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Kirkland Alert

SEC Proposes New Climate Disclosure Requirements

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On March 21, 2022, the SEC proposed rule amendments that would require public companies to include certain climate-related information in their registration statements and periodic reports, including oversight and governance, material impacts (operational and financial), risk identification and management, and Scope 1, 2 and 3 emissions (the "Proposed Rule"). For large companies, the Scope 1 and 2 emissions disclosures would require attestation from a third party. The Proposed Rule would also impose enhanced disclosure requirements on companies that have taken certain climate actions, including setting public goals or targets or adopting transition plans. These new requirements, if adopted, would at the earliest take effect in fiscal year 2023 and begin to apply to SEC filings in 2024.

If adopted, the breadth, specificity and complexity of the Proposed Rule would arguably result in one of the most sweeping changes to public companies' disclosure obligations in recent memory. The SEC has framed the Proposed Rule as a justified response to "investor need [for] information about climate-related risks" that "have present financial consequences."[1] According to the SEC, existing climate disclosures are reported inconsistently in different documents and formats, and the Proposed Rule would provide investors with information investors may consider material to their investment and voting decisions. But critics, including within the SEC, view the Proposed Rule as a significant regulatory overreach that would effectively result in substantive environmental policymaking and impose massive disclosure and compliance burdens on companies.

This *Alert* discusses the context and key requirements of the Proposed Rule and outlines next steps companies may want to consider as they evaluate the potential impacts of the Proposed Rule on their climate-related initiatives and disclosures.

What Did the SEC Cite as the Basis for the Proposed Rule?

We provided background on the SEC's climate disclosure activities leading up to the Proposed Rule in an October 2021 *Alert*. Since then, the appetite for climate disclosure has only increased from many large institutional investors. In crafting the Proposed Rule, the SEC attempted to synthesize letters received in response to a request for public input, while likely also taking into account companies' responses to dozens of comment letters regarding climate disclosures. Notwithstanding the SEC's position in the Proposed Rule that some or all of the proposed disclosure is considered material by investors, many of these response letters indicated that climate change was not material to the company's business.[2]

The Proposed Rule also reflects the SEC's attempt to harness two significant global shifts on climate-related disclosure. First, regulators worldwide (e.g., in the UK, EU and Hong Kong) have begun to shift from regimes of voluntary to mandatory climate disclosure, largely based on the recommendations of the Task Force on Climate-Related Financial Disclosures ("TCFD"). The SEC similarly modeled the Proposed Rule in part on the TCFD framework.[3]

Second, investors, consumers and other market participants are increasingly clamoring for a global climate disclosure standard not only to obtain consistent information, but also to avoid perceived "greenwashing" or "climate-washing." The SEC is involved in reviewing the soon-to-be-released proposed climate standard from the International Sustainability Standards Board ("ISSB")[4] through its participation in the International Organization of Securities Commissions ("IOSCO"). IOSCO recently announced its intent to thoroughly review the ISSB's proposed standard as part of its commitment to combat greenwashing. Similarly, the Proposed Rule acknowledges growing concerns about greenwashing and includes various components that appear designed to mitigate those risks.

Key Aspects of Proposed Rule

The Proposed Rule would require public companies (including foreign private issuers) to provide climate-related disclosure in periodic reports (Forms 10-K, 10-Q and 20-F) and registration statements (Forms S-1, S-3, F-1 and F-3). The Proposed Rule includes mandatory disclosures regarding:

- the oversight and governance of climate-related risks by the company's board and management;
- how climate-related risks identified by the company have had or are likely to have a material impact on its business and consolidated financial statements,[5] as well as how climate risks affect its strategy, business model and outlook;
- the company's processes for identifying, assessing and managing climate-related risks and whether any such processes are integrated into the company's overall risk management system or processes;
- Scope 1 and 2 greenhouse gas ("GHG") emissions,[6] separately disclosed, expressed in absolute terms (not including offsets) both:
  - by disaggregated constituent greenhouse gases and in the aggregate, and
  - in terms of intensity;

- Scope 3 GHG emissions[7] and intensity, if material, or if the company has set a GHG emissions reduction target or goal that includes its Scope 3 emissions; and
- to the extent applicable, details on the company's public climate-related targets or goals (including any use of carbon offsets or renewable energy certificates ["RECs"] to achieve such targets and goals), transition plan, use of scenario analysis and/or use of internal carbon pricing.

The Proposed Rule would require companies to: (i) provide the climate-related disclosures in a separately captioned section of their registration statement or periodic report, (ii) provide climate-related financial statement metrics addressing the impact of various climate-related events and mitigation and transition expenditures, together with related estimates and assumptions, in a note to the company's financial statements addressing the impact on line items in companies' financial statements, (iii) electronically tag both narrative and quantitative climate-related disclosures in Inline XBRL, and (iv) generally file rather than furnish the climate-related disclosure.

Assuming it is finalized in 2022, the Proposed Rule would begin to apply to filings in 2024. It includes a phase-in period for all companies, with the compliance date dependent on the company's filer status, as well as an additional phase-in period for the attestation requirement and Scope 3 emissions disclosure. Tables detailing the phase-in periods are provided in the Fact Sheet issued in conjunction with the Proposed Rule. Smaller reporting companies are exempt from the attestation and Scope 3 emissions disclosure requirements.

Practical Implications/FAQs

The Proposed Rule will likely receive numerous substantive comments[8] that could change its contours significantly before it is finalized, and it is expected to be challenged in court.[9] Nonetheless, companies may wish to begin analyzing their current climate-related governance, strategy, risk management, metrics, targets and disclosures in light of the Proposed Rule, which is likely to influence investor expectations even before it is finalized and enacted. Companies may also wish to consider participating in the public comment process.

Governance

How Could the Proposed Rule Inform Expectations Around Climate Governance, and What Actions Should Companies Consider Taking in Response?

- The Proposed Rule does not mandate any specific climate governance practices. But it does identify a series of items that must be disclosed regarding companies' climate governance practices, if applicable, such as board committees with responsibility for climate oversight; the processes and frequency by which the board or board committee discusses climate risks; how the board or board committee integrates climate risk into its business strategy, risk management and financial oversight; and how the board sets and oversees climate goals. These practices, even if not required, could influence investor and regulatory expectations. Therefore, companies may wish to identify where oversight of climate-related initiatives and climate risk management are, or will be, assigned at the board level and consider including these responsibilities directly in their governance documents. In many instances, these responsibilities can be allocated to existing committees, and companies should not interpret the Proposed Rule to mean that forming standalone climate committees is required. Additionally, the Proposed Rule, similar to the SEC's recent cybersecurity proposed rule, requires identification of directors with expertise in climate-related risks. Companies should not interpret the Proposed Rule to mean that they must begin recruiting climate experts to their boards, but some companies, particularly those facing more significant climate risks, may wish to consider (or may be asked by investors to consider) appointing board members with climate expertise or enhancing the climate knowledge of existing board members.[10]
- The Proposed Rule would necessitate robust practices to manage the new information required for the disclosures. Companies who already provide extensive data in sustainability reports would need to "uplift" the procedures applied to such data, applying existing disclosure and financial controls and procedures to new and voluminous information. These controls and procedures include ERP reporting systems, segregation of duties to mitigate fraud, clear data management and

documentation policies, as well as appointing a management oversight team and requiring legal review for all climate-related disclosures. Disclosure mandated by the Proposed Rule to be included in companies' annual reports and financial statements would be subject to officer certifications required by Rules 13a-14 and 15d-14 under the Exchange Act and attendant liability. Companies may ultimately seek to (but are not necessarily required to) increase their internal talent and resources to bolster their climate capacity across business functions, which could result in significant costs. They may also seek to ensure climate expertise at their audit firms, which are already under pressure to properly account for climate risk in their review of financial statements.[11]

Material Climate-Related Impacts on Strategy, Business Model and Outlook

How Can Companies Assess Climate Impacts?

- The Proposed Rule would require companies to describe the actual and potential impacts of climate-related risks that are reasonably likely to have a material impact on the business and its consolidated financial statements. Companies would have to provide robust and company-specific disclosure, including how the company identifies material physical and transition risks, and how it identifies the impacts as part of its business strategy, financial planning and capital allocation. For many companies, this would require expending significant resources to build out their climate risk assessment processes. Doing so could require working with consultants to conduct physical climate risk assessments of a company's assets, assessing related vulnerabilities in supply chains, and evaluating and assessing the impact of shifts in customer preferences, again potentially resulting in significant costs. Companies facing more significant climate risks may wish to begin thinking about allocating resources to evaluating the most critical and vulnerable areas of their businesses.
- Companies may choose to use scenario analysis to assess potential climate impacts, although the Proposed Rule would require disclosure of the parameters, assumptions, analytical choices and projected financial impacts if scenario analysis is used. The Proposed Rule suggests that investors would benefit from companies' use of widely accepted scenarios, such as those developed by the Intergovernmental Panel on Climate Change or the International Energy Agency.

Climate-Related Risk Management

How Should Companies Approach Risk Management?

- The Proposed Rule would require companies to provide disclosure regarding their process for identifying, assessing and managing material climate-related risks, including physical and transition risks. A particular focus is how companies determine the relative significance of climate-related risks compared to other risks, so companies may wish to consider this point in conjunction with developing a risk management strategy. Companies that adopt transition plans to mitigate or adapt to climate-related risks would have to provide a description of the plan under the Proposed Rule.

GHG Emissions Metrics

Does the Proposed Rule Embrace a Standard Process for Calculating and Disclosing Emissions?

- The Proposed Rule notably, and controversially, requires all companies to disclose their Scope 1 and 2 emissions. In addition, the Proposed Rule includes a Scope 3 emissions disclosure requirement that could apply to many companies.[12] The Proposed Rule bases its GHG emissions disclosure requirement on the GHG Protocol, which is a widely accepted GHG accounting standard. Consultants can assist companies with calculating their emissions utilizing this standard. However, current disclosure rates reflect that, particularly for Scope 3 emissions, many companies may find it challenging to collect the information required for the GHG emissions calculation.[13] The Proposed Rule also notes that, for financial companies, no specific methodology is required to calculate "financed emissions" (a category of Scope 3 emissions), but it does note the Partnership for Carbon Accounting Financials standard as one possible option.

How Can Companies Determine Whether Scope 3 Emissions Are Material?

- The Proposed Rule would require large companies (smaller reporting companies would be exempt) to disclose Scope 3 emissions only if they are "material" to the company or if the company has set a GHG emissions target or goal that includes Scope 3 emissions. However, determining whether Scope 3 emissions are ultimately material to a particular company requires an intensive fact-specific inquiry and may be a complicated endeavor for some companies, particularly since it typically involves collecting and relying on third-party data. The SEC provided examples of where Scope 3 emissions may be material: (1) if an industry is in the process of transitioning to lower-emission products or processes that may result in financial risks; (2) if a company is required to allocate capital to invest in lower emissions equipment; or (3) if Scope 3 emissions make up a relatively significant portion of a company's overall GHG emissions. The SEC cites auto manufacturers and oil and gas product manufacturers as industries where Scope 3 emissions are likely to be material, but it is worth noting that for most business sectors, about 80% of total emissions are Scope 3.[14]

Would Companies Need to Hire GHG Emission Attestation Providers?

- If the Proposed Rule is adopted in its current form, an attestation report from an independent GHG emissions attestation provider will be required to cover Scope 1 and 2 GHG emissions metrics for large accelerated and accelerated filers after the first disclosure year. Companies could choose to engage their existing independent audit firms for this purpose (although the independence of these firms is being scrutinized as they provide increased amounts of non-audit services), or they could engage third-party climate or ESG consulting firms. The timing and cost for this process varies depending on the nature and scale of a company's operations and the availability of accurate data (e.g., with respect to energy, gas and water consumption, and business travel). It typically takes several weeks or months at a minimum. With respect to cost, the SEC proposes that "accelerated filers and large accelerated filers should have the necessary resources to devote to complying with such requirements over the proposed implementation timetable."[15] The advent of the Proposed Rule may strain limited existing capacity for the top consultants, and companies should be prepared to factor this process into their annual audit and disclosure timelines.

Climate-Related Targets and Goals

What Should Companies Consider with Respect to Existing or Planned Climate Goals?

- Companies should inventory their existing climate risk disclosures and consider whether they would be subject to enhanced reporting under the Proposed Rule because they have adopted transition plans, completed scenario analysis, set public emissions targets or goals (such as a net zero target), or deployed internal carbon pricing. Companies should also consider the potential disclosure implications and incremental compliance burdens under the Proposed Rule with respect to any future climate targets or goals. Due to compliance burdens, the Proposed Rule could discourage companies from making public climate commitments, but companies will need to balance potential regulatory compliance considerations with pressure from investors and other stakeholders to take climate action.

Other Considerations

What Are Other Relevant Risks for Companies?

- **Scope 3 Risk:** Scope 3 emissions information collected from third parties has heightened risks with respect to reliability and could present challenges to companies in their efforts to make materiality determinations. While the SEC has created a safe harbor for Scope 3 emissions disclosure, companies would need to design frameworks to collect and analyze vast new amounts of data, and to form a reasonable basis for forward-looking information.
- **Liability Exposure from Filed Information:** The SEC has proposed that the information required by the Proposed Rule will generally be filed rather than furnished, which results in substantial incremental liability exposure. As noted above, certain of the information required by the Proposed Rule would also be subject to officer certifications regarding disclosure and internal controls. In the Proposed Rule, the SEC has acknowledged that it is purposefully requiring filing this information but is requesting comments on its approach, acknowledging this is a significant focal point for companies.
- **Litigation Risk:** The Proposed Rule only provides a safe harbor for Scope 3 emissions disclosure and forward-looking climate disclosures, and thus companies would be subject to increased litigation risk. Even now, companies should treat public disclosures of climate-related information as seriously as financial disclosures and apply robust disclosure controls and legal review. Companies should use cautionary language and forward-looking statements legends with respect to climate-related disclosures, set achievable targets and goals and carefully assess the feasibility of any assurances or firm projections around future climate goals or results. The growing risk of greenwashing (or "climate-washing") lawsuits and government enforcement actions for climate-related disclosure will likely only increase in light of the significantly expanded disclosure contemplated by the Proposed Rule.

What Insights Can Companies Draw from Other SEC Rulemakings?

- Although the Proposed Rule is significantly more expansive, certain parallels can be drawn to the SEC's Conflict Minerals Rule, including concerns with respect to gathering and disclosing large amounts of data, subjecting such data to internal controls and ensuring its reliability, and obtaining third-party assurance. Notably, the Conflict Mineral Rule was subject to litigation that resulted in the SEC stating that it would not recommend enforcement if companies scaled back disclosure. In the final Conflict Minerals Rule, Form SD is required to be filed, rather than furnished, but is not automatically incorporated into registration statements unlike the disclosure in the Proposed Rule. In addition, the SEC adopted Form SD to alleviate concerns regarding officer certifications over conflict minerals disclosure, unlike the framework that would apply to disclosures under the Proposed Rule.[16]

What Other Disclosures May Companies Consider?

- Companies should note that the Proposed Rule allows, but does not require, disclosures regarding climate-related opportunities. As companies prepare to disclose more climate-related risks in their filings, they may consider balancing such disclosures by discussing business opportunities presented by climate change.

How does the Proposed Rule Impact Private Companies?

- The Scope 3 emissions disclosure requirement would likely have a significant impact on private companies and foreign companies not subject to the regulation, as many are suppliers or customers to, or have received loans or investments from, public companies subject to the proposed rule. These non-subject companies would face pressure to disclose their emissions in order to enable reporting of Scope 3 emissions by public companies that are subject to the rule. It may also drive market expectations to include the same disclosure in private securities offerings under Rule 144A, where it has become standard practice to follow disclosure rules applicable to public securities offerings. In addition, the significant costs and burden of complying with the Proposed Rule may, at the margin, further discourage private companies from going public or potentially influence public companies to go private.

Next Steps

The Proposed Rule will remain open to public comments through at least May 20, 2022. Companies should consider whether they have specific cost, feasibility, liability or other concerns with respect to the Proposed Rule that may warrant participation in the public comment process, either on their own or as part of a coalition or industry group.

After it is finalized, the Proposed Rule is expected to be challenged, particularly with respect to the SEC's statutory authority to enact comprehensive climate disclosure regulations in the absence of explicit Congressional authorization. Notably, Commissioner Peirce voted against the Proposed Rule and argued that it "turns the disclosure regime on its head" by identifying specific risks and opportunities that companies must consider, rather than allowing companies to "disclose their performance through their own eyes." In a dissenting statement titled "We are Not the Securities and Environment Commission – At Least Not Yet," Commissioner Peirce states that the Proposed Rule lacks a materiality limitation, an adequate statutory basis, a credible rationale ("when existing disclosure requirements already capture material risks relating to climate change"), and other key elements.[17] Future legal challenges, even if they are ultimately not successful, could delay the implementation of the rule.

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1. Proposed Rule at 9. ↩

2. The comment letters were based on the SEC's seminal interpretive guidance, issued in 2010, on how existing SEC disclosure requirements apply to climate change matters. The SEC also issued a sample comment letter intended to be considered and reviewed by all companies regarding climate change-related disclosure, risks and opportunities. *See also* Bloomberg, SEC Drops Hints About ESG Rule in Retorts to Vague Disclosures (March 18, 2022). ↩

3. *See* our November 2021 *Alert* for more information about the TCFD and its adoption by regulators in other jurisdictions. Although the SEC modeled the Proposed Rule in part on the TCFD framework, it would impose mandatory disclosures that exceed nearly all companies' current practices. Companies that already report in line with TCFD would benefit from their existing practices; however, for many companies, the extensive obligations set forth in the Proposed Rule would go well beyond current practice. Of note, the TCFD's most recent Status Report found that TCFD reporting among companies was 32% across 1,600+ companies analyzed, based on the average score across the TCFD's 11 recommended disclosures. ↩

4. The ISSB was established by the IFRS Foundation to develop a global baseline for climate and ESG disclosures. The climate standard will be based on the TCFD's recommendations. ↩

5. The Proposed Rule adds a new article to Regulation S-X. The financial impact disclosure requirements would require a company to disclose the financial impacts of severe weather events, other natural conditions and transition activities, as well as future climate-related risks, unless the aggregated impact is **less than 1%** of the total line item for the relevant fiscal year. As stated in the Proposed Rule, "the proposed threshold would provide a bright-line standard for companies and should reduce the risk of underreporting such information." Proposed Rule at 127. ↩

6. "Scope 1 emissions are direct GHG emissions that occur from sources owned or controlled by the company," and "Scope 2 emissions are those emissions primarily resulting from the generation of electricity purchased and

consumed by the company." Proposed Rule at 41, citing the Greenhouse Gas Protocol. ↩

7. "Scope 3 emissions are all other indirect emissions not accounted for in Scope 2 emissions. These emissions are a consequence of the company's activities but are generated from sources that are neither owned nor controlled by the company." Proposed Rule at 41-42, citing the Greenhouse Gas Protocol. ↩

8. The Proposed Rule includes over 200 requests for comments on specific points, in addition to a general request for comments. ↩

9. *See* Bloomberg, SEC's Climate Proposal Tees Up Test of 'Material' Info Standard (March 23, 2022). ↩

10. We recently issued a Blog Post on how directors and executives are positioning themselves to lead on climate. ↩

11. *See* Financial Times – Moral Money, SEC's Proposed Climate Rule Hangs in the Balance (March 23, 2022). ↩

12. In 2021, approximately two-thirds of S&P 500 companies disclosed their Scope 1 and 2 emissions; however, the percentage dropped to 43% for Scope 3 emissions. *See* The Conference Board, Sustainability Disclosure Practices. However, these disclosures may not fully align with the expectations of the Proposed Rule, and disclosure rates are significantly lower for companies outside the S&P 500. ↩

13. The SEC acknowledges that Scope 3 emissions disclosures present "unique challenges," and "[d]epending on the size and complexity of a company and its value chain, the task of calculating Scope 3 emissions could be relatively more burdensome and expensive than calculating Scope 1 and Scope 2 emissions." Proposed Rule at 240. ↩

14. *See* Financial Times – Moral Money, A Turning Point for Corporate Climate Disclosures (March 21, 2022). ↩

15. Proposed Rule at 238. ↩

16. The SEC adopted Form SD as a separate form to alleviate those concerns for information required by the Conflict Minerals Rule, stating: "[R]equiring the disclosure in a new form, rather than in issuers' Exchange Act annual reports, should alleviate some commentators' concerns about the disclosure being subject to the officer certifications required by Rules 13a-14 and 15d-14 under the Exchange Act." FN 343 of the Conflicts Mineral Rule. ↩

17. Commissioner Peirce's argument is consistent with her views in her March 9, 2022 statement on the SEC's proposed cybersecurity rules, Dissenting Statement on Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure Proposal, in which she states that the SEC is overstepping its bounds by becoming a substantive regulator of cybersecurity issues when that is beyond the SEC's Congressional authorization and core rulemaking expertise. ↩

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Suggested Reading

- 13 June 2022 - 15 June 2022 Sponsored Event Kayo Women's Private Equity and ESG Investment Summits
- 21 March 2022 Article Cos. Must Prepare For Emerging ESG Risks In Supply Chains
- 21 March 2022 Press Release Kirkland Represents Arrail Group on Hong Kong IPO