Key Takeaways – ESG Center

Proposed SEC Climate-related Disclosure Rules

Center Briefing for ESG Center Members Held Under the Chatham House Rule

Thursday, April 21, 2022

On April 21st, we were fortunate to have experts from Cleary Gottlieb Steen & Hamilton, Francesca Odell, Partner, Nick Grabar, Partner, and Shuangjun Wang, Associate, brief members on the SEC's proposed climate-related disclosure rules. Here is a summary of some of the main takeaways:

The Proposed SEC Climate-related Disclosure Rules

Scope:

The proposed rules apply to virtually all reporting companies, including foreign private issuers. It would not apply to Canadian issuers filing on Form 40-F and sovereigns.

The proposed rule can be described into three broad categories.

1. *The new "climate-related disclosure" section on Annual Reports on Form 10-K and 20-F under Regulation S-K*. These will include matters such as climate-related risks, climate-related strategy, disclosure of targets and goals, and disclosure of how a company has organized itself to address climate (governance disclosure).
2. *GHG emissions disclosure and a subsequent attestation report under Regulation S-K*. Companies must disclose their Scope 1 and Scope 2 emissions. Scope 3 emissions must be disclosed if *material* for the company or if they are including Scope 3 into their targets and goals. An attestation report is required for a company's Scope 1 and 2 emissions and by a provider who is 1) an expert in GHG emissions and 2) independent.
3. *New climate-related disclosures in the notes to the audited financial statements under Regulation S-X*. This includes a 1% threshold financial line item on weather events and transition costs.

Discussion:

1. **Companies have a choice of how detailed they want their narrative disclosures to be.** While providing general information may be low risk, being more specific is going to be necessary to satisfy expectations from investors.

2. **The proposed SEC rules will require incremental disclosures beyond your current voluntary climate-related disclosure under frameworks like SASB, GRI, and TCFD.** While the SEC has based its rule largely on TCFD, disclosing under TCFD does not mean a company is complying with the proposed rule. Companies should take inventory of what they are currently disclosing, see where they already comply with the rules, and address any gaps.

3. **Do not expect the SEC's final rule to be sensitive to industry sector.** The SEC does not have the resources or the expertise to provide rules by industry that would be similar to SASB. This would also contradict the objective of creating comparable baseline information for investors.

4. **Don't hold off on taking actions you believe are in the company's best interest simply because they could result in disclosure under the proposed rule.** The proposed rule requires companies to make disclosures on: (1) if applicable, the board's role in overseeing, and management's role in assessing and managing, climate-related risks and opportunities, (2) any transition plan that is part of the company's climate risk management strategy, and (3) targets, if any, for the reduction of GHG emissions. Given investor and stakeholder expectations, the benefit of taking action in each of these areas is likely to outweigh the incremental costs and risks associated with additional disclosure.

5. **There are possible chilling effects as a result of these rules, especially around carbon prices and offsets.** The rule would require companies to disclose internal information used to establish and achieve emissions targets and goals. Companies may decide to stop using carbon pricing and offsets if they have to disclose it and rethink the way they achieve their goals. Another possible chilling effect is on innovative thinking on climate reduction and impact, as this will lead to increased disclosure and liability around those innovative processes.

6. **The SEC may still review the climate section of your Sustainability/CSR/ESG report to see how it compares to the information provided in your SEC filings, but don't expect that to be a focus on the SEC's enforcement efforts.** In the autumn, the SEC issued comment letters asking companies to explain why they included certain information in their sustainability reports, but not in their SEC filings. In the future, the SEC may, on a case-by-case basis, cross check company's 10-K disclosure with the sustainability report to see if there any gaps, but that is not likely to be the focus of the agency's attention. In any event, companies should not back away from continuing to provide information in their sustainability reports, as they are important vehicles for informing stakeholders in a way that is more effective than SEC filings.

7. **Encourage the SEC to approach compliance with these disclosures much as they did the 2006 executive compensation disclosure rules.** In the wake of the executive compensation disclosure requirement, the SEC did not focus immediately on enforcement actions but instead evaluated the first round of disclosures and provided guidance based on what it found.

8. **When it comes to Scope 3, don't panic.** The SEC has recognized the difficulty in calculating Scope 3 emissions, providing a safe harbor from certain kinds of liability for Scope 3 emission disclosures, as long as companies reasonably explained their process and methodology and have not made these statements in bad faith.

9. **Private companies will also be affected by this rule.** Private companies, especially in public company supply chains, will be pressured to provide similar information. A lot of these companies do not have the resources yet to provide such information and will take time to catch up, especially if a public company is trying to measure their Scope 3 emissions. **Read more on ESG and Private Companies**: B2B Sustainability Disclosure: Telling Your Sustainability Story to Your Business Partners and Five Reasons Private Companies Care About ESG

10. **Be prepared to update disclosures.** The good news is that companies are allowed the use of 'reasonable estimates' for their fourth fiscal quarter when disclosing GHG emissions if the data are not available during the filing period. But companies will need to disclose any material differences between the estimate and actual numbers in subsequent filings.

11. **Expect the supply of attestation firms to be an issue.** There are currently not enough firms that can supply the attestation services called for by the proposed rule for the entirety of reporting companies in the US. Companies cannot just use the consultant who has been helping in prepare the sustainability report as they are not independent, and your independent auditor may not be defined as an expert.

12. **Even if the SEC backs away from the 1% threshold, get ready to comply with something similar.** The requirement that companies disclose weather-related events and transition costs that amount to 1% of a line item in their financial statements is receiving a lot of pushback. One of the biggest challenges is that it would require companies to aggregate unrelated weather events to see if they satisfy the 1% threshold. While the 1% threshold may not stand, companies should not wait to engage their auditors in discussing how companies can track and measure impacts. Further, while audit committee members do not need to become experts in GHG emissions, they do need to have sufficient knowledge about climate-related risks, costs, and opportunities to be able to review the disclosures. So it's time to begin board training on these matters if you haven't already

13. **Build the infrastructure *now* to comply with the proposed rule.** This includes: 1) establishing a cross-functional team to address the rule, 2) itemizing what you are already disclosing and cataloging your current disclosure infrastructure, 3) identifying any gaps between your current disclosure and the proposed rule, 4) highlighting areas of uncertainty and risk, 5) building climate-related data expertise, and 6) planning to integrate the new climate-related disclosures into your disclosure controls and procedures (DCP) and internal control over financial reporting (ICFR).

14. **Recognize that complying with the new rules may set back some of your more strategic sustainability efforts.** The SEC's proposed rules are already causing some firms to divert legal and other resources from focusing on business-related sustainability efforts to preparing to comply with these rules. Be sure your CFO and CEO understand the impact so you can have a candid discussion about resources.

15. **Expect the rule to be challenged, but don't count on it making a difference in the timetable.** Once finalized, the rule will certainly be challenged in court on the grounds that it exceeded the Commission's authority, violated the First Amendment rights of companies, and violated the Administrative Procedure Act by being arbitrary and capricious. While the first two claims might be appealing to some judges, the third is the most likely one to gain traction. The urgent question for companies will not be whether the plaintiffs can ultimately prevail, but whether the court will issue a preliminary injunction to stop the implementation of the rule. Absent such an injunction, the Commission is likely to proceed with the implementation of the rule even if there is a pending court challenge

16. **Don't expect the SEC rules, if adopted, to significantly change your litigation risk**. You are unlikely to face a traditional class action lawsuit seeking damages because of a drop in share price associated with climate disclosure. And the risk of securities law claims, and breach of fiduciary duty claims is already present – although the new rules may heighten it. The bigger challenge companies will face is an operational one – how to meet the deadlines of collecting, analyzing, obtaining attestation, and disclosing the required information on the timeline of its annual financial statement.