Proposed SEC Rule: "The Enhancement and Standardization of Climate-Related Disclosures for Investors"

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Jacob Hupart has a multifaceted litigation practice that encompasses complex commercial litigation, securities litigation, including class action claims, as well as white collar criminal defense and regulatory investigations. He has extensive experience handling all phases of litigation before federal and state courts, managing discovery, and conducting settlement negotiations. Jacob has represented clients in a variety of industries, including financial services, energy, healthcare, education, and the media. Jacob is a prolific thought leader who frequently writes and publishes articles on the legal and regulatory issues impacting ESG disclosures, climate change, and pending environmental litigations.

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Prior SEC Guidance on Climate-Related Disclosures

- Over ten years ago, the SEC issued guidance to public companies—the 2010 Climate Change Guidance—regarding existing disclosure requirements as they applied to climate change matters.
- While not a regulation, the Guidance noted four topics that companies should consider, which could trigger climate change disclosures under the SEC's rules at the time:
  - the impact of legislation and regulation related to climate change in the United States and globally;
  - the impact of international accords relating to climate change;
  - actual and potential indirect consequences of climate change-related regulation and business trends; and
  - actual or potential impacts of the physical effects of climate change on their business.

The Proposed Rule: “The Enhancement and Standardization of Climate-Related Disclosures for Investors”

- On March 21, 2022, the SEC issued proposed rules under the Securities Act and the Exchange Act that would require registrants to provide certain ***climate-related information*** in their registration statements and periodic reports.
- The proposed rules focus on disclosure of:
  - ***material climate risks*** (*i.e.*, information about climate-related risks that are reasonably likely to have a material impact on a registrant’s business, results of operations, or financial condition),
  - ***management and governance*** of those risks, and
  - the registrant’s greenhouse gas emissions (with some exceptions).

Key Take-Aways:

- Would apply to ***all issuers*** with registered classes of securities in the public U.S. capital markets (including foreign registrants and smaller reporting companies (“SRCs”)).
- Separate section (under new Subpart 1500 of Reg. S-K) to be included in existing SEC filings, including Forms 10-K and 10-Q, and registration statements (including for IPOs).
- New footnote to audited financial statements (under new Article 14 of Reg. S-X).
- “***Filed,” rather than “furnished***” (has potential liability implications).
- Phase-in periods, with certain safe harbors.
  - ***Scope 3*** Greenhouse Gas (GHG) emissions disclosure would be subject to a safe harbor.
  - Private Securities Litigation Reform Act (PSLRA) safe harbor still applies to any forward-looking statements (*except in IPOs*).
- Heavy focus on ***governance issues*** and how a registrant’s board and management are assessing and addressing climate-related risks.

Proposed Content

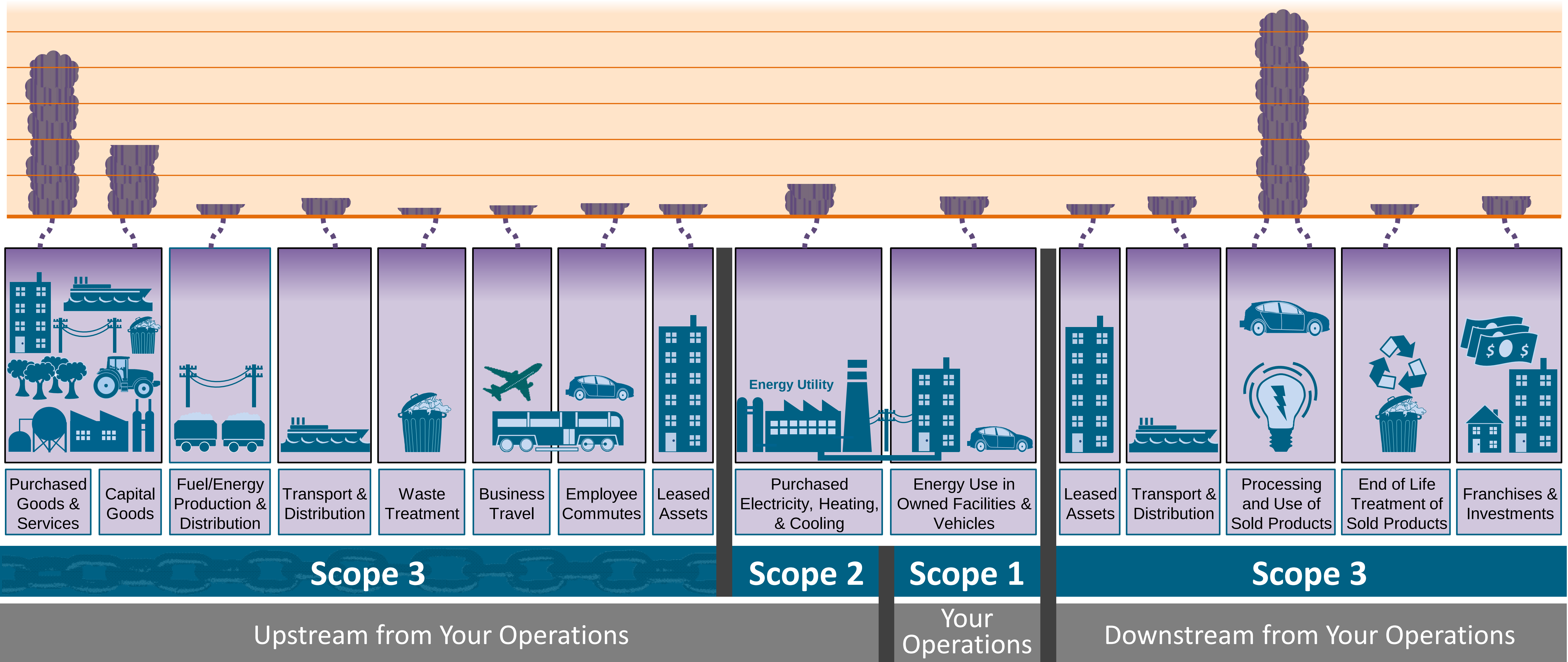
- Climate-related risks and their actual or likely material impacts on the registrant’s business, strategy, and outlook;
- The registrant’s governance of climate-related risks and relevant risk management processes;
- The registrant’s greenhouse gas (“GHG”) emissions, which, for accelerated and large accelerated filers and with respect to certain emissions, would be subject to assurance;
- Certain climate-related financial statement metrics and related disclosures in a note to its audited financial statements; and
- Information about climate-related targets and goals, and transition plan, if any.

Location of Disclosures

- Proposed climate-related disclosures will be incorporated into existing SEC filings (e.g., ’34 Act Forms 10-K and 10-Q, and also ’33 Act Forms S-1 and S-3):
  - The SEC is proposing to “include the climate-related disclosure rules in Regulation S-K and Regulation S-X because the required disclosure is fundamental to investors’ understanding the nature of a registrant’s business and its operating prospects and financial performance, and therefore, should be presented together with other disclosures about the registrant’s business and its financial condition.”
  - Would create a separately captioned “Climate-Related Disclosure” section in Securities Act or Exchange Act registration statements and Exchange Act annual reports, and in the financial statements.

GHG Emission Disclosures

SEC proposed rule requires disclosure of Scope 1 and 2 emissions, and material Scope 3 emissions.



GHG Emission Disclosures (I)

- ***All registrants*** must disclose Scope 1 and Scope 2 greenhouse gas (GHG) emissions.
  - This requirement applies irrespective of any materiality determination.
  - Scope 1 emissions: direct GHG emissions from operations that are owned or controlled by a registrant.
  - Scope 2 emissions: indirect GHG emissions from the generation of purchased or acquired electricity, steam, heat, or cooling that is consumed by operations owned or controlled by a registrant.
  - Must be identified "both by disaggregated constituent greenhouse gases and in the aggregate."
- Companies must also identify these emissions "in absolute and intensity terms."
  - Intensity is defined as "emissions per economic output."
  - The GHG intensity disclosure would be in terms of mtCO2e per unit of total revenue and per unit of production by FY.
- These disclosures would be subject to attestation for accelerated filers and large accelerated filers.
  - Attestation must be provided by a person or firm that satisfies the relevant SEC criteria.
  - The attestation report is required as part of the filing.

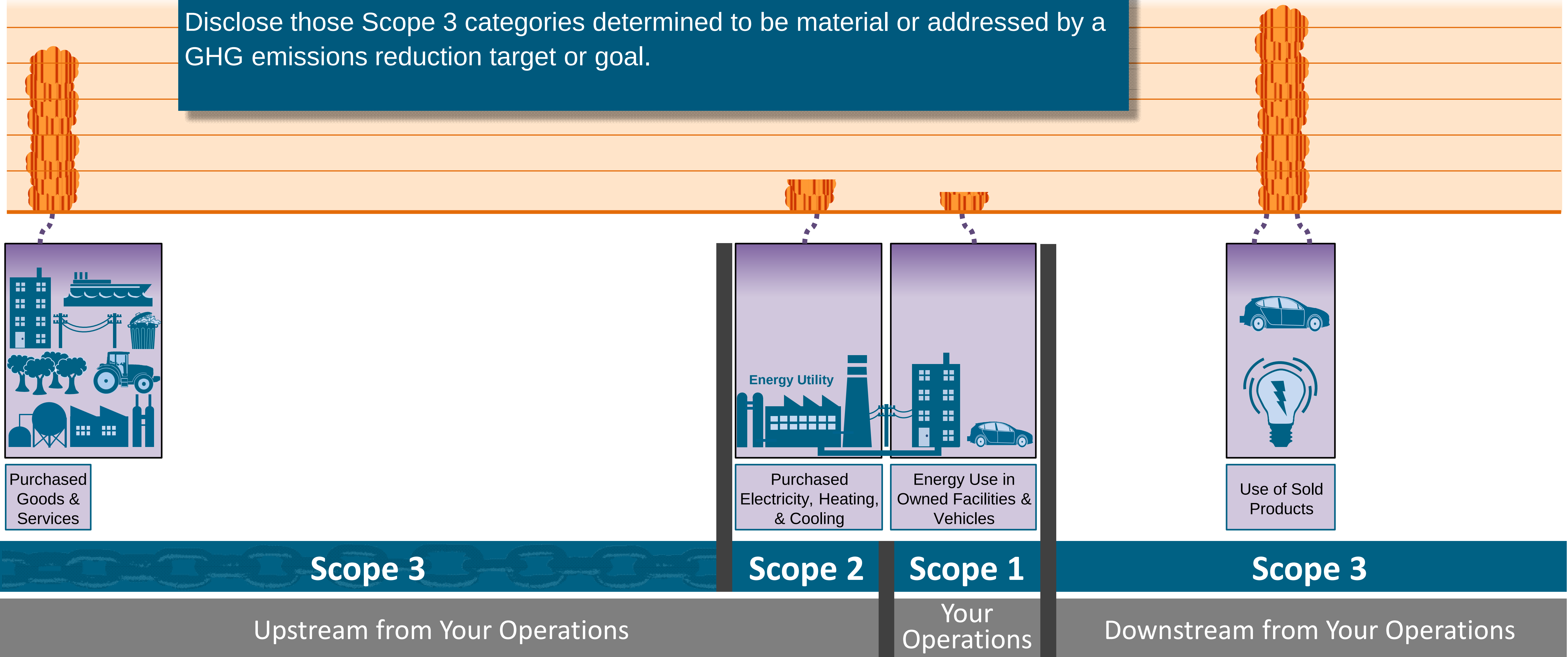
GHG Emission Disclosures (II)

- Scope 3 Emissions
  - All *indirect* GHG emissions not otherwise included in a registrant's Scope 2 emissions, which occur in the upstream and downstream activities of a registrant's value chain.
  - This is difficult to calculate, as the SEC recognizes ("the task of calculating Scope 3 emissions could be challenging").
  - Must be disclosed only "<u>if those emissions are material</u> or if [the company] has set a GHG emissions reduction target or goal that includes its Scope 3 emissions."
    - SEC commentary suggests Scope 3 emissions will be material under most circumstances.
  - GHG intensity is to be disclosed separately for Scope 3 emissions only.
  - Scope 3 disclosures are subject to a <u>limited safe harbor.</u>
    - No liability unless made "without a reasonable basis or was disclosed other than in good faith."
  - SRCs are <u>exempt</u> from this requirement.
  - Delayed phase-in of this mandatory disclosure.

GHG Emission Disclosures

The data shown is conceptual, not indicative of calculated results

Disclose those Scope 3 categories determined to be material or addressed by a GHG emissions reduction target or goal.



GHG Emission Disclosures (III)

- Targets & Goals
  - Disclose any targets or goals related to the reduction of GHG emissions, or any other climate-related target or goal.
  - Report the scope of activities and emissions included in the target or goal, the unit of measurement, absolute or intensity basis, time horizon of the target, and baseline time period and emissions.
  - Explain how the registrant intends to meet its climate-related targets or goals.
  - Disclose progress toward meeting the target or goal and how it has been achieved. Updates are required each fiscal year.

Climate-Related Risk Disclosures (I)

- The definition of climate-related risks is based on the TCFD standard.
  - Promotes consistency and comparability across multiple disclosure contexts.
- Different types of climate-related risks, such as ***physical*** risks and ***transition*** risks:
  - Physical risks are defined as “both acute and chronic risks to a registrant’s business operations.”
  - Transition risks are defined as “actual or potential negative impacts . . . to address the mitigation of, or adaptation to, climate-related risks.”

Climate-Related Risk Disclosures (II)

- Only to be disclosed if they are ***material.***
- Need to be considered across multiple timeframes: ***short, medium, and long term.***
  - The SEC has not defined these three timeframes – leaving it to issuers' discretion/judgment.
- Financial impacts related to physical and transition risks (if above disclosure thresholds).
- The PSLRA safe harbor expressly applies to forward-looking statements assessing climate risk.
  - (But this safe harbor does not apply to disclosures made in connection with IPOs.)

Climate-Related Risk Disclosures (III)

- Once material risks are disclosed, a company must cover the actual and potential impacts of those risks on its ***strategy, business model, and outlook***.
- ***If*** a registrant uses: carbon offsets or renewable energy credits or certificates ("RECs"), an internal carbon price, or climate-related scenario analyses, must disclose the role that these elements play in the registrant's climate-related business strategy.
- Registrant must describe any processes for identifying, assessing, and managing climate-related risks.
  - Must also disclose how these processes are integrated into registrant's overall risk management system or processes, and any details of a transition plan (if adopted).

Governance Disclosures (I)

- The SEC has proposed significant, prescriptive changes to corporate governance in this area.
  - The SEC's stated goal 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".
- Corporate boards of directors should consider taking these steps now.
  - Even if the SEC has not mandated particular actions, compelled disclosures may reveal the absence of relevant action, with potential negative consequences for the company's perceived value by investors, stakeholders and the SEC.

Governance Disclosures (II)

- Board of Directors:
  - Information concerning the board's oversight of climate-related risks as well as management's role in assessing and managing those risks.
    - Identify any board members or board committees responsible for the oversight of climate-related risks.
  - Whether any member of [the] board of directors has ***expertise*** in climate-related matters.
  - The ***processes and frequency*** by which the board discusses climate-related factors.
  - Whether and how the board or board committee considers climate-related risks as part of its business strategy, risk management, and financial oversight.
  - Whether and how the board sets ***climate-related targets or goals***, and how it oversees progress against those targets or goals, including the establishment of any interim targets or goals.

Governance Disclosures (III)

- Management:
  - Whether certain management positions are responsible for assessing and managing climate-related risks.
  - The processes by which the responsible managers are informed about and manage climate-related risks.
  - Whether the responsible positions or committees report to the board or board committee on climate-related risks, and how frequently this occurs.

Governance Disclosures (IV)

- Board and Organizational Structure:
  - The SEC has not specified how boards of directors should organize themselves in order to address climate disclosures or other ESG issues.
  - The preferred structure will likely depend upon an individual company's specific circumstances and practices.
  - A number of potential alternatives:
    - Forming a new, ESG-focused committee of the board of directors;
    - Adding this responsibility to an existing committee of the board of directors (e.g., audit or nominating); or
    - Making this the purview of the entire board of directors.
  - But it is clear that responsibility for these issues must be clearly assigned and defined.

Other Notable Disclosures (I)

- The SEC disclosures would mandate that companies consider “reputation impacts” when evaluating climate risk.
  - “Reputation impacts” are defined to include those “stemming from a registrant’s customers or business counterparties.”
- If a company conducts extensive business with entities perceived as problematic from an environmental perspective (e.g., oil & gas, mining, etc.) this could be considered a reputational risk.
  - This raises the potential prospect of stigmatizing large swaths of the economy, or increasing the cost of capital for many companies.
- It is possible that this provision could be interpreted to conflict with state laws prohibiting discrimination against companies that do business with the fossil fuel industry.

Other Notable Disclosures (II)

- The SEC specifically states on several occasions that these disclosures should be meaningful and not “boilerplate”.

- The impact of climate change on financial metrics must be disclosed unless the aggregate impact is less than one percent of each line item.

- The SEC has stated that executive compensation linked to ESG metrics need not be disclosed in this context (as it would nonetheless be disclosed pursuant to other required disclosures).

Phased-In Approach to Disclosures

- The SEC will allow a "phase in" period for registrants to prepare for these proposed rules. Specifically, the proposed rules would be "phased in for all registrants, with the compliance date dependent upon the status of the registrant as a large accelerated filer, accelerated or non-accelerated filer, or SRC, and the content of the item of disclosure."
- Assuming that the effective date of the proposed rules occurs in December 2022 and that a registrant has a December 31st fiscal year-end, the compliance date for the proposed disclosures in annual reports, other than the Scope 3 emissions disclosure, would be:
  - For large accelerated filers, fiscal year 2023 (filed in 2024);
  - For accelerated and non-accelerated filers, fiscal year 2024 (filed in 2025); and
  - For SRCs, fiscal year 2025 (filed in 2026).
- In addition, registrants subject to the proposed Scope 3 disclosure requirements would have one additional year to comply with those disclosure requirements.
- The auditing requirements would similarly be phased-in over time. The proposed transition periods would provide existing accelerated filers and large accelerated filers one fiscal year to transition to providing limited assurance and two additional fiscal years to transition to providing reasonable assurance.

Phased-In Approach to Disclosures: Charts

Registrant Type	Disclosure Compliance Date		Financial Statement Metrics Audit Compliance Date
	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 as disclosure compliance date
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	

Filer Type	Scopes 1 and 2 GHG Disclosure Compliance Date*	Limited Assurance	Reasonable Assurance
Accelerated Filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	Fiscal year 2027 (filed in 2028)
Large Accelerated Filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)	Fiscal year 2026 (filed in 2027)

Litigation Implications of Disclosures

- The SEC's new proposed disclosures greatly increase the potential scope of liability.
- These rules establish new requirements, and companies face the prospect of government enforcement action or private securities litigation based upon perceived misleading or inaccurate disclosures.
- Many aspects of the SEC's new proposed rules encourage the potential for liability:
  - Incorporated into Forms 10-K and 10-Q;
  - Subject to attestation and;
  - Disclosures are filed rather than furnished.
- The only significant exceptions are the safe harbor provision for Scope 3 GHG emissions and the reiterated PSLRA exception for forward-looking statements.

Notice and Comment Period

- Immense Number of Comments
  - 14,645 comments
  - 12,304 form letters—88% (10,861) in favor, 12% (1,443) opposed
  - 2341 individualized comment letters—53% (1238) in favor, 43% (1015) opposed, 4% (88) express no position
- Supporters
  - Democratic politicians, civil society organizations, individual corporations, professional service organizations, academics
  - Frequently suggest that the disclosures will (1) help protect the environment; (2) enable the standardization of climate disclosures; and (3) help investors make informed choices about climate risk
- Opposed
  - Republican politicians, individual corporations, trade industry groups, NGOs
  - Frequently suggest that the rules are (1) *ultra vires* (i.e., beyond the scope of the SEC's authority); (2) will impose considerable compliance costs; and (3) express skepticism about climate science

Next Steps

- Potential Changes to the Proposed Rule
  - There has been recent talk in the media that the SEC may drop the requirement for Scope 3 GHG emissions disclosures.
- Expected legal challenges.
  - A number of industry organizations, companies, and political authorities have indicated that they will challenge the rules as exceeding the SEC's authority (ultra vires).
  - This proposed rule has been perceived as newly vulnerable since the Supreme Court's June 2022 decision in *West Virginia* v. *EPA*, which limited the EPA's authority pursuant to the "major questions" doctrine.
- <u>Note</u>: The SEC has identified ESG investing as the second of its examination priorities for 2022.

How to Prepare

- Public Companies
  - Map existing disclosures against the SEC proposal for alignment.
    - Examples include TCFD, CDP, SASB, GRI, etc.
    - Identify gaps in your strategy and disclosures.
  - Secure resources and cross-functional team to address your needs.
  - Time may be limited!

- Non-Public Companies
  - Be prepared for the trickle-down effect.
  - If you are a supplier or customer to a registrant, you may be requested for climate-related information or receive new requirements.

How to Prepare – Emissions Disclosure

- Develop internal GHG emission accounting and reporting systems/processes.
  - Seek consistency with the GHG Protocol.
- Utilize a flexible GHG accounting system
  - Adapt to FY or CY reporting
  - Disclose by gas and CO2e
  - Track metrics for calculating intensities
  - Estimated data in lieu of actual data not being available
- Identify and document your company’s organizational and operational boundaries on the basis of ownership and control.
- Document emission calculation results, including the methodologies, significant inputs, significant assumptions, material changes from year-to-year, and data gaps.

How to Prepare – Emissions Disclosure

- Determine Scope 3 categories that may be 'material'.
  - A quantitative threshold was not defined by SEC for determining materiality.
  - SEC states "a registrant would be required to disclose Scope 3 emissions if there is substantial likelihood that a reasonable investor would consider them important when making an investment or voting decision".
  - Categories covered by a GHG emission reduction target or goal must be disclosed.
- Identify calculation methodologies and estimate impacts from each Scope 3 category to understand materiality.
  - Limited tools are available – these are free and a great place to start:
    - GZA: https://www.gza.com/scope3
    - Quantis: https://quantis-suite.com/Scope-3-Evaluator/
- Prepare for third-party assurance.

How to Prepare – Risk Assessment

- Review various climate-related risks for materiality
  - Examples of **Transition** Risks (risks related to the transition to a lower-carbon economy)
    - Current regulation (e.g., carbon pricing, product mandates, emission reporting)
    - Emerging regulation (e.g., carbon pricing, product mandates, emission reporting)
    - Legal (e.g., litigation exposure)
    - Technology (e.g., low emission products, unsuccessful investment in new technologies)
    - Market (e.g., changing consumer behavior, increased cost of raw materials, uncertain market signals)
    - Reputation (e.g., shift in customer preferences, negative stakeholder feedback, negative press)
  - Examples of **Physical** Risks (risks related to the physical impacts of climate change)
    - Acute (e.g., hurricanes, floods, heat waves, heavy precipitation, wildfire)
    - Chronic (e.g., changing precipitation patterns, changing temperature, sea level rise, water scarcity)

How to Prepare – Risk Assessment

- Document your process for identifying and assessing climate-related risks and opportunities
  - Identify value chain coverage of your assessment (i.e., direct operations, upstream, downstream)
  - Address the frequency of how often risks are assessed (annually or more often)
  - Understand the time horizons of each risk and how they are defined (i.e., short-term, medium-term, long-term)
- Develop a “transition plan” to document how your organization is planning to mitigate or adapt to climate-related risks.
- Integrate climate-related risks into your strategic business and financial planning.

How to Prepare - Governance

- Align governance approach with SEC's proposed guidance.
- Identify board members or board committees responsible for the oversight of climate-related issues. Ensure they maintain relevant expertise.
- Identify management-level positions throughout your organization responsible for assessing and managing climate-related issues. Ensure they also maintain relevant expertise.

How to Prepare - Governance

- Create and maintain organizational structure for governance of climate-related issues.
- Review processes for keeping management and the board and/or board committee informed on climate-related issues.
- Clarify how management is informed by in-house staff or third-party consultants.
- Identify the frequency for informing the board and/or board committees.
- Review whether the board and/or board committees consider climate-related issues as part of guiding strategy, major actions, risk management policies, budgets, and business planning.
- Understand board’s role in setting climate-related targets or goals and how it oversees progress (e.g, net-zero emissions or carbon neutral products).