Public Chatter

The SEC's Climate Disclosure Proposal: A Comprehensive Look

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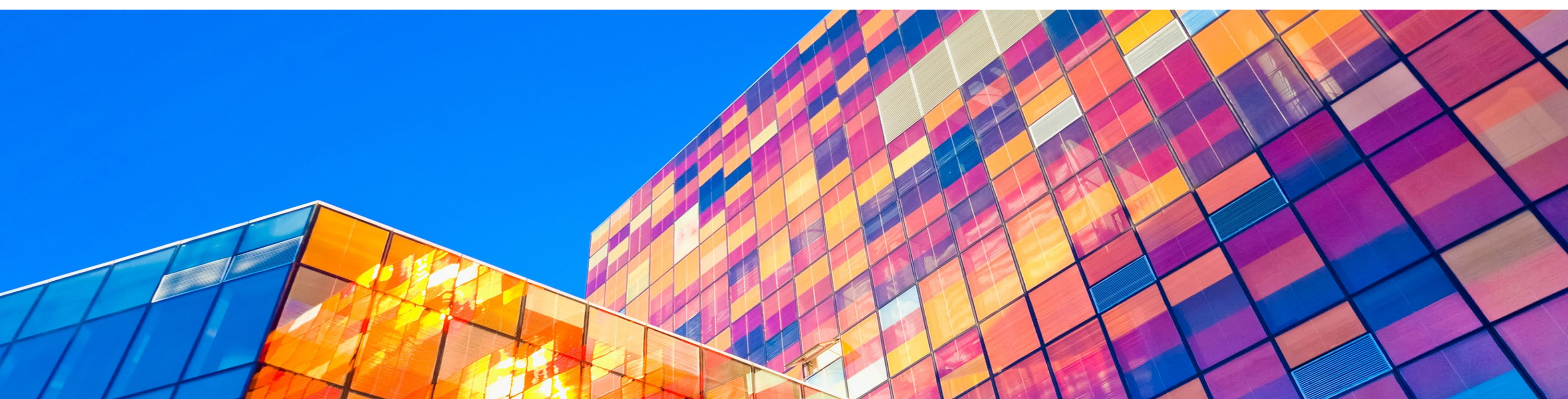

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1. SEC PROPOSES CLIMATE DISCLOSURE RULES: 9 THINGS TO KNOW

In March, as noted in this press release, the SEC proposed climate disclosure rules. Here's the hefty 490-page proposing release - and here's the fact sheet. The SEC's summary of the proposed rules can be found on pages 40-46 of the proposing release - that is the "must read" section of the tome.

Given the magnitude of this proposal - this NPR piece calls it "historic" - we have put together this Guide covering discrete aspects of this proposal. To summarize the SEC's proposal, here are 9 things to know at a glance:

A. When Will Final Rules Be Adopted? - Even though comments are due 30 days after the proposal is published in the Federal Register or by May 20th (whichever is later), the SEC may not adopt final rules in 2022 given the magnitude of the proposal and based on how long it took to even get this proposal out.

The SEC is being careful with this rulemaking given the grumblings about an inevitable lawsuit challenging its validity. Remember that the SEC normally will consider comments that are submitted beyond the deadline.

B. When Would Final Rules Be Phased In? - Even if final rules were adopted in 2022, there would be a phase-in period for all sizes of companies, with the compliance date dependent on a company's filer status - and an additional phase-in period for Scope 3 greenhouse gas (GHG) emissions disclosure. For the details of the phase-in periods, see the table on page 3 of the fact sheet.

C. What Are the New Disclosure Requirements? - The proposed rules would create a new subpart of Regulation S-K covering several topics, including:

- Various aspects of climate-related risks, such as board and management oversight, material impacts of these risks on the company over the short-, medium- and long-term, and effects on company strategy;

- The company's Scope 1 and Scope 2 GHG emissions, separately disclosed, expressed both by disaggregated constituent greenhouse gases and in the aggregate, and in absolute terms, not including offsets, and in terms of intensity (per unit of economic value or production);

- Description of scenario analysis used to assess the company's resilience to climate-related risks, if the company uses scenario analysis; and

- If the company has adopted a transition plan as part of its climate-related risk management strategy, a description of the plan, including the relevant metrics and targets used to identify and manage any physical and transition risks.

D. What About Financial Statement Disclosures? - In addition to the Regulation S-K disclosures, the proposed rules would also add a new article to Regulation S-X, governing the requirements for a company's financial statements. The new article would require disclosure of:

- Impact of climate-related events (severe weather events and other natural conditions) and transition activities on the line items of a company's financial statements;

- Expenditures made to mitigate risks of climate-related events and those related to transition activities; and

- Impact of climate-related events on estimates and assumptions used to produce the company's financial statements.

E. <u>What Must a Company Disclose If It Has Publicly Set Climate Goals? - These four things:</u>

- The scope of activities and emissions included in the target, the defined time horizon by which the target is intended to be achieved, and any interim targets;

- How the company intends to meet its climate-related targets or goals;

- Relevant data to indicate whether the company is making progress toward meeting the target or goal and how such progress has been achieved, with updates each fiscal year; and

- If carbon offsets or renewable energy certificates ("RECs") have been used as part of the plan to achieve climate-related targets or goals, certain information about the carbon offsets or RECs, including the amount of carbon reduction represented by the offsets or the amount of generated renewable energy represented by the RECs.

F. <u>What Types of Scope 3 GHG Emissions Would Be Required to Be Disclosed?</u> - In addition to Scope 1 and 2 GHG emissions disclosures, companies would be required to make Scope 3 disclosures - <u>if material</u> - or if the company has set a GHG emissions target or goal that includes Scope 3 GHG emissions. There would be a safe harbor for liability from Scope 3 GHG emissions disclosure and an exemption from the Scope 3 GHG emissions disclosure requirement for smaller reporting companies.

G. <u>In Which SEC Filings Would These Disclosures Be Provided?</u> - Regulation S-K mandated disclosures would be made in registration statements and Form 10-Ks, in a separate, appropriately captioned section. Mandated Regulation S-X disclosures would be in a note to the financials. Both narrative and quantitative disclosures would need to tagged with Inline XBRL.

H. <u>Which Companies Would Be Required to Obtain Attestations Reports?</u> - Accelerated filers and large accelerated filers would be required to include an attestation report from an independent attestation service provider covering Scope 1 and 2 GHG emissions disclosures, with a phase-in over time.

For all companies, the new disclosures in the notes to financial statements would, of course, be subject to audit - and be within the scope of the company's internal controls over financial reporting requirements.

I. <u>How Long Does It Take to Read a 490-Page Proposing Release?</u> - Longer than it takes to get to the center of a tootsie pop…

2. WHERE DID WE WIND UP WITH "MATERIALITY"?

Leading up to the recent issuance of the SEC's climate disclosure proposal, there had been much debate regarding the definition of "materiality" – both outside the SEC and reportedly even within it. The SEC's proposing release deals with "materiality" in a variety of ways, including:

A. Avoidance of "Double" Materiality: The SEC's proposing release first addresses "materiality" in the 3rd paragraph of the "Introduction" on page 7. It makes clear that the proposal targets disclosure based on financial materiality – "information can have an impact on public companies' financial performance or position and may be material to investors in making investment or voting decisions."

Interestingly, the proposing release carefully avoids the debate over whether "double," "dynamic," "nested" materiality should be considered as an appropriate litmus test for disclosure. Those terms aren't mentioned a single time in the proposing release (see this graphic about what those terms mean). This likely is an effort to reduce the likelihood that the SEC would be successfully challenged in court over whether it has overstepped its authority in promulgating these rules. It also would keep the SEC's rule in line with the accounting literature.

B. Line-Item Approach: The SEC's existing guidance relies heavily on the traditional definition of "materiality" to elicit climate disclosure. The 2010 interpretive release uses a principles-based approach.

The SEC's new climate proposal is much more line-item based. Just look at the text of the proposed rules that starts on page 457 of the proposing release and continues to page 490. The proposed rules cover detailed specifics, both for financial statements (including required disclosures of impacts of severe weather events, climate-related transition activities, and climate-related risks on financial statement line items) and narrative discussions of the business (including highly specific disclosure requirements regarding governance, strategy, business model, outlook, and risk management), in addition to the greenhouse gas (GHG) emissions disclosure requirements.

In statements made at the open Commission meeting, Commissioners expressed opposing views on this approach. Commissioner Caroline Crenshaw noted that the proposed rules are "carefully calibrated and the staff took great pains to ensure a thoughtful and balanced approach that provides investors with information that they have been seeking for years."

From the other perspective, Commissioner Hester Peirce expressed frustration that the proposed rules stray from most existing SEC disclosure mandates. Commissioner Peirce summarized the principles-based approach: "Rather than simply ticking off a preset checklist based on regulators' prognostication of what should matter, companies have to think about what is financially material in their unique circumstances and disclose those matters to investors."

C. Use of "Scenario Analyses" & the Resulting Forward-Looking Information: The proposal doesn't go as far as requiring companies to conduct scenario analyses (identifying and assessing a potential range of outcomes of future events under conditions of uncertainty). But it does call for certain disclosures when a company does use scenario analysis - regarding scenarios considered and projected principal financial impacts on business strategy under each scenario. See pages 83-88 of the proposing release.

Scenario analysis is already recommended by the TCFD - and many companies are using it. Many companies may find that this process is helpful to determine "materiality" in assessing climate-related risks and climate-related business opportunities. In the climate context, scenario analysis envisions perhaps a more formal process than what in-house lawyers are accustomed to when making materiality judgments – and to what executives typically consider when making their strategic business decisions.

Disclosure about scenario planning inevitably will wind up with companies making more forward-looking disclosure in their SEC filings. Although the SEC's proposal notes that the PSLRA forward-looking statement safe harbor would cover this type of disclosure, it still would require companies to be very careful about what they do – and what they disclose.

D. **Short-, Medium- and Long-Term Horizons:** The SEC's proposing release digs into "Disclosure of Material Impacts" on strategy, business model and outlook starting on page 72. Once a company has described the climate-related risks reasonably likely to have a material impact on its business or financial statements – as manifested over the short-, medium-, and long-term as would be required by proposed Item 1502(a) of Regulation S-K – companies would have to describe the actual and potential impact of those risks. Scenario analyses could help companies make these short-, medium- and long-term evaluations.

E. **Disclosure of Climate Risk Assessment Processes:** The SEC's proposing release – starting on page 100 – details how the SEC's proposal would require companies to describe any processes they have for identifying, assessing, and managing climate-related risks.

This would elicit disclosure from companies about their processes to determine the "materiality" of climate-related matters, really drilling down into how companies make their disclosure determinations. This would be a first for this type of disclosure rule.

Under the SEC's proposal, a company specifically would be required to disclose:

- 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; and
- How it determines the materiality of climate-related risks, including how it assesses the potential size and scope of any identified climate-related risk.

3. WHEN SHOULD SCOPE 3 EMISSIONS BE CONSIDERED "MATERIAL"?

Under the SEC's proposal, companies would be required to make Scope 3 emissions disclosures – only if material (or if the company has set a GHG emissions target or goal that includes Scope 3 GHG emissions).

So when it comes to Scope 3 disclosures, there is a materiality qualifier if a company hasn't established a pledge that includes Scope 3. That begs the question then, "when would Scope 3 emissions be considered material?" Of course, to answer this question, a company would have to

collect all the requisite Scope 3 data to make the determination. That's where the rubber hits the road – where the extensive work and burdensome costs come in.

A. Disclosure That Scope 3 Emissions Aren't Material?

Putting that aside, the SEC suggests on page 166 of the proposing release: "If a registrant determines that its Scope 3 emissions are not material, and therefore not subject to disclosure, it may be useful to investors to understand the basis for that determination." It would be pretty unusual for the SEC to have a requirement eliciting disclosure about why something wasn't material and we imagine this concept will draw a fair amount of comment.

B. Disclosure That "Some" Scope 3 Emissions Are Material

The proposing release also suggests, "Further, if a registrant determines that certain categories of Scope 3 emissions are material, registrants should consider disclosing why other categories are not material." So some companies might be mixing and matching which Scope 3 emissions might be material.

C. Disclosing Actions Taken (Or Not) When Scope 3 Emissions Are Material

If a company deems all of its Scope 3 emissions to be material, the proposing release suggests: "If, however, Scope 3 emissions are material, then understanding the extent of a registrant's exposure to Scope 3 emissions, and the choices it makes regarding them, would be important for investors when making investment or voting decisions." Companies here would need to disclose the actions (or inactions) they take regarding Scope 3 emissions.

D. Many Companies Will Deem Scope 3 Emissions to Be Material?

So getting back to the question of, "when would Scope 3 emissions be considered material?" it's noteworthy that on page 162 of the proposing release, the SEC says "When recommending that the Commission require the disclosure of Scope 3 emissions, some commenters indicated that Scope 3 emissions represent the relatively large source of overall GHG emissions for many companies. Given their relative magnitude, we agree that, for many registrants, Scope 3 emissions may be material to help investors assess the registrants' exposure to climate-related risks, particularly transition risks, and whether they have developed a strategy to reduce their carbon footprint in the face of regulatory, policy, and market constraints."

Note what the proposing release says here. For many companies. For many companies.

E. The SEC Proposes Three Things to Make Scope 3 Disclosures More Palatable

As noted on page 210 of the SEC's proposing release, there are three accommodations proposed for Scope 3 disclosures:

- Limited safe harbor for Scope 3 emissions disclosure from certain forms of liability under the federal securities laws;
- Reporting exemption for "smaller reporting companies"; and
- Delayed compliance date of one year for Scope 3 emissions disclosures.

4. ASSESSING "PHYSICAL RISKS"

In parsing the SEC's proposing release for climate disclosure, there are a fair number of new concepts for securities lawyers to get their arms around. But let's start with something that appears easy, at least on its face – assessing the risks posed by climate on a company's physical operations and properties.

Note that when companies disclose a climate-related risk, they will need to identify whether the risk is a "physical risk" or a "transition risk" (and then disclose the company's plans to mitigate - or adapt to - that risk).

A. Breaking Down "Physical Risks" Into "Acute" and "Chronic" Categories

The SEC's proposing release digs into this "physical risk" analysis starting on page 55 (this is all part of proposed Items 1502(a) and (b) of Regulation S-K). The SEC breaks the concept of "physical risk" into two: "acute risks" and "chronic risks." They are defined as:

- "Acute risks" are event-driven risks related to shorter-term extreme weather events, such as hurricanes, floods, and tornadoes; and

- "Chronic risks" are risks that the business may face as a result of longer-term weather patterns and related effects, such as sustained higher temperatures, sea level rise, drought and increased wildfires, as well as related effects such as decreased arability of farmland, decreased habitability of land, and decreased availability of fresh water.

The SEC believes that many companies have already experienced physical risks. And under its proposal, companies would be required to describe the nature of the physical risk, including whether it may be categorized as an acute or chronic risk. That's easy enough to do.

B. Identifying Locations (Including ZIP Codes) of Those Physical Risks with a Likely Material Impact

But here comes one that could wind up being more challenging. If a physical risk has had – or is likely to have – a material impact on a company's business or financial statements, the proposal would require the company to identify the location of the properties, processes, or operations subject to that physical risk. For companies with limited physical operations that might be easy to do. For companies with more widespread operations, that could be a real bear.

Let's drill down. Companies would be required to provide the ZIP code for the location of the properties, processes or operations (or if a location doesn't have a ZIP code, a similar subnational postal zone or geographic location). Investors should weigh in during the comment process about how useful a table or list of ZIP codes might be for them.

C. Disclosures Specific to Water-Related Physical Risks

For companies with water-related acute physical risks, the SEC's proposal would require disclosure of the percentage of buildings, plants or properties (square meters or acres) that are located in flood hazard areas, in addition to their location. If a material risk relates to the location of assets in regions of high-water stress, that company would need to make additional disclosures.

The proposing release offers the examples of increased temperatures and changes in weather patterns that result in water scarcity and regulatory restrictions on water usage that results in increased expenses to find alternative sources of water or a possible need to curtail operations.

If the location with high water stress presents a material risk, the proposed rules would require disclosure of the amount of assets (e.g., book value and as a percentage of total assets) located in such regions in addition to their location – as well as disclosure of the percentage of the company's total water usage from water withdrawn in those regions.

D. Disclosures Specific to Temperature-Related Physical Risks

Of course, increased temperatures could also materially impact companies in other ways. The proposing release offers the example of the construction industry and how the physical risk of increased heatwaves affects the ability of personnel to safely work outdoors, which could result in a cessation - or delay - of operations.

Another example is companies that are operating in wildfire-prone areas could be exposed to potential disruption of operations, destruction of property and relocation of personnel. And those in the real estate sector might need to disclose the likelihood that sea levels rise faster than expected.

E. The Parade of Horribles

There is a real parade of horribles that unfortunately are no longer uncommon in the world - and disclosure lawyers are going to need to become more attuned to climate developments in the world and consider that regardless of the industry that their company is in.

5. ASSESSING "TRANSITION RISKS"

In parsing the SEC's proposing release for climate disclosure, the SEC's proposal would elicit disclosure about "transition risks." When companies disclose a climate-related risk, they will need to identify whether the risk is a "physical risk" or a "transition risk." And then disclose the company's plans to mitigate - or adapt to - that risk.

A. Definition of "Transition Risk"

On page 58 of the SEC's proposing release, "transition risks" are defined to mean the actual or potential negative impacts on a company's financial statements, business operations, or value chains attributable to regulatory, technological, and market changes to address the mitigation of - or adaptation to - climate-related risks.

Transition risks would include increased costs attributable to climate-related changes in law or policy, reduced market demand for carbon-intensive products leading to decreased sales, prices, or profits for such products, the devaluation or abandonment of assets, risk of legal liability and litigation defense costs, competitive pressures associated with the adoption of new technologies, reputational impacts (including those stemming from a company's customers or business counterparties) that might trigger changes to market behavior, changes in consumer preferences or behavior, or changes in a company's behavior.

The SEC notes that a company that has significant operations in a jurisdiction that has made a GHG emissions reduction commitment would likely be exposed to transition risks related to the implementation of the commitment.

B. <u>What to Disclose About Transition Risks</u>

As noted on page 62 of the SEC's proposing release, proposed new Item 1502(a) of Regulation S-K would require companies to describe the nature of their transition risks, including whether these risks relate to regulatory, technological, market (including changing consumer, business counterparty, and investor preferences), liability, reputational, or other transition-related factors, and how those factors impact the company.

The proposing release lays out these examples:

- An automobile manufacturer might describe how market factors, such as changing consumer and investor preferences for low-emission vehicles, have impacted or will likely impact its production choices, operational capabilities, and future expenditures;

- An energy producer might describe how regulatory and reputational factors have impacted or are likely to impact its operational activities, reserve valuations, and investments in renewable energy; and

- An industrial manufacturer might describe how investments in innovative technologies, such as carbon capture and storage, have impacted or are likely to impact its consolidated financial statements, such as by increasing its capital expenditures.

C. <u>"Impacts from the Value Chain": Disclosure of Third-Party Impacts on a Company's Transition Risks</u>

As mentioned above, transition risks are defined in the proposed rules to include the actual - or potential - negative impacts on a company's "value chains." Value chain is defined to include upstream activities (like materials sourcing, materials processing, and supplier activities) and downstream activities (like transportation and distribution, processing of products, use of products and end of life treatment of products).

This proposal represents a fairly significant departure from typical SEC disclosure requirements - requiring a company to disclose potential negative impacts of climate change transitions *from third parties* that are upstream and downstream from the company.

Although the overall proposed rule (Item 1502) is limited only to climate-related risks that are "reasonably likely to have a material impact" on the company, the need to include a discussion of the negative impacts on "value chains" could create a significant disclosure burden. The proposing release seeks comments on whether negative impacts on a company's value chain should be included in the definition of climate-related risks. Companies and investors may want to consider commenting on this item.

D. <u>Voluntary Disclosure of "Climate-Related Opportunities"</u>

Many companies are already considering the opportunities that might arise during their transition to a world filled with climate events. The proposed rules define "climate-related opportunities" to mean the actual - or potential - positive impacts of climate-related conditions and events on a company's financial statements, business operations, or value chains, as a whole.

Starting on page 62 of the proposing release, the SEC describes how companies might address strategic planning for these opportunities in their disclosures under proposed new Items 1502(a), 1503(a), and 1503(c)(3).

We say "might address" because the SEC does emphasize that disclosure of climate-related opportunities is a voluntary disclosure. It is optional because of concerns that making this disclosure mandatory could have anti-competitive effects in some instances. However, if a company does decide to voluntarily make this disclosure, then the SEC's rules kick in to ensure consistency of disclosure across companies.

6. DISCLOSING CARBON OFFSETS

Digging further into the SEC's proposing release for climate disclosure, the SEC's proposal would elicit disclosure about carbon offsets – for those companies that engage in that sort of thing. For some companies, carbon offsets and renewable energy credits or certificates (known as "RECs" and defined by the SEC consistently with how the EPA defines it) play a role in their climate-related business strategy.

A. The Difference Between Carbon Offsets and RECs

Most securities lawyers don't know the difference between a "carbon offset" and a "REC." The SEC provides an explanation in footnote 237 on page 77 as:

- A company may purchase carbon offsets to address its direct and indirect GHG emissions (i.e., its Scopes 1, 2, and 3 emissions) by verifying global emissions reductions at additional, external projects. The reduction in GHG emissions from one place ("offset project") can be used to "offset" the emissions taking place somewhere else (at the company's operations); and

- A company may purchase a REC in renewable electricity markets solely to address its indirect GHG emissions associated with purchased electricity (i.e., Scope 2 emissions) by verifying the use of zero- or low-emissions renewable sources of electricity. Each REC provides its owner exclusive rights to the attributes of one megawatt-hour of renewable electricity whether that renewable electricity has been installed on the company's facilities or produced elsewhere.

B. The Disclosure Requirements

As noted on page 77 of the proposing release, companies would be required to disclose, under proposed Item 1502(c) of Regulation S-K, the role that carbon offsets or RECs play in the company's climate-related business strategy.

Given the sensitivity of how much carbon offsets and RECs cost over time, the SEC believes those companies using them should address the risk of higher costs over time in their disclosures. The SEC also notes that the value of an offset may decrease substantially and suddenly – and provides the example of an offset representing protected forest land that burns in a wildfire and no longer represents a reduction in GHG emissions and the company needs to replace that offset with something that now costs more. That's another type of disclosable risk.

There also are regulatory risks in addition to market risks when it comes to carbon offsets and RECs. A change in a regulation could impact the cost – or even the availability – of certain types of carbon offsets and RECs.

In addition to risk disclosure, under the proposal, companies would make disclosures about their carbon offsets and RECs when they address their targets and goals disclosures. That disclosure would cover the extent to which a company relies on offsets and RECs to meet target and goal commitments and their progress over time in meeting those commitments. This type of disclosure would also include a description of the carbon offset or REC, including any registries or authentication of the offset or RECs, and the cost.

Carbon offsets and RECs are addressed in the proposed rules in other contexts too. For example, for each type of Scope – 1, 2, and 3 – companies would be required to disclose the emissions disaggregated by each constituent greenhouse gas, and in the aggregate. This greenhouse gas emissions data would be disclosed in gross terms, *excluding* any use of carbon offsets.

C. What Will Sunlight Do to the Future of Carbon Offsets?

Some investors increasingly are vocal that they don't believe carbon offsets should be considered a valid climate strategy. It is possible that this is another area – like internal carbon pricing where sunlight on a company's practices might be a disincentive to continue engaging in those practices.

7. DISCLOSING INTERNAL CARBON PRICING

Digging further into the SEC's proposing release for climate disclosure, the SEC's proposal would elicit disclosure about a company's internal carbon price – for those companies that do that sort of thing. Some companies use an internal carbon price tool as a planning tool for considering climate-related risks and opportunities, and to quantify costs, and guide investment decisions. For some companies, use of an internal carbon price may be an alternative to conducting scenario analysis planning.

A. The Disclosure Requirements

As noted on pages 79-80 of the proposing release, proposed Item 1502(e) of Regulation S-K would require disclosure about:

- Price in units of the company's reporting currency per metric ton of carbon dioxide equivalent ("CO_2e");
- Total price, including how the total price is estimated to change over time;
- Boundaries for measurement of overall CO_2e on which the total price is based (if different from the GHG emission organizational boundary);
- Rationale for selecting the price used; and
- How the company uses its disclosed internal carbon price to evaluate and manage climate-related risks.

B. More Than One Internal Carbon Price

If a company uses more than one internal carbon price, the SEC's proposal would require it to provide disclosures for each internal carbon price - and to disclose its reasons for using different prices. The SEC gives the example of a company disclosing that it uses different internal carbon prices when considering various scenarios to help it develop a business strategy over different time horizons.

C. Forward-Looking Information Inevitable

This is another disclosure that inevitably would result in more forward-looking information being made publicly available. The PSLRA safe harbors would apply – but the upshot is there is a risk that these types of disclosures could wind up disincentivizing companies from establishing internal carbon prices.

8. DISCLOSING TARGETS & GOALS

Digging further into the SEC's proposing release for climate disclosure, the SEC's proposal would elicit disclosure about a company's climate targets and goals – for those companies that have done that sort of thing.

We have blogged before about things to consider when companies publicly announce a climate pledge. Most companies making such pledges have not publicly disclosed many details about how they intend to accomplish the goals set forth in their pledges – nor have they disclosed much about their interim progress in meeting those goals. That all would change if this part of the SEC's proposal was adopted as proposed.

One thing to note is that the SEC's proposal doesn't seem to limit this "targets and goals" requirement to those that have been publicly disclosed. So companies that have privately established targets and goals would appear to trigger this type of detailed disclosure.

A. The Disclosure Requirements

If a company has set any climate-related targets or goals - as noted in the discussion starting on page 268 of the proposal release - proposed Item 1506 of Regulation S-K would require disclosure about a long list of items related to those targets or goals:

- 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 intended to be achieved, 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.

If a company uses carbon offsets or RECs in its plan to meet targets and goals, there would need to be disclosure about the amount of carbon reduction represented, the source of the offsets or RECs, a description and location of the underlying projects and the cost of the offsets or RECs.

B. Disclosure of Baseline Years & Intervening Targets

Digging into the list above, there are some interesting points to highlight, beyond just the significant level of detail. Companies would be required to disclose the baseline year for their targets - and that baseline year would need to be consistent for all targets if the company has set multiple targets. And if a company has set intervening targets – such as a goal of net zero GHG emissions by 2050 in line with the Paris Agreement, with plans to cut Scopes 1 and 2 emissions by 50% by 2030 and reducing Scope 3 emissions by 35% by 2030 - the company would be required to disclose all of those targets.

C. Companies That Don't Have Detailed Plans Yet

On page 270, the SEC's proposing release contemplates those situations where a company has made a pledge but doesn't yet know how it will meet its goals.

Here's that relevant excerpt: "Some companies might establish climate-related goals or targets without yet knowing how they will achieve those goals. They might plan to develop their strategies over time, particularly as new technologies become available that might facilitate their achievement of their goals. The fact that a company has set a goal or target does not mean that it has a specific plan for how it will achieve those goals. What is important is that investors be informed of a registrant's plans and progress wherever it is in the process of developing and implementing its plan."

D. Board Oversight of Targets & Goals

The board oversight part of the SEC's proposal also touches upon targets and goals. Proposed Item 1501(a) would require companies to 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.

E. Location of Target & Goals Disclosure

Proposed Item 1506(a)(2) states that cross-reference can be made to targets and goals disclosure made in either the strategy discussion (Item 1502) or risk management (Item 1503) if they fulfill the disclosure requirements of Item 1506. In other words, companies won't need to repeat the same targets and goals disclosure in two places within its SEC filing.

F. Forward-Looking Information Inevitable

This is another disclosure that inevitably would result in more forward-looking information being made publicly available and *filed* with the SEC (which many companies are currently avoiding by discussing targets and goals only in reports that are outside of their SEC filing stream). The PSLRA safe harbors would apply. On page 272 of the proposing release, the SEC does make the interesting statement of "A registrant's disclosure of its climate-related targets or goals should not be construed to be promises or guarantees." Not sure that will be enough to stave off climate-related lawsuits…

9. IMPACT ON FINANCIAL STATEMENTS

Digging further into the SEC's proposing release for climate disclosure, the SEC's proposal would expand Regulation S-X and create specific requirements for a note to financial statements addressing climate change issues in a number of ways.

This is a big deal. By requiring this type of disclosure in the financial statements, the SEC's rules would be directing independent auditors to get more involved with climate change matters during the auditing process. It also means that these climate disclosures would fall within the purview of a company's internal controls. The result would be quite a significant extension from what is required now during the preparation, and audit, of financial statements.

Both FASB and IFRS have previously put out guidance regarding the ways in which climate-related matters may require disclosure in financial statements. But the proposed rules go far beyond that guidance, and the proposing release notes that the rules would increase consistency and comparability of such disclosures.

A. The Disclosure Requirements

Starting on page 110, the proposing release outlines the ways that metrics would be laid out in a company's financial statements. Proposed Item 14-02 of Regulation S-X would require disclosure about climate metrics in the notes to financial statements about certain disaggregated climate-related metrics that are mainly derived from existing financial statement line items.

The types of note disclosure would fall into these three categories:

(1) Financial Impact Metrics – Companies would be required to disclose the financial impacts of severe weather events and other natural conditions; transition activities; and identified climate-related risks on line items in the financial statements - unless the sum of the absolute values of the impacts on the line item is less than 1% of the total line item for the relevant fiscal year (so this 1% threshold is akin to a "materiality" qualifier).

(2) Expenditure Metrics – Companies would be required to disclose expenditure metrics, which are the positive and negative impacts associated with the same climate-related events, transition activities, and identified climate-related risks as the financial impact metrics that companies identified in #1 above (including the 1% threshold). Companies would need to separately aggregate the amounts of expenditure expensed and capitalized costs incurred during the fiscal years presented.

(3) Financial Estimates & Assumptions – Companies would be required to disclose whether the estimates and assumptions used in their financial statements were impacted by exposures to risks and uncertainties associated with - or known impacts from - climate-related events, such as flooding, drought, wildfires, extreme temperatures, and sea level rise.

B. Putting the Disclosure in Context

These financial statement metrics would involve estimation uncertainties that are driven by the application of judgments and assumptions – just like any other financial statement disclosures (e.g., estimated loss contingencies, fair value asset measurements, etc.) – and proposed new Item 14-02(a) of Regulation S-X would require companies to disclose contextual information to enable an investor to understand how it derived the metric,

including a description of significant inputs and assumptions used, and if applicable, policy decisions made by the company to calculate the specified metrics.

C. Examples of What Might Need to Be Disclosed

As noted on pages 124-125 of the proposing release, the SEC's proposed rule includes specific examples of severe weather conditions and other natural conditions events – as well as transition activities – to help provide guideposts to companies about what they should be considering, including:

- Changes to revenue 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;
- Changes to total expected insured losses due to flooding or wildfire patterns;
- Changes to revenue or cost 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 upstream costs, such as transportation of raw materials;
- Changes to the carrying amount of assets (such as intangibles and property, plant, and equipment), for example, due to 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.

The proposing release also highlights that some of these might pose opportunities for companies – positive impacts. A company may disclose the impact of opportunities in the note to financial statements as well, and if it does so, it must do so consistently (e.g., for each fiscal year presented, for each financial statement line item, and for all relevant opportunities identified).

D. Presentation of the Disclosure - Financial Impacts

As noted on pages 121-122 of the proposing release, for purposes of the financial impacts disclosure, within each category (i.e., climate-related events or transition activities), impacts would, at a minimum, be required to be disclosed on an aggregated, line-by-line basis for all negative impacts - and, separately, on an aggregated, line-by-line basis for all positive impacts.

However, for purposes of determining whether the disclosure threshold has been met, a company would be required to aggregate the absolute value of the positive and negative impacts on a line-by-line basis.

On pages 122-123 of the proposing release, the SEC provides an example of what a disclosure might look like (excluding the required contextual information).

E. Presentation of the Disclosure - Expenditure Metrics

As noted on pages 132-133 of the proposing release, the expenditure metrics would require disclosure of expenditures expensed and capitalized costs incurred within the fiscal years presented, with separate disclosure of impacts within the two categories (climate-related events and transition activities).

However, for purposes of determining whether the disclosure threshold has been met, a company would be required to aggregate expenditure related to climate-related events and transition activities within the two expenditure metrics (amount capitalized and amount expensed).

On pages 133-134 of the proposing release, the SEC provides an example of what a disclosure might look like (excluding the required contextual information).

10. DISCLOSING BOARD OVERSIGHT

Digging further into the SEC's proposing release for climate disclosure, the SEC's proposal would elicit disclosure about a board's oversight of climate-related matters. For some companies, this type of disclosure undoubtedly would impact how much time and resources they devote to climate issues going forward.

A. The Disclosure Requirements

As noted starting on page 93 of the proposing release, proposed Item 1501(a) of Regulation S-K would require quite a bit of detailed disclosure about board oversight of climate-related matters:

- The identity of those directors or board committees responsible for the oversight of climate-related risks;
- Whether any directors have expertise in climate-related risks;
- The processes and frequency by which the board - or any board committees - discuss climate-related risks, including how the board is informed about climate-related risks;
- Whether - and how - the board (or any board committees) 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.

B. Identifying Responsible Directors & Board Committees

The first prong of the board governance requirement - the one about identifying which directors and board committees have climate responsibilities - could quickly become dated. Particularly for those industries heavily impacted by climate change, it's not far-fetched to think of each - and every - board committee (as well as the full board) discussing climate as part of their committee's purview.

C. Directors With Climate Expertise

When it comes to disclosure about whether boards have any directors with expertise in climate-related risks, this obviously might spur even more companies to recruit directors with this kind of background. That already is something that has been a growing trend. Many of these climate experts aren't the traditional C-suite officers that get recruited onto boards.

Note that the proposed rule would require disclosure "in such detail as necessary to fully describe the nature of the expertise."

D. Processes – and Frequency – of Climate Discussions (and Board Materials)

This prong really gets into the nitty gritty of what the board does: a description of the processes and frequency by which the board - or any board committees - discuss climate-related risks. And "how the board is informed" about these risks, which would seem to boil down to a discussion of the board materials.

This will require the corporate secretary to keep track of the discussions when climate is mentioned, which could be a little tricky. What if the discussion is "there's nothing new to report." Does that count towards "frequency"? Or what if a single board committee meeting has climate on the agenda three separate times? Does that count as "one" or "three" towards frequency?

This type of disclosure requirement seems to get too far into the weeds of board meeting processes, eliciting disclosure that would be more detailed than typically entered into the board minutes. And a description of related board materials should definitely be considered a unique type of disclosure – and perhaps push corporate secretaries to overload directors with too much climate-related information.

E. Business Strategy, Risk Management & Financial Oversight

This prong gets to the heart of what investors really want to know. Investors want to know how boards are looking at climate-related risks and opportunities as part of their business strategies. Are they engaging in the proper risk oversight when it comes to climate?

The danger here for companies is that some companies might disclose that their boards are baking climate considerations into their business strategies – but that might not really be the case. Disclosure lawyers will want to really kick the tires on this one.

F. Board Oversight of Targets & Goals

If companies make climate pledges, smart boards should be informed about what the plan is to meet the targets and goals associated with that pledge, and checking on the interim progress being made towards that end. This type of disclosure is just one piece of a larger

set of disclosures that companies would be making about their targets and goals under the SEC's proposal.

11. HOW MUCH IS THIS GONNA COST US? THE SEC'S CLIMATE ECONOMIC ANALYSIS

The SEC's proposing release has no less than 127 pages dedicated to an economic analysis of the rule. That's pages 293 to 420, covering benefits, costs, and effects on efficiency, competition, and capital formation. Here are eight interesting things to note about that analysis:

A. **The Challenges in Estimating Costs:** This statement on page 333 speaks volumes: "In many cases, however, we are unable to reliably quantify these potential benefits and costs."

   As reflected by the anecdotal evidence based on the experience of a variety of companies described starting on page 373, the actual cost for a particular company will vary widely, partially dependent on where they already stand when it comes to evaluating their emissions and what they already disclose in sustainability reports, etc.

B. **Estimated Price Tag for Larger Companies is $640,000 for Year One (Not Counting Third-Party Assurance):** As noted on page 373, "For non-SRC registrants, the costs in the first year of compliance are estimated to be $640,000 ($180,000 for internal costs and $460,000 for outside professional costs), while annual costs in subsequent years are estimated to be $530,000 ($150,000 for internal costs and $380,000 for outside professional costs)."

   That estimate doesn't take into account third-party assurance costs, which are estimated, per page 380, with wide ranges depending on size of company and level of assurance: "For limited assurance, we estimate that accelerated filers will incur costs ranging from $30,000 to $60,000 (with a median of $45,000), while large accelerated filers will incur costs ranging from $75,000 to $145,000 (with a median of $110,000). For reasonable assurance, we estimate that accelerated filers will incur costs ranging from $50,000 to $100,000 (with a median of $75,000), while large accelerated filers will incur costs ranging from $115,000 to $235,000 (with a median of $175,000)."

C. **Estimated Price Tag for Smaller Companies is $490,000 for Year One:** As noted on page 373, "For SRC registrants, the costs in the first year of compliance are estimated to be $490,000 ($140,000 for internal costs and $350,000 for outside professional costs), while annual costs in subsequent years are estimated to be $420,000 ($120,000 for internal costs and $300,000 for outside professional costs)."

   The SEC proposed that it would not require smaller reporting companies to obtain third-party assurance.

D. **Scope 3 Emissions Analysis:** Scope 3 GHG emissions would need to be disclosed only if material to the company - or if the company has set a target or goal related to Scope 3 emissions.

   The discussion of economic benefits of Scope 3 emissions disclosures starts on page 355. Scope 3 GHG emissions can represent the majority of the carbon footprint for many companies - in some cases, as high as 85% to 95% - but are not measured or disclosed by most companies. Disclosure of Scope 3 emissions data could help investors understand transition risks – and potential disruptions in a company's supply chain, business model and cash flows.

E. The Benefits of Standardized Disclosure: By requiring that climate disclosure be "filed" with the SEC (and not wholly outside the SEC filing stream, as most sustainability reports currently are, or "furnished"), there would be enhanced reliability given the increased liability attached.

There would be a reduction in investor search costs since the location of such disclosure would be standardized – and the market would benefit from more consistent disclosure, as well as an enhanced comparability by requiring companies to provide disclosures on a common set of qualitative and quantitative climate-related topics.

Which all leads to improved liquidity, lower costs of capital, higher company valuations, etc.

F. Percentage of Form 10-Ks with Climate Keywords: Starting on page 303, the proposing release has a number of tables that break out how many companies have certain climate-related keywords in their 10-Ks today, broken out by filer size and industries. The industries with the highest usage shouldn't come as a surprise: maritime transportation; electric services; oil & gas; steel manufacturing and rail transportation.

G. Types of Current Climate Disclosures: Today, as noted on page 307, climate-related disclosures can be broadly organized into four topics: business impact, emissions, international climate accords, and physical risks. Other disclosure trend surveys are described starting on page 310, including the relative use of third-party disclosure frameworks.

H. Use of Third-Party Assurance Today: Page 311 notes that a Governance & Accountability Institute study found that 35% of Russell 1000, which are virtually all large accelerated filers, obtained third-party assurance for some portion of their sustainability reports in 2020, up from 24% in the year prior. The rate of assurance is concentrated among the larger half of the companies (i.e., the S&P 500 firms). Among the companies that obtained assurance, however, only 3% obtained assurance for the entire report.

12. Client Memo: "What Companies Should Know Now About the SEC's Proposed Climate Rule"

We are excited to share our firm memo – "What Companies Should Know Now About the SEC's Proposed Rule on Mandatory Climate Disclosures — and How to Plan Ahead" – authored by Kevin Feldis, Angela Luh, Allison Handy and Bo Uuganbayar. Check it out!