

Locke Lord QuickStudy: SEC Proposes Climate-Related Disclosure Rules – What You Need to Know

Locke Lord LLP

WRITTEN BY

Gerald J. Pels | Gislar Donnenberg | Stanley Keller | Rob Evans | Rachael Beavers | Nicole Chakraborty | Andrew D. Otis | Michelle Earley

On March 21, 2022, the Securities and Exchange Commission (“SEC”) proposed new rules (the “Proposal”) that, if finalized, will require reporting companies to disclose climate-related risks, metrics, and other information in their audited financial statements, registration statements, annual reports, (such as Form 10-K) and other SEC filings. Provisions requiring climate-related risk disclosure and metrics would be added to Regulation S-X, which governs reporting companies’ financial statements, and Regulation S-K, which generally governs the disclosures required in SEC filings.

The proposed rules will be open for comment until the later of 30 days after publication in the Federal Register or May 20, 2022.

The Proposal builds upon earlier SEC climate risk disclosure guidance and in many ways draws upon recommendations by the Task Force on Climate-Related Financial Disclosures (“TCFD”), as well as accounting and reporting standards from the Greenhouse Gas Protocol (“GHG Protocol”). Through these approaches, the SEC says it seeks to provide a “consistent, comparable, and reliable” structure for the measurement, tracking, and reporting of greenhouse gas (“GHG”) risks and emissions. Even for companies currently tracking GHG emissions, it is likely that the Proposal will not only materially increase requirements associated with tracking and quantitation of GHGs, but also impose further layers of disclosure obligations. For those companies that do not currently measure, track and report such metrics, the new rules will present a significant and potentially costly new disclosure regime that could require major management and reporting changes. For all reporting companies, compliance with the breadth of the Proposal will require significant coordination between a business’s environmental, operations, and financial functions.

The Proposal

The Proposal calls for the consideration and disclosure of a reporting company’s climate-related risks, as defined in the proposed rules and its direct (Scope 1) and indirect GHG emissions (Scope 2 and also, in some instances, Scope 3). This degree of emissions tracking goes well beyond what is currently required under traditional air emissions regulatory programs. If adopted, the Proposal requires:

- Inclusion of climate-related financial statement metrics in their audited financial statements, including:
 - financial impact metrics;

- expenditure metrics; and
- estimates and assumptions.
- Climate-related disclosures in SEC filings, including:
 - board and management oversight of climate-related issues;
 - climate-related effects and risks and how they have had or may have a material impact on the business in the short, medium, and long term;
 - how the climate-related risks have affected or are likely to affect a reporting company's strategy, business model, and outlook;
 - processes for identifying, assessing, and managing climate-related events and associated plans for transition to a lower-carbon economy (including financial estimates and assumptions affected by climate events and transition activities);
 - all Scope 1 and 2 GHG emissions, including:
 - referencing GHGs in both an aggregated and disaggregated constituent basis;
 - in absolute terms and based on GHG intensity;^[1]
 - except for smaller reporting companies, Scope 3 emissions;
 - climate-related targets and goals and the use of offsets or credits to achieve such targets and goals; and
 - any use of an internal carbon price and expected changes to the price over time.

Importantly, the GHG emissions calculations are subject to third party attestation for accelerated filers and large accelerated filers. Particularly for industrial companies, this will place a premium on fully understanding and inventorying their equipment and processes as well as documenting and considering process and equipment change that may affect GHG emissions on an ongoing basis.

Defining Climate Related Risks

Under the Proposal, a new subpart is added to Regulation S-K requiring the disclosure of “climate-related risks” that are “reasonably likely to have material impacts” on a reporting company’s business.^[2] “Climate-related risks” is defined in a manner substantially similar to that defined by the TCFD to mean “the actual or potential negative impacts of climate-related conditions and events on a reporting company’s consolidated financial statements, business operations, or value chains, as a whole.”

Physical Risks and Transition Risks

These risks are grouped generally into “physical” and “transition” risks. Physical risks include both “acute risks” that may result from climate change, such as risks arising from severe weather, floods, tornadoes, and hurricanes, as well as “chronic risks” relating to expected longer-term effects such as sustained high temperatures, drought, sea level rise, impacts to agricultural productivity, and decreased availability of fresh water.

The second category of climate-related risk is “transition risk” associated with the potential transition to a lower carbon economy. The Proposal requires separate disclosure for those risks, which are defined to include actual or potential negative impacts “attributable to regulatory, technological, and market changes to address the mitigation of, or adaptation to, climate-related risks.” Transition risks include increased costs caused by changes leading to impacts on market behavior, consumer preferences or behavior, and reporting company behavior.

Materiality

Rather than develop a quantitative level of materiality, the Proposal is consistent with current SEC materiality guidance and requires the disclosure of climate-related risks that are reasonably likely to may have a material impact on the reporting company, its business, or its consolidated financial statements over the short, medium, and long term (as such terms will be defined by each company). The Proposal is nebulous as to the definitions of these time horizons and as to the “materiality” of these risks, calling for reporting companies to define these parameters as they relate to the reporting company’s particular business. The SEC states that any “materiality” determination “requires an assessment of both the probability of the event occurring and its potential magnitude, or significance to the reporting company.” The SEC likens the materiality determination required for these new disclosures to the determination required when preparing the management discussion and analysis (“MD&A”) in a registration statement or annual report. It appears that the SEC’s justification for a body of rules in addition to existing MD&A disclosure requirements is the “dynamic nature” of environmental risk over the short, medium and long term and what a reasonable investor would consider as material in making an investment or voting decision. Since a multitude of organizations have developed voluntary standards of climate change disclosure which have been adopted by institutional and other investors to varying degrees, it is possible that those standards may be viewed as evidence by the SEC as to what an investor would want to know and thus material to a reporting company.

Financial Statements – Regulation S-X

The Proposal would add a new article to Regulation S-X requiring a reporting company’s audited financial statements to include a note containing certain disaggregated climate-related impacts on existing financial statement line items. These metrics would be subject to audit and would fall within the scope of the reporting company’s internal control over financial reporting (“ICFR”). Disclosures would include financial impact metrics, expenditure metrics, and descriptions of financial estimates and assumptions.

Financial Impact Metrics

The Proposal requires reporting companies to include actual and potential financial impacts to the business related to both physical risk and transition risk. Physical risk impacts include impacts to the business’s “revenues or costs from disruptions to business operations or supply chains;” “impairment charges and changes to the carrying amount of assets (such as inventory, intangibles, and property, plant and equipment) due to the assets being exposed to severe weather, flooding, drought, wildfires, extreme temperatures, and sea level rise;” “changes to loss contingencies or reserves (such as environmental reserves or loan loss allowances) due to impact from severe weather events;” and “changes to total expected insured losses due to flooding or wildfire patterns.”

Transition risk disclosure includes “changes to revenue or costs due to new emissions pricing or regulations resulting in the loss of a sales contract;” “changes to operating, investing, or financing cash flow from changes in ... costs, such as transportation of raw materials;” “changes to the carrying amount of assets (such as intangibles and property, plant, and equipment) due to, among other things, a reduction of the asset’s useful life or a change in the asset’s salvage value by being exposed to transition activities;” and “changes to interest expense driven by financing instruments such as climate-linked bonds issued where the interest rate increases if certain climate-related targets are not met.”

Expenditure Metrics

The Proposal requires reporting companies to analyze and describe present and future aggregate amounts of expenditure and the aggregate amount of capitalized costs incurred during the fiscal years presented to reduce GHG emissions or otherwise reduce vulnerability to transition risks. Those costs and expenditures would include “research and development of new technologies, purchase of assets, infrastructure, or products that are intended to reduce GHG emissions, increase energy efficiency, offset emissions (purchase of energy credits), or improve other resource efficiency.” If a reporting company discloses GHG emissions reduction targets or other climate-related commitments, it must also disclose the expenditures and costs related to meeting those targets, if any, in the fiscal years presented (which will include two fiscal years when first filed).

Estimates and Assumptions

The Proposal requires the reporting company to provide a qualitative description of how the development of its climate change related estimates and assumptions were impacted by a potential transition or the reporting company’s disclosed climate-related targets.

SEC Filings – Changes to Regulation S-K

The Proposal affords reporting companies the option to include the new Regulation S-K mandated climate-related disclosures in a separate captioned section of its registration statement or annual report, or alternatively, to incorporate that information in the separate section by reference from another section, such as Risk Factors, Description of Business, or MD&A. The required disclosure includes the following:

Board and Management Oversight of Climate-Related Issues

The Proposal requires a reporting company to disclose information about the oversight of climate-related risks by both its board of directors and management, including specific information about which board members or committees are responsible for managing climate-related risks, the qualifications of board directors in managing climate-related risks, the climate-related risk analysis process, the frequency of discussions, and whether and how management and/or directors consider climate-related risks as part of business strategy, risk management, and financial oversight.

Climate Strategy, Business Model, and Outlook

The Proposal requires reporting companies to disclose any material climate-related risks reasonably likely to have a material impact on the business or consolidated financial statements over the short, medium, and long term. Reporting companies would be required disclose the role that climate plays in its strategy and outlook, its use of carbon offsets or other climate mitigation instruments in the business’s strategy, any use of an internal carbon price and change over time, and use of scenario analyses to determine impacts.

Reporting companies will be required to provide a narrative discussion of whether and how any climate-related risks have affected or are reasonably likely to affect the reporting company’s consolidated financial statements. Under the Proposal, the reporting company must include a discussion of how it defines short- medium- and long-

term time horizons and the effects of climate-related risks over those time frames. This includes a qualitative discussion of the climate-related risks considered by the reporting company as well as disclosure of the percentage of assets that may be vulnerable to those risks.

The Proposal also calls for a qualitative and quantitative description of the analytical tools used by the reporting company to assess climate-related risk, including scenario analyses, parameters, assumptions, and analytical choices, and the projected principal financial impacts on the reporting company's business strategy under each scenario.

Risk Management and Processes for Identifying, Assessing, and Managing Climate Risks

To provide further information about the internal processes for climate-related risk assessment, the Proposal requires a reporting company to disclose "more granular information" regarding the processes used by the reporting company to identify, assess, and manage climate-related risks. In particular, the Proposal requires reporting companies to describe the existing or likely regulatory requirements or policies that were considered when identifying climate-related risks, as well as shifts in customer or counterparty preferences, technological changes, or changes in market prices in assessing potential transition risks. The disclosure also requires information about how the reporting company determined the scope and impacts, as well as the ultimate materiality, of climate-related risks. Reporting companies must also disclose whether the processes are integrated into the reporting company's overall risk management system or processes.

If the reporting company has adopted a transition plan as part of its climate-related risk management strategy, relevant metrics and targets used to identify and address physical and transition risks must be disclosed. Upon disclosure of the transition plan, the reporting company is required to provide annual updates regarding the reporting company's progress to meet targets or goals. These disclosures are eligible for the Private Securities Litigation Reform Act ("PSLRA") forward-looking statement safe harbors, provided all conditions for qualification are met.

GHG Emissions

Under the Proposal, all reporting companies will have to disclose their Scope 1 and Scope 2 emissions, as defined by the GHG Protocol. Scope 3 emissions would be disclosed only if the emissions are material, or if the reporting company has set forth Scope 3 GHG emissions reduction targets or goals. Further, smaller reporting companies are generally exempt from Scope 3 emission disclosure requirements.

Under the GHG Protocol standards, Scope 1 emissions are those that are directly emitted by sources directly owned or controlled by the reporting company, such as emissions from assets, facilities, and vehicles. Scope 2 emissions are generally those emissions generated by electricity, steam, heating and cooling purchased by the reporting company. The United States EPA considers Scope 3 emissions as "those emitted by assets not owned or controlled by the reporting organization, but that the organization indirectly impacts in its value chain through its operational decisions." Scope 3 emissions include all sources attributable to a reporting company that are not within its Scope 1 and 2 boundary.

To determine the extent of each category of its GHG emissions, a reporting company must describe the

methodology, inputs, and assumptions used to calculate the GHG metrics it uses. This includes disclosure of the reporting company's organizational and operational boundaries used to define the extent of Scope 1 and Scope 2 emissions. While the GHG Protocol offers some flexibility in defining organizational boundaries, the SEC's proposed method requires alignment with the scope of entities, operations, assets, and other holdings based on the same set of accounting principles applied to a reporting company's consolidated financial statements.

Because of the nature of Scope 3 emissions, the collection and quantification of these emissions may be more difficult to assess. To try to account for these challenges, the SEC proposes more flexibility for Scope 3 disclosures than for Scope 1 and Scope 2 emissions disclosures. Attestation would not be required for Scope 3 emissions disclosures, and the disclosures would be subject to a more flexible "good faith" standard for liability. The Proposal also includes an additional phase-in period for Scope 3 emissions disclosures and an exemption for smaller reporting companies.

Emissions must be reported per individual constituent of GHG, in the aggregate, in absolute terms without offsets, and in terms of GHG intensity (i.e., per unit of economic activity or production). Reporting GHG intensity allows reporting companies to provide needed context to distinguish those reporting companies whose gross emissions decrease due to divestiture or losses, as opposed to reporting companies whose gross emissions may increase year-over-year due to growth, mergers, or acquisitions, despite effective GHG reduction measures.

Attestation of Scope 1 and Scope 2 Emissions Disclosure

Under the Proposal, an accelerated filer or a large accelerated filer must include an attestation report for its Scope 1 and Scope 2 GHG disclosures. The attestation report must be prepared and signed by an independent firm or person with expertise in GHG emissions calculation. An attestation service provider is not required to be a registered public accounting firm.

Targets & Goals

The Proposal requires the reporting company to disclose whether any targets or goals related to resource conservation or GHG emissions have been set by the company. If so, the reporting company must disclose information about those targets and goals, including: the scope of activities and emissions included, the unit of measurement, the defined time horizon, intended course of action to achieve the targets and goals, and the role of carbon offsets or renewable energy credits ("RECs") in achieving the targets and goals. The reporting company must also provide disclosures each fiscal year to describe the actions taken during the year and progress made toward achieving the targets and goals.

Compliance Timeline

The proposed rules are subject to "phase-ins" for all reporting companies. Filers required to provide attestation for Scope 1 and Scope 2 emissions have additional phased in "limited assurance" and "reasonable assurance" deadlines for attestation to allow time for the development of climate risk assessment methods. A reporting company's compliance deadline depends on the reporting company's filing status and the content of the disclosure. The earliest potential compliance dates are shown in [Table 1](#) below.

Table 1 – Earliest Possible Compliance Deadlines

Reporting Company’s Filing Status	All proposed disclosures, including GHG emissions metrics: Scope 1, Scope 2, and associated intensity metric, but excluding Scope 3, and Financial Statement Metrics Audit Compliance Date (assuming December 2022 Effective Date)	GHG emissions metrics: Scope 3 and associated intensity metric (Limited Assurance Attestation)	Reasonable Assurance Attestation
Large Accelerated Filers	FY2023 (filed in 2024)	FY2024	FY2026
Accelerated Filers & Non-Accelerated Filers	FY2024 (filed in 2025)	FY2025	FY2027
Smaller Reporting Companies (“SRC”)	FY2025 (filed in 2026)	N/A	N/A

For the purposes of establishing appropriate deadlines, general rules of thumb for determining filing status are:

- **SRC** – (1) public (non-affiliate) float of less than \$250 million OR (2) public float of less than \$700 million *and* less than \$100 million in annual revenue.
- **Accelerated filer** – (1) has reported with the SEC for one year; (2) a public float of not less than \$75 million to less than \$700 million *and* (3) does not meet the SRC revenue test.
- **Large Accelerated filer** – (1) has reported with the SEC for one year; (2) a public float of \$700 million or more *and* (3) does not meet the SRC revenue test.

An SRC, irrespective of its accelerated filer status, should be able to avail itself of the extended compliance deadline for SRCs and should be exempt from the Scope 3 emissions disclosure.

Reporting companies required to disclose Scope 3 GHG emissions have one additional year to comply with those disclosure requirements.

The disclosure requirements in the Proposal reach back into the historical fiscal year(s) included in the consolidated financial statements in the filing. The required historical fiscal years’ data must include climate-related metrics that correspond to balance sheet, income statement or cash flow statement line items for that fiscal year.

Analysis

For those publicly traded companies that are not already tracking and reporting climate risk and GHG emissions in a detailed manner, the Proposal will unquestionably increase securities compliance costs. Those public companies that are already reporting will need to ensure that their existing tracking systems and reporting formats are consistent with any final rules that are adopted. Given the breadth of reporting coupled with attestation requirements, it is likely that many industrial and energy-related companies will need to undertake a comprehensive review of all potential GHG sources, including equipment and processes. Developing a roster of

Scope 2 and Scope 3 emissions will only increase the time commitment, cost, and complexity of this exercise. Companies that do not currently track and report climate risk will be required to perform a materiality analysis and may be required to develop and implement new climate risk and GHG emissions tracking, management and reporting systems in compliance with any final rule. Companies with significant GHG emissions will undoubtedly need to bolster staffing to track emissions on an ongoing basis. Further, management of change process and procedures will need to be effectively developed with integration of a reporting company's environmental, operational, and financial functions to allow for timely and accurate data development and attestation. Inattention to those details could give rise to potential securities law claims, shareholder actions, and other litigation and enforcement actions. Further, disclosures required apart from GHG tracking will also require a very significant investment of time and thought.

Additionally, the disclosures required by final rules could provide a basis for shareholders to exert pressure on company decisions. Shareholders are already taking actions to influence companies that are considered significant GHG emitters. For example, in its most recent United States Proxy Voting Guidelines and Benchmark Policy Recommendations, proxy advisory firm Institutional Shareholder Services ("ISS") included a recommendation that investors generally vote against incumbent directors in cases where the company is "not taking the minimum steps needed to understand, assess, and mitigate risks related to climate change to the company and the larger economy." In that recommendation, ISS defined the "minimum steps" to consist of (i) detailed disclosure of climate-related risks, such as those developed by the TCFD and (ii) appropriate GHG emissions reduction targets.

Companies should also consider carefully the GHG metrics disclosed in SEC filings. Particular attention should be paid to developing accurate and meaningful measures of GHG intensity to provide context to gross emissions inventory, whether increasing or decreasing. Further, public and private companies that are not subject to SEC reporting requirements may face unexpected costs as their SEC-regulated customers demand information about their emissions in order to satisfy Scope 2 and Scope 3 GHG emissions reporting. Importantly, because the Proposal includes within its focus GHG intensity, pressure will be put upon non-reporting companies, including those that are privately owned, to develop their own intensity data to allow for consideration of the climate change impact of their operations. Should these companies fail to do so, it could affect the attractiveness of their product offerings and ultimately undermine their enterprise profitability and sustainability.

Moreover, if the Proposal is adopted, regulators, competitors, and environmental groups will have access to more detailed information about the internal decision-making processes, operations, and air emissions from publicly-traded companies. This information, along with required governance disclosures of board and management supervision of climate-related risk, may provide a toe-hold for litigation alleging director and management liability for certain environmental actions. Parties seeking to bring shareholder suits or climate-related actions will likely have access to more particular data, including comparative data concerning climate change mitigation expenditures, to support claims, including those of inaction.

Conclusion

The much-anticipated SEC climate-disclosure rules, if adopted as proposed, will create new costs and liability exposure for publicly traded companies, particularly those not already tracking and reporting climate risk and GHG emissions in a detailed manner. The Proposal may also impact non-reporting companies, including those that are

privately held. This is because end users, lenders, or investors may seek or require information for comparative analyses of such companies' product or service offerings. Engaging environmental and securities counsel will be key to protect companies from liability associated with these disclosures, including inaccurate or incomplete data assimilation.

—

?[1] GHG intensity is quantifying GHG emissions based upon a volume or production.

?[2] A reporting company may also disclose actual and potential impacts of climate-related opportunities it is pursuing.

RELATED INDUSTRIES + PRACTICES

- [Capital Markets](#)
- [Corporate](#)
- [Energy](#)
- [Energy Transition](#)
- [Environmental + Natural Resources](#)
- [Insurance + Reinsurance](#)