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# Memorandum

## SEC Proposes Long-Awaited Climate-Related Disclosure Rules

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On March 21, 2022, by a 3-1 vote, the SEC approved long-awaited proposed rules aimed at enhancing and standardizing climate-related disclosures in an effort to foster greater consistency, comparability and reliability of climate-related information among public issuers.[1] The proposal, if adopted, would require domestic registrants and foreign private issuers to include prescribed climate-related information in their registration statements and annual reports substantially beyond what is currently required by existing disclosure rules. Importantly, among other elements, the proposed rules contemplate new attestation requirements for certain issuers and require climate-related financial statement metrics to fall within the scope of an issuer's internal control over financial reporting and be subject to any required audit. Although the rules would be subject to phase-in periods as described in the "*Phase-in Periods*" subsection below, we expect that issuers would face tremendous challenges in implementing the proposal, if adopted as proposed.

### New Disclosure Requirements:

Under the proposed rules, which are modeled in part on recommendations of the Task Force on Climate-Related Financial Disclosures, issuers would be subject to the increased disclosure requirements summarized below:

- **Disclosure of climate-related risks and their impacts on strategy, business model and outlook.** Although many registrants already provide climate-related disclosures in their securities filings as a result of existing requirements that encourage companies to discuss, for example, material risks to their business, the proposed rules are far more prescriptive in mandating climate-specific disclosure. Pursuant to the proposed rules, issuers would be required to disclose in registration statements and annual reports any climate-related risks reasonably likely to have a material impact on their business or consolidated financial statements and would be required to identify if a specific climate-related risk is a "physical risk," *e.g.*, risks related to the physical impacts of the climate, or a "transition risk," *e.g.*, risks related to a potential transition to a lower carbon economy. The proposed rules would mandate that issuers provide information on how climate-related risks are impacting their business operations, products and services, suppliers and other parties in their value chains, activities to mitigate or adapt to climate-related risks, expenditures for research and development and other significant changes or impacts. Furthermore,

[1] *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors as well as Enhancement and Standardization of Climate-Related Disclosures Fact Sheet.

under the proposed rules, issuers would be expected to discuss their assessment of the materiality of climate-related risks and their current and proposed impacts specifically over the short-, medium- and long-term.

- **Carbon Offsets and RECs.** The proposed rules would require issuers that use carbon offsets[2] or renewable energy certificates[3] ("RECs") as part of their net emissions reduction strategy to disclose the manner in which the offsets or RECs are being used (for example, whether offsets or RECs are the primary means of achieving greenhouse gas ("GHG") reductions vs. reducing emissions through operational changes). Such issuers would be required to disclose the short- and long-term costs and risks attendant to their use of offsets and RECs, such as the risk that offsets or RECs may not be available in the future or may be subject to changes in value due to regulatory or market developments. The proposed rules also would require such issuers that use offsets or RECs in meeting climate-related targets or goals to disclose certain other information, including the amount of carbon reduction represented by the offsets or the amount of generated renewable energy represented by the RECs, the source of the offsets or RECs, a description of the underlying projects, any authentication of the offsets or RECs, and the cost of the offsets or RECs.
- **Carbon Pricing.** If issuers use an internal carbon price when assessing climate-related factors, the proposed rules would require disclosure of certain information, including the price in units per metric ton of carbon dioxide equivalent ("CO2e"), the total carbon price (including any estimates for how total price may change over time), and the rationale for the internal carbon price. Such issuers would also be required to disclose how they use the internal carbon price to evaluate and manage climate risks and, if more than one internal carbon price is used, the reason for using different pricing.
- **Scenario Analysis.** The proposed rules would require issuers to discuss the resilience of their business strategies to potential changes in climate-related risks. The proposed rules would not require issuers to evaluate the resilience of their business strategies in various climate scenarios (*e.g.*, different increases in global temperature), but issuers who do use scenario analysis or other analytical tools in such evaluations must provide certain information regarding their analysis (*e.g.*, if scenario analysis was used, the scenarios considered and the projected principal financial impacts on their business strategy under each scenario).
- **Governance disclosures.** Pursuant to the proposed rules, issuers would be required to disclose, as applicable, certain information concerning their boards' oversight of climate-related risks, and management's role in assessing and managing those risks. While many companies already incorporate board oversight of ESG matters in their existing SEC disclosures, the proposed rules are far more granular in dictating the type of information that would be expected; in particular, issuers would be required to (i) identify any board members or board committees responsible for the oversight of climate-related risks and

[2] Carbon offsets are defined as representing emissions reduction or removal of GHGs in a manner calculated and traced for the purpose of offsetting an entity's GHG emissions.

[3] RECs are defined as a credit or certificate representing each purchased megawatt-hour of renewable electricity generated and delivered to an issuer's power grid.

whether any member of the issuer's board has expertise in climate-related risks; (ii) describe the processes and frequency by which the board or board committee discusses climate-related risks; (iii) disclose whether and how the board or board committee considers climate-related risks as part of its business strategy, risk management and financial oversight; and (iv) disclose 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. The proposed rules have similar disclosure requirements for an issuer's management and how it assesses and manages climate-related risks. Notably, the SEC determined not to propose a specific compensation-related disclosure requirement at this time, noting that it believes that existing compensation disclosure rules already provide a framework for disclosing any connection between executive compensation and achieving progress in addressing climate-related risks.

- **Risk management disclosures.** The proposed rules would require issuers to describe any processes they have for identifying, assessing, and managing climate-related risks and whether and how climate-related risks are integrated into their overall risk management system. Additionally, issuers would be required to disclose if they have adopted a transition plan (*e.g.*, an implementation plan to reduce climate-related risks) and to describe the plan, including the relevant metrics and targets. This transition plan disclosure must be updated each year and describe the actions taken during the year to reach the plan's targets and goals.

- **Financial statement metrics.** Through a new article to Regulation S-X, issuers would be required to disclose a new note to their financial statements requiring certain disaggregated climate-related financial statement metrics. In particular, the proposed rules would require disclosure falling under the following three categories of information:

    i. *Financial impact metrics*. Issuers will be required to disclose the financial impacts, on each consolidated financial statement line item, of severe weather events (flooding, drought, wildfires, extreme temperatures, and sea level rise), other natural conditions, transition activities, and identified climate-related risks unless the aggregated impact is less than one percent of the total line item for the relevant fiscal year.

    ii. *Expenditure metrics*. Issuers will be required to separately aggregate amounts of (i) expenditure expensed and (ii) capitalized costs incurred during the fiscal years presented that are associated with the same climate-related events, transition activities and identified climate-related risks as the proposed financial impact metrics. Required narrative disclosures would include the impacts from severe weather events and other natural conditions and as well as the impacts for transition risks. The proposed expenditure metrics would be subject to the same one percent disclosure threshold as the financial impact metrics described above.

    iii. *Financial estimates and assumptions*. The proposed rules would require issuers to disclose whether the estimates and assumptions used to produce the consolidated financial statements were impacted by exposures to risks and uncertainties associated with, or known impacts from,

climate-related events. If so, issuers would be required to provide a qualitative description of how such events have impacted the development of the estimates and assumptions used by such issuer in the preparation of its financial statements. Similarly, separate disclosure focused on transition activities (including identified transition risks) would be required.

- **GHG Emissions Metrics Disclosure.** The proposed rules would require issuers to disclose their GHG emissions for the most recent fiscal year, using a framework that largely tracks the GHG Protocol (the most widely-used global GHG accounting standard), including the categorization of Scope 1, 2, and 3 emissions.

  i. *Disclosure of Scope 1 and 2 Emissions*. The proposed rules would require issuers to disclose their Scope 1 emissions (*e.g.*, direct GHG emissions from operations owned or controlled by an issuer) and Scope 2 emissions (*e.g.*, indirect GHG emissions from the generation of purchased or acquired electricity, steam, heat or cooling that is consumed by operations owned or controlled by an issuer). An issuer would be required to separately disclose its Scope 1 and Scope 2 emissions from all sources in its organizational and operational boundaries. The proposed rules contemplate consistency in reporting financial and GHG emissions data; when setting organizational boundaries for purposes of GHG emissions reporting, an issuer would be required to use the same scope of entities, operations, assets and other holdings as those included in, and based on the same accounting principles used for, its consolidated financial statements.

  ii. *Disclosure of Scope 3 Emissions*. In addition, certain issuers may need to disclose their Scope 3 emissions, which consist of all other indirect GHG emissions from the upstream and downstream activities of an issuer's value chain, which includes sources as varied as suppliers, transport of goods, employee travel and commuting, consumption of a product and investments of the issuer.[4] The proposed rules would require an issuer to disclose Scope 3 emissions if (i) such emissions are "material" or (ii) if it has set a GHG emissions reduction target or goal that includes Scope 3 emissions; however, smaller reporting companies would be exempt from such disclosure requirements. In line with the SEC's definition of "material" and Supreme Court precedent, an issuer would be required to disclose its Scope 3 emissions if there is a substantial likelihood that a reasonable investor would consider them important when making an investment or voting decision. The proposed rules also note that issuers should consider whether Scope 3 emissions are a relatively significant part of their overall GHG emissions from a quantitative or qualitative standpoint. If required to disclose Scope 3 emissions, an issuer would be required to (i) identify the categories of upstream and downstream activities included in its Scope 3 calculation, separately disclose Scope 3 emissions data for any significant categories, and disclose the aggregate total of its Scope 3 emissions and (ii) describe the sources of data used to calculate its Scope 3 emissions (*e.g.*, emissions reported by parties in the issuer's value chain, and whether such reports were verified). Scope 3 emissions disclosures made by issuers pursuant to the

[4] A nonexclusive list of activities in the value chain is set forth at Item 1500(r) of the proposed rule.

proposed rules would be deemed not to be a fraudulent statement unless made or reaffirmed without a reasonable basis or in other than good faith.

iii. *GHG Emissions Disclosure Content*. The proposed rules would require issuers to disclose Scope 1, Scope 2 and (if applicable) Scope 3 emissions by each of the seven GHGs[5] individually and in the aggregate. To facilitate the ability to compare different types of GHG emissions, issuers would be required to report GHG emissions in terms of CO2e, which is the standard unit of measurement used by the GHG Protocol to indicate the global warming potential of a GHG. Issuers would also be required to disclose all of their GHG emissions in gross terms (as opposed to net after applying purchased or generated offsets), as well as the sum of their Scope 1 and Scope 2 emissions (and their Scope 3 emissions, if required, separately) in terms of intensity, *i.e.*, metric tons of CO2e per unit of total revenues and per unit of production for the fiscal year. The SEC declined to prescribe a GHG emissions calculation methodology, allowing issuers flexibility in selecting an applicable methodology (for example, based on industry-specific standards), but issuers would be required to describe the methodology used to calculate their GHG emissions metrics.

## Additional Auditing and Attestation Requirements:

Pursuant to the proposed rules, the proposed financial metrics that would be required in the financial statements would be included in the scope of any required audit as well as an issuer's internal control over financial reporting. Additionally, the proposed rules would require an accelerated filer or a large accelerated filer to include, in the relevant filing, an attestation report covering, at a minimum, the disclosure of its Scope 1 and Scope 2 emissions disclosure as discussed above. The proposed rules would provide minimum attestation report requirements, minimum standards for acceptable attestation frameworks and would require an attestation service provider to meet certain minimum qualifications. The proposed rules would not, however, require an attestation service provider to be a registered public accounting firm. With respect to the assurance levels applicable to the attestation report, the proposed phase-in periods described below 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, starting with the respective compliance dates for Scopes 1 and 2 disclosure described below. For purposes of these assurance standards, reasonable assurance is equivalent to the level of assurance provided in an audit of a registrant's consolidated financial statements included in a Form 10-K, while limited assurance is equivalent to the level of assurance (commonly referred to as a "review") provided over a registrant's interim financial statements included in a Form 10-Q. We would expect these new proposed requirements, in particular, to impose significant additional costs and resource constraints on public companies.

[5] Carbon dioxide, methane, nitrous oxide, nitrogen trifluoride, hydrofluorocarbons, perfluorocarbons, and sulfur hexafluoride.

## Phase-in Periods:

The proposed disclosure rules would be phased in for all issuers, with the compliance date dependent upon the filing status of the issuer and the content of the disclosure, as set forth below.

i. *Disclosure Requirements (other than Scope 3 emissions and associated intensity metric).* Large accelerated filers would be required to provide the required disclosures, including Scopes 1 and 2 emissions disclosures, for the fiscal year following the year of adoption. Accelerated and non-accelerated filers would be required to provide the required disclosures for the second fiscal year after adoption, and smaller reporting companies would be required to provide the proposed disclosures for the third fiscal year after adoption.

ii. *Attestation Reports.*

- **Large accelerated filers** would be required to obtain *limited assurance* over Scopes 1 and 2 emissions disclosures for the second and third fiscal years after adoption. They would then be required to obtain *reasonable assurance* over these disclosures for the fourth fiscal year after adoption and going forward.
- **Accelerated filers** would follow the same timeline as large accelerated filers but with a delay of one fiscal year. Specifically, accelerated filers would be required to obtain limited assurance over Scopes 1 and 2 disclosures for the third and fourth fiscal years after adoption. They would then be required to obtain reasonable assurance over these disclosures for the fifth fiscal year after adoption and going forward.

iii. *Scope 3 emissions and associated intensity metric.* Large accelerated filers would be required to provide the required disclosures for Scope 3 admissions for their second fiscal year following adoption. Accelerated and non-accelerated filers would be required to provide the required disclosures beginning with their third fiscal year after adoption. Smaller reporting companies are exempt from this requirement.

Below is a table summarizing the compliances dates for the proposed rules, assuming the rules will be adopted with an effective date in December 2022 and that the filer has a December 31st fiscal year-end:

| Registrant Type | Disclosure 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) |
| Accelerated Filer and Non-Accelerated Filer | Fiscal Year 2024 (filed in 2025) | Fiscal Year 2025 (filed in 2026) |
| Smaller Reporting Company | Fiscal Year 2025 (filed in 2026) | Exempted |

| Filer Type | Scopes 1 and 2 | Limited Assurance | Reasonable Assurance |
|---|---|---|---|
| Large Accelerated Filer | Fiscal Year 2023 (filed in 2024) | Fiscal Year 2024 (filed in 2025) | Fiscal Year 2026 (filed in 2027) |
| Accelerated Filer | Fiscal Year 2024 (filed in 2025) | Fiscal Year 2025 (filed in 2026) | Fiscal Year 2027 (filed in 2028) |

## Conclusion

While SEC rulemaking on climate-related disclosures had long been anticipated, the sweep and scope of the proposed rules (which exceeded 500 pages in length) was still jarring. Given the complexity of the proposed rules, it will take significant time to digest the longer-term implications. In the short-term, we expect significant push back by issuers and trade groups, and perhaps legal challenges, with respect to the SEC's rulemaking initiative. In the meantime, issuers are encouraged to review their existing climate-related disclosures and governance practices, assess their disclosure controls and procedures to determine whether they're sufficiently robust to ensure the accuracy of the new disclosures, and consider engaging counsel and other third-party experts as necessary to implement a plan for compliance.

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