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SEC Proposes New Rules to Enhance and Standardize Climate-Related Disclosures

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Overview

On March 21, the SEC proposed a highly anticipated set of rules that would require public companies to include a suite of climate-related disclosures in their SEC filings. Although the SEC published guidance in 2010 emphasizing that existing rules might require disclosures about climate-related risks, the proposed rules would impose a mandatory disclosure framework of significantly more information about climate-related risks, plans, governance, and costs. Even though the proposal is in an open comment period, subject to litigation challenges, and contains phase-in periods, many companies already have been preparing for the requirements, and all should be engaged in understanding and adapting to the proposed requirements in the interim.

The SEC modeled the required climate-related disclosures on recommendations by the Task Force on Climate-Related Financial Disclosures (TCFD) and the Greenhouse Gas (GHG) Protocol, as anticipated. The SEC views this approach as potentially mitigating the compliance burden because public companies already comply with these recommendations. It also avoids imposing self-promoted reporting standards, such as those developed by the Sustainability Accounting Standards Board.

As you will see from the (necessarily lengthy) discussion below, the proposed rules represent an enormous expansion of the required disclosure, and for every public company, will result in additional complexity and expense. We are particularly worried about the required Scope 3 disclosures, the additional required footnote disclosure (which will have audit implications), and the additional attestation requirements for Scope 1 and Scope 2 GHG emissions.

While we focus below on the proposed changes to regulation S-K and Regulation S-X, these changes would flow through to changes in many of the SEC's forms, including Form 10-K, Form 10-Q, and various registration statements.

Governance Disclosure

Proposed Item 1501 of Regulation S-K would require a company to disclose information regarding its board oversight of climate-related risks and management's role in assessing and managing those risks. With respect to boards, the required disclosure would include:

- The identity of any board members or board committee responsible for the oversight of climate-related risks;

- Whether any board member has expertise in climate-related risks, with a description of the nature of that expertise;
- The processes by which the board or a board committee discusses climate-related risks, including how the board is informed about climate-related risks, and the frequency of that discussion;
- Whether and how the board or a board committee considers climate-related risks as part of its business strategy, risk management, and financial oversight; and
- Whether and how the board sets climate-related targets or goals, and how it oversees progress against those targets or goals.

Proposed Item 1501 also would require a company to disclose information regarding management's role in assessing and managing any climate-related risks, including:

- The identification of any management positions or committees responsible for assessing and managing climate-related risks and the relevant expertise of the individuals;
- The processes by which such positions or committees are informed about and monitor climate-related risks; and
- Whether and how frequently such positions or committees report to the board or a board committee on climate-related risks.

The SEC did not propose any compensation-related disclosure as part of the release – and we are increasingly seeing incentive compensation partially tied to climate-related achievements – but noted that the existing CD&A rules already provide a framework for disclosing any connection between executive compensation and achieving progress in addressing climate-related risks.

Disclosure of Climate-Related Risks

Proposed Item 1502(a) of Regulation S-K would require a company to disclose any climate-related risks reasonably likely to have a material impact on the company's business or consolidated financial statements that may manifest over the short, medium, and long term. The SEC based its definitions of climate-related risks on the TCFD framework in an attempt to improve the comparability and usefulness of the disclosures for investors. A company would be required to disclose several types of "climate-related risks" per the proposed rules, including "physical risks," "transition risks," "acute risks," and "chronic risks."

Additionally, the SEC noted that materiality for these purposes would be determined consistently with current MD&A requirements.

Like other forward-looking statements, a company would be entitled to rely on the current safe harbor for forward-looking statements (Safe Harbor) when making climate-related disclosures. However, as is the case for other forward-looking statements, the Safe Harbor would not apply to climate-related disclosures made in connection with IPOs, which disclosures the proposed rules would require.

Disclosure Regarding Climate-Related Impacts on Strategy, Business Model, and Outlook

Once a company has complied with proposed Item 1502(a) by describing the relevant climate-related risks, proposed Item 1502(b) would require the company to describe the actual and potential impacts of those risks on its strategy, business model, and outlook. Specifically, the proposed rule would require a company to disclose impacts on its:

- Business operations, including the types and locations of its operations;
- Products or services;
- Suppliers and other parties in its value chain;
- Activities to mitigate or adapt to climate-related risks, including adoption of new technologies or processes;
- Expenditures for research and development; and
- Any other significant changes or impacts.

Similar to the proposed rule for new Item 1502(a), this item would require a company to disclose the time horizon for each described impact (*i.e.*, short-, medium-, or long-term risk manifestation).

Proposed Item 1502(d) of Regulation S-K would require a company to provide a narrative description of whether and how any of its identified climate-related risks have affected or are reasonably likely to affect the company's consolidated financial statements, including any of the financial statement metrics disclosed pursuant to proposed Regulation S-X Rule 14-02 (discussed below).

If applicable to and used by a company, the proposed rules would also require disclosure of:

- Carbon offsets or renewable energy credits;
- A maintained internal carbon price; and
- Scenario analysis and similar analytical tools used to assess the impact of climate-related risks.

Risk Management Disclosure

Proposed Item 1503 of Regulation S-K would require a company to describe any processes the company has for identifying, assessing, and managing climate-related risks by disclosing:

- How it determines the relative significance of climate-related risks compared to other risks;
- How it considers existing or likely regulatory requirements or policies, such as GHG emissions limits, when identifying climate-related risks;
- How it considers shifts in customer or counterparty preferences, technological changes, or changes in market prices in assessing potential transition risks;
- How it determines the materiality of climate-related risks, including how it assesses the potential size and scope of any identified climate-related risk;
- How it decides whether to mitigate, accept, or adapt to a particular risk;
- How it prioritizes addressing climate-related risks; and
- How it determines how to mitigate a high-priority risk.

If a company has adopted a transition plan to mitigate or adapt to climate-related risks, Item 1503(c) would require the company to describe the plan, including the relevant metrics and targets used to identify and manage any physical and transitions risks. The transition plan disclosure would need to be updated each fiscal year. Forward-looking statements made as part of a company's discussion of its transition plan would be eligible for the Safe Harbor.

Financial Statement Metrics

If a company files the disclosure required by the proposed Regulation S-K items in a form that also requires audited financial statements (*e.g.,* a Form 10-K), proposed Regulation S-X Rule 14-01 would require the company to disclose in a note to its financial statements certain disaggregated climate-related metrics underlie existing financial statement line items. Specifically, the proposed rules would require disclosure of:

- Financial impact metrics;
- Expenditure metrics; and
- Financial estimates and assumptions.

The proposed rules would require a company to disclose contextual information, explaining how it derived each type of financial statement metric, including a description of significant inputs and assumptions used, and, if applicable, policy decisions made by the company to calculate the specified metrics. The SEC noted that while currently existing accounting standards could elicit climate-related disclosures in the financial statements, the proposed rules would benefit companies by specifying when to provide such disclosures. Retroactive disclosure also would be required.

GHG Emissions Metric Disclosure

Proposed Item 1504 of Regulation S-K would require a company to disclose its GHG emissions for its most recently completed fiscal year. The SEC based the disclosure rules on the "scopes" concept contained in the GHG Protocol:

- Scope 1 emissions would include direct GHG emissions from operations owned or controlled by a company.

- Scope 2 emissions would include indirect GHG emissions from the generation of purchased or acquired electricity, steam, heat, or cooling consumed by operations owned or controlled by a company.

- Scope 3 emissions would include all indirect GHG emissions not otherwise included in a company's Scope 2 emissions, which occur in the upstream and downstream activities of a company's value chain. Upstream emissions include emissions attributable to goods and services that the company acquires, the transportation of goods, and employee business travel and commuting. Downstream emissions include the use of the company's products, transportation of products, end-of-life treatment of sold products, and investments made by the company.

The proposed rules would require a company to disclose its total Scope 1 and Scope 2 emissions separately. In addition, a company also would be required to disclose separately its total Scope 3 emissions if either those emissions are material or it has set a GHG emissions reduction target or goal that includes its Scope 3 emissions. Disclosures would be provided both disaggregated by the constituent greenhouse gases (*e.g.*, carbon dioxide, methane, nitrous oxide, nitrogen trifluoride, hydrofluorocarbons, perfluorocarbons, and sulfur hexafluoride) and in the aggregate.

In addition to requiring the disclosure of its GHG emissions in gross terms, the proposed rules would also require a company to disclose the sum of its Scope 1 and 2 emissions in terms of GHG intensity, which the SEC noted should provide context to a company's emissions in relation to its business scale. Similar to the Financial Statement Metrics proposed under Regulation S-X, proposed Item 1504 would require both current and historic disclosures.

For companies that would be required to calculate and disclose Scope 3 emissions, which the SEC admitted "could represent a challenge for certain public companies," the SEC proposes to offer the following "accommodations" for Scope 3 emissions disclosure:

- A safe harbor for Scope 3 emissions disclosure from certain forms of liability under the federal securities laws;

- An exemption for smaller reporting companies (SRCs) from Scope 3 emissions disclosure; and

- A delayed compliance date for Scope 3 emissions disclosure.

Attestation of Scope 1 and Scope 2 Emissions Disclosure

Proposed Item 1505(a) of Regulation S-K would require accelerated filers or large accelerated filers to include an attestation report covering the disclosure of its Scope 1 and Scope 2 emissions.

The attestation report could be provided by anyone who:

- Is an expert in GHG emissions by virtue of having significant experience in measuring, analyzing, reporting, or attesting to GHG emissions. Significant experience means having sufficient competence and capabilities necessary to:
    - perform engagements in accordance with professional standards and applicable legal and regulatory requirements; and
    - enable the service provider to issue reports that are appropriate under the circumstances.
- Is independent with respect to the company.

The independence requirement is modeled on the SEC's qualifications for accountants under Rule 2-01 of Regulation S-X.

Targets and Goal Disclosure

Proposed Item 1506 of Regulation S-K would require a company, if it has set any climate-related targets or goals, to provide information about those targets or goals, including a description of:

- The scope of activities and emissions included in the target;
- The unit of measurement, including whether the target is absolute or intensity based;
- The defined time horizon by which the target is absolute or intensity based, and whether the time horizon is consistent with one or more goals established by a climate-related treaty, law, regulation, policy, or organization;
- The defined baseline time period and baseline emissions against which progress will be tracked with a consistent base year set for multiple targets;
- Any interim targets set by the company; and
- How the company intends to meet its climate-related targets or goals.

The Safe Harbor would apply to any forward-looking statement a company makes, especially in connection with how a company intends to achieve its climate-related targets and goals and expected progress regarding those targets and goals.

Phased Approach

The SEC proposed phased-in dates for complying with the proposed rules that would include:

- A phase-in period for all companies, with the compliance date dependent on a company's filer status, and an additional phase-in period for the Scope 3 emissions disclosure;
- A phase-in period for the assurance requirement and the level of assurance required for accelerated filers and large accelerated filers; and
- An exemption from the Scope 3 emissions disclosure requirement for SRCs.

While the timing and scope of final rules remains uncertain, the SEC provided the following compliance dates, assuming that the proposed rules are effective in December 2022 for companies with a December 31 fiscal year end:

Public Company Type	**Disclosure Compliance Dates**	
	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)
SRC	Fiscal year 2025 (filed in 2026)	Exempted

Filer Type	**Scopes 1 and 2 GHG Disclosure Compliance Date**	**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)

Litigation clearly could result in extending at least the earliest of these deadlines, and the U.S. Chamber of Commerce indicated on a call with its members that it does expect to litigate.

Observations

The proposed rules passed on a 3-1 vote. We expect that the final rules, if adopted, will face litigation. Detractors argue that many aspects of the proposed rules appear to reflect a philosophy of regulation through disclosure (and the accompanying public scrutiny) and not disclosure tailored to investor needs. In a lengthy statement, dissenting Commissioner Hester M. Peirce stated that the "proposal turns the disclosure regime on its head" by telling corporate managers how "regulators, doing the bidding of an array of non-investor stakeholders, expect them to run their companies," rather than "provid[ing] investors with an accurate picture of the company's present and prospective performance through managers' own eyes." Commissioner Peirce's dissent provided a roadmap for litigation likely to ensue.

The public comment period for the proposing release will remain open for 60 days following its publication on the SEC's website (May 20, 2022), or for 30 days following its publication in the *Federal Register*, whichever period is longer.

About Troutman Pepper's ESG Practice

Businesses across a range of industries — from startup to standout — are increasingly turning to Troutman Pepper for advice on the myriad of business and legal implications connected with Environmental, Social, and Governance (ESG). Troutman Pepper attorneys closely track SEC and Federal Trade Commission regulations and policies relating to ESG to better advise clients on reporting requirements and their implications. We also understand that ESG is not just driven by regulatory requirements, but also by the demands of client's stakeholders, including shareholders, customers, employees, suppliers, and communities. We understand these drivers and can help develop strategies for enacting policies and programs to implement ESG strategies.

Our teams are already at work on comment letters regarding the recent proposals, both on the climate proposal and the SEC's March 9 proposal on cyber breach disclosure requirements, and are available to support you in your ESG needs. If you would like assistance in analyzing the proposed rules or submitting a comment letter, please reach out to the Troutman Pepper attorney with whom you usually work.

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