including the EU and individual states within the EU). Support among climate change advocates to compel disclosures from corporations concerning their role in contributing to climate change grew over the last decade. This effort to use the market to advance climate policy led to the passage of a bill by the

Democrat-controlled U.S. House of Representatives in June 2021 (which has not yet been taken up by the Senate, and is unlikely to proceed further) that sought to compel the SEC to issue rules mandating the type of climate disclosures currently being proposed.

It should be noted, though, that the use of climate disclosures is merely one part of an “all-of-the-above” strategy to institute climate policy through government action and to pressure corporations to change their behavior, whether through public media and pressure campaigns or through litigation. These new proposed rules by the SEC may enable both environmental litigation (both by private actors and government enforcement authorities), as well as providing additional information that could be utilized to initiate or maintain public pressure on companies.

Disclosures

GHG Emissions

Under the SEC’s proposed climate disclosures, registrants will have to disclose certain kinds of GHG emissions, regardless of any materiality determination. According to the SEC, “GHG emissions information is important to investment decisions for various reasons, including because GHG emissions data is quantifiable and comparable across industries . . . [and] it may be relevant to investment or voting decisions because GHG emissions could impact the company’s access to financing, as well as its ability to reduce its carbon footprint in the face of regulatory, policy, and market constraints.”

The SEC has structured its proposed GHG disclosure rules in accordance with the GHG Protocol and its concept of “scopes,” which distinguish between direct and indirect emissions. Simply stated, Scope 1 emissions are direct GHG emissions by the company, Scope 2 emissions are the GHG emissions that the company is indirectly responsible for based upon its consumption of electricity, and Scope 3 emissions reflect the indirect GHG emissions relating to the company’s supply chain and products. While Scope 1 and Scope 2 emissions are comparatively straightforward to calculate, deriving a company’s Scope 3 emissions is an extremely complex and challenging process, subject to substantial estimation and various approximations. Perhaps recognizing the difficulty in calculating Scope 3 emissions, the SEC has stated that “a registrant may use reasonable estimates” when disclosing its Scope 3 emissions.

Most significantly, the SEC has included specified limitations on its proposed reporting requirements for Scope 3 GHG emissions. First, unlike the disclosure of Scope 1 and Scope 2 GHG emissions, the SEC will only require the disclosure of Scope 3 emissions if those emissions are material. The SEC’s proposal states that “the proposed rules would require disclosure of Scope 3 emissions only if those emissions are material, or if the registrant has set a GHG emissions reduction target or goal that includes its Scope 3 emissions.” (However, the SEC’s commentary suggests that Scope 3 emissions would be deemed material in many, if not all, circumstances.) Second, smaller reporting companies (“SRCs”) are exempt from this requirement entirely.[1] Third, the SEC has established a safe harbor provision with respect to disclosures of Scope 3 GHG emissions. Specifically, unless the Scope 3 GHG emissions disclosure “was made or reaffirmed without a reasonable basis or was disclosed other than in good faith,” no liability for these disclosures will attach under the federal securities laws. Finally, the SEC has proposed a phase-in period for the compliance date for the Scope 3 emissions disclosure, which would extend the deadline for at least a year beyond the compliance date for disclosing Scope 1 and Scope 2 GHG emissions. These provisions may afford some relief for registrants.

The Impact of Climate-Related Risks

The SEC's "proposed rules would require a registrant to disclose any climate-related risks reasonably likely to have a material impact on the registrant's business or consolidated financial statements." The SEC has expressly preserved the significance of a materiality determination when disclosing climate-related risks. Further, the SEC has explicitly invoked the TCFD parameters when defining "climate-related risks," stating that "[the SEC] ha[s] based [its] definitions on the TCFD's definitions because they provide a common terminology that allows registrants to disclose climate-related risks and opportunities in a consistent and comparable way." This reliance on a common definition for these concepts reinforces one of the SEC's rationales in promulgating these disclosures, namely that it will "improve the comparability and usefulness" of the climate-related information.

With respect to climate-related risks, the SEC has stated that registrants must "disclose whether any climate-related risk is reasonably likely to have a material impact on a registrant . . . over the short, medium, and long term." The SEC has not proposed definitions of these time horizons, instead leaving that determination to the individual registrant. (According to the SEC, this is to "allow flexibility" that will enable a company to select a timeframe "most appropriate to its particular circumstances.") The SEC has recognized the uncertainties inherent in this formulation, and has expressly stated that "[t]o the extent that the proposed climate-related disclosures constitute forward-looking statements . . . the forward-looking statement safe harbors pursuant to the Private Securities Litigation Reform Act ("PSLRA") would apply." (However, the SEC also noted that "forward-looking statements made in connection with an initial public offering are excluded from the protections afforded by the PSLRA"—and so IPOs, which will feature required climate disclosures, would not benefit from this protection.) The existence and application of the PSLRA safe harbor provision may provide a certain degree of comfort for companies that will now be compelled to make material disclosures concerning the uncertain impact of climate change on their business over an extended period of time.

The SEC has also proposed certain other disclosures relating to a company's internal assessment and evaluation of the potential impact of climate change. Notably, the SEC has demanded the disclosure of "an internal carbon price," as well as "[t]he rationale for selecting the internal carbon price applied," should a registrant employ that internal calculation. Similarly, the SEC has required that companies, to the extent they employ this device, "describe any analytical tools, such as scenario analysis, that the registrant uses to assess the impact of climate-related risks on its business and consolidated financial statements, or to support the resilience of its strategy and business model in light of foreseeable climate-related risks." In effect, the SEC is demanding that companies disclose their internal analysis (and supporting model) concerning adaptions to climate change. Significantly, these disclosures need only be made if the company is already engaged in these calculations, or chooses to do so in the future—there is no express requirement that a company calculate an internal carbon price or engage in similar analysis. Further, the SEC is not mandating that companies employ any particular methodology when engaged in such calculations.

Other Disclosures

Besides the proposed disclosures noted above, there are also a number of other items identified by the SEC in the proposed rules that could create additional pressures for reporting companies.

For example, one of the items about which the SEC has requested disclosures is "transition risk." The SEC's draft rule has defined "[t]ransition risk," which generally refers to "the actual or potential negative impacts . . . attributable to climate-related risks," to include "reputation impacts (including those stemming from a registrant's customers or business counterparties)." Thus, the SEC's proposed disclosure rules could be read to require companies to assess whether the activities of their business counterparties could result in potential negative impacts to their own operations. In effect, this disclosure could potentially stigmatize companies that conduct a significant amount of business with entities perceived as problematic actors by the environmental movement—such as companies engaged in extraction industries such as oil, gas, and mining.

Additionally, the SEC's proposed rules contain multiple statements expressing the need for meaningful disclosure and an aversion to "boilerplate." Although this may reflect nothing more than the intent of the SEC to emphasize the necessity of robust compliance with these proposed requirements, it is also possible that this may signal a particular animus toward generic disclosures in the climate context, which may ultimately be the target of enforcement action. Indeed, this quest for specificity can also be seen in the sample comment letter to companies regarding climate change disclosures that the SEC issued in September 2021.

Governance

The SEC has proposed significant, prescriptive changes to corporate governance with respect to matters concerning climate change and related disclosure. Specifically, according to the SEC, the proposed rules would require a registrant to disclose:

- information concerning the board's oversight of climate-related risks as well as management's role in assessing and managing those risks;
- whether any member of its board of directors has expertise in climate-related matters;
- the processes and frequency by which the board discusses climate-related factors;
- whether certain management positions are responsible for assessing and managing climate-related factors; and
- the processes by which the responsible managers are informed about and manage climate-related factors.

The stated purpose of such disclosures is to "enable investors to better understand how the firm is informed about climate-related factors and how frequently the firm considers such factors as part of its business strategy, risk management, and financial oversight."

The fact that the SEC has proposed public disclosures on these particular topics will likely compel corporate boards to address climate change, and to do so substantively, to the extent they are not doing so already. Further, these required disclosures will likely increase the demand for corporate directors who possess as yet to be defined "expertise in climate-related matters."

These particular governance disclosures are likely to affect the agenda of corporate boards across the United States in pursuit of a public policy goal—namely, the adoption of more climate-conscious policies. This is an indirect, but potentially effective, means of advancing the Biden Administration's environmental goals.

Implementation Process

The proposed rules, which apply to all domestic or foreign registrants, feature a gradual phase-in period for all registrants, and also would allow certain exemptions for SRCs. Broadly speaking, the SEC rules contemplate the implementation of these rules over a period of five years, with the degree of reporting requirements and the level of attestation increasing in stringency over time, and with smaller companies able to adopt a more leisurely implementation schedule. Further, the most rigorous requirements—such as reporting on Scope 3 emissions or providing “assurance”—are not applicable to SRCs.

The below table, featured in the draft rules proposed by the SEC, summarizes the reporting requirements and corresponding timeline:[2]

Registrant Type	Disclosure Compliance Date		Financ Aud
	All proposed disclosures, including GHG emissions metrics: Scope 1, Scope 2, and associated intensity metric, but excluding Scope 3.	GHG emissions metrics: Scope 3 and associated intensity metric	
Large Accelerated Filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)	Same a
Accelerated Filer and Non-Accelerated Filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	
SRC	Fiscal year 2025 (filed in 2026)	Exempted	

Also, as stated in the SEC’s proposed rules, the requirement to offer “limited assurance” and “reasonable assurance” for GHG disclosures would be subject to an even more gradual phase-in period. (“Limited assurance,” or a review, reflects a diminished level of assurance compared to the “reasonable assurance” obtained through an audit, and is less intrusive and costly.) Specifically, “limited assurance” is required for the two years immediately following the initial compliance date (e.g., fiscal years 2024 and 2025 for Scope 1 and Scope 2 emissions for large accelerated filers), and “reasonable assurance” beginning in the fourth year after the initial compliance date (e.g., beginning in fiscal year 2026 for Scope 1 and Scope 2 emissions for large accelerated filers). SRCs are exempt from these attestation requirements.

Also, on a practical note, the 60-day public notice and comment period for the SEC’s proposed climate disclosures has now begun. We would expect a significant number of interested stakeholders, ranging from corporations to public officials or advocacy groups, to offer comments on the proposed rule. (Indeed, when SEC Chairman Gensler requested public comments when drafting the proposal, the SEC had received approximately six hundred unique responses.) The final version of these proposed disclosures may differ significantly from the draft rules that the SEC has published. Ultimately, based on both the regulatory implementation timeline and these proposed disclosures, we would not expect any comprehensive changes by corporations to regulatory filings until next year, at the earliest.

Political Issues

While the majority of Democrats support the SEC’s proposed disclosures, both sides of the political spectrum have already subjected them to substantial criticism. Prominent Republican lawmakers have criticized these rules, including Senator Patrick Toomey (R-PA), the ranking member of the Senate Banking Committee, who described the proposal as extending "far beyond the SEC's mission," and constituting "a thinly-veiled effort to have unelected financial regulators set climate and energy policy for America." Conversely, certain Democrats have articulated the view that the rules are not expansive enough. For example, Senator Sheldon Whitehouse (D-RI) criticized the failure to include disclosure requirements concerning climate-related lobbying and influencing activities, which he described as "the single most material disclosures a company could make to achieve climate safety."

The critique of the SEC's proposed climate-related disclosures will likely extend beyond press statements to legal challenges. Opponents of the disclosure requirements are expected to file lawsuits in federal court against any final rule that the SEC may ultimately adopt. These challengers, potentially including business associations or state attorneys general, will likely argue that these rules constitute an *ultra vires* exercise of the SEC's authority under its enabling statutes. This line of attack has been prefigured by public statements from the Republican SEC Commissioners,[3] who have consistently challenged the SEC's potential ESG rulemaking for the past year. Notably, this legal argument is also aligned with the broader conservative campaign that seeks to roll back significant aspects of the regulatory and administrative state and limit the rule-making ability of Federal agencies.

It is also useful to adopt a wider perspective when assessing the impact of the SEC's proposed climate disclosures, as this is only one aspect—albeit a significant one—of the broader push by the Biden Administration and Congressional Democrats to address climate change. The SEC itself has already issued comment letters and initiated enforcement actions concerning climate disclosures under existing law. The Environmental Protection Agency has initiated several climate-related actions under the Biden Administration, including issuing GHG emissions standards for passenger cars and light trucks. And on Capitol Hill, House and Senate Democrats continue to introduce legislation, hold hearings, and negotiate legislative packages that demonstrate their belief that action to address climate change is necessary. In that vein, Democrats on the House Oversight Committee launched an investigation into the alleged dissemination of disinformation concerning climate change by the fossil fuel industry. These policy and political developments are themselves only part of the overall mosaic of actions advanced in connection with addressing climate change. Market participants are also engaging in this issue. Notably, major Wall Street investment managers, including BlackRock and State Street, have also advocated for climate-related disclosures according to the TCFD framework. So, although the proposed SEC disclosures are undoubtedly significant, and would impose substantial regulatory compliance burdens on industry if adopted as proposed, these proposed climate disclosures are part of other, ongoing related trends.

Conclusion

The proposed climate disclosures issued by the SEC, although not yet finalized, constitute a profound shift in the SEC's disclosure regime. For the first time, climate-related financial disclosures could be mandatory for public companies trading in the U.S. capital markets, and these corporations would have to disclose their greenhouse gas emissions. This presents a new arena for regulatory enforcement or private civil litigation relating to those disclosures. Moreover, the increased prevalence of and access to detailed environmental data is likely to create additional pressures for corporations as they try to adhere to new standards of conduct in this emerging and rapidly evolving area.

Should the reporting requirements be adopted as proposed, some relief would be afforded through the gradual phase-in and by the application of safe harbor provisions. And it is still unclear whether these proposed disclosures will survive the inevitable legal challenges (or how such legal challenges could impact the proposed rules). Nonetheless, the SEC has now established a potential benchmark for climate disclosures, and corporations will have to adapt to this proposed landscape in order to continue accessing the capital markets in the United States.

Thanks to Mintz **Senior Project Analyst** Luke Haubenstock for his significant contributions to this memo.

Endnotes

[1] As stated in the SEC's proposal, "[t]he Commission's rules define a smaller reporting company to mean an issuer that is not an investment company, an asset-back issuer, or a majority-owned subsidiary of a parent that is not a smaller reporting company and that (1) had a public float of less than $250 million; or (2) had annual revenues of less than $100 million and either: (i) no public float; or (ii) a public float of less than $700 million."

[2] As stated in the SEC's proposal, and according to the Code of Federal Regulations, an "accelerated filer" is defined as ""an issuer after it first meets the following conditions as of the end of its fiscal year: (i) the issuer had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $75 million or more, but less than $700 million, as of the last business day of the issuer's most recently completed second fiscal quarter; (ii) the issuer has been subject to the requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least twelve calendar months; (iii) the issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and (iv) the issuer is not eligible to use the requirements for SRCs under the SRC revenue test."

Likewise, a "large accelerated filer" is defined as "an issuer after it first meets the following conditions as of the end of its fiscal year: (i) the issuer had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $700 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter; (ii) the issuer has been subject to the requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least twelve calendar months; (iii) the issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and (iv) the issuer is not eligible to use the requirements for SRCs under the SRC revenue test."

[3] Commissioner Roisman offered multiple criticisms of this proposed disclosure regime over the past year, but he is no longer a member of the Commission.

National Law Review, Volume XII, Number 91