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Proposed Climate Disclosure Rules for Public Companies

By Elizabeth A. Diffley, Walé Y. Oriola, Amy C. Seidel, Hamilton S. Carpenter and Katharine T. Thayer*

In this article, the authors provide a high-level summary of the disclosure requirements proposed recently by the Securities and Exchange Commission that would require public companies to include climate-related disclosures in their annual reports and registration statements, as well as some key observations.

The Securities and Exchange Commission ("SEC") has issued highly anticipated proposed rules[1] that would require public companies to include climate-related disclosures in their annual reports and registration statements. The proposal, which received support from three of the four SEC commissioners, would impose extensive, prescriptive and complex disclosure requirements on public companies to provide quantitative and qualitative information about climate-related risks, greenhouse gas ("GHG") emissions and climate-related financial measures. The proposed rules would require large accelerated filers and accelerated filers to obtain third-party assurance and file an attestation report covering certain of their GHG emissions disclosure, and for those companies that set climate-related goals or targets, the proposed rules would require specific disclosure about those goals and targets, including the plan for meeting them.

If the proposed rules are made final, the earliest any of these disclosures would be required is 2024 for the largest companies, with requirements being phased in over a longer period for smaller companies.

The proposal identifies increasing investor demand for disclosure about climate-related risks and notes among the rationales for the proposed rules that climate-related information can have a material impact on public companies' financial performance or position and may be material to investors making

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[1] https://www.sec.gov/rules/proposed/2022/33-11042.pdf.

investment or voting decisions. The release further indicates that these requirements are designed to improve the consistency, comparability and reliability of climate-related disclosures.

This article provides a high-level summary of the proposed disclosure requirements, as well as some key observations.

CLIMATE-RELATED DISCLOSURE IN A SEPARATELY CAPTIONED SECTION OF ANNUAL REPORTS AND REGISTRATION STATEMENTS

Drawing from the Task Force on Climate-Related Financial Disclosures ("TCFD") framework, including its defined terms, the proposed rules would create a new subpart 1500 of Regulation S-K (including definitions of climate-related terms)[2] and would require domestic public companies and foreign private issuers to include certain climate-related information in their periodic reports and registration statements,[3] including the information discussed below.

Risks, Strategy, Governance and Risk Management

Material Climate-Related Risks to Business and Financial Statements

The proposed rules would require a registrant to disclose climate-related risks reasonably likely to have a material impact on the registrant that may manifest over the short, medium and long term. A registrant would be required to describe how it defines its short-, medium- and long-term horizons including how it takes into account or reassesses the expected useful life of its assets and the time horizons for its planning processes and goals.

The proposal would require a discussion of climate-related risks, including specifying whether they are "physical risks," related to the physical impacts of the climate, or "transition risks," related to a potential transition to a lower carbon economy. For any identified material risk, registrants would be required to describe the nature of the risk including:

- For a physical risk, whether it may be categorized as acute or chronic, and the location and nature of the assets subject to the physical risk; and
- For a transition risk (defined in the proposal as the actual or potential

[2] A detailed review of the defined terms is beyond the scope of this article, but those terms can be found on pages 472–477 of the proposal.

[3] For example, the proposed rules would designate Part II, Item 6, of Form 10-K as "Climate-Related Disclosure" and require a section titled "Climate-Related Disclosure" in Part I, Item 11, of Form S-1.

negative impacts on a registrant's consolidated 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), whether it relates to regulatory, technological, market, liability, reputational, or other transition-related factors and how those impact the registrant.

It is worth observing that the proposal clarifies that the proposed rules are based on the concept of "materiality" in the federal securities laws, meaning that information is material if there is a substantial likelihood that a reasonable investor would consider the information important in deciding how to vote or make an investment decision.

The proposal also notes that materiality determinations are fact-specific and require quantitative and qualitative considerations, and that materiality determinations for potential future events require an assessment of both the probability of occurring and the potential magnitude or significance to the registrant. In clarifying its reliance on the existing definitions and guidance, the SEC chose not to adopt other approaches to materiality, such as "double materiality" or "dynamic materiality" used in some other ESG-focused disclosure regimes.

Impact of Climate-Related Risks on the Registrant's Strategy, Business Model and Outlook

Having identified the material climate-related risks, the proposed rules would require a registrant to disclose the actual and potential impacts of those risks on the registrant's strategy, business model, and outlook. Specifically, a registrant would be required to disclose:

- The impact of those risks on its business operations, its products or services, its suppliers and others in its value chain, activities to mitigate or adapt to climate-related risk, expenditure for research and development, and any other significant changes or impacts, and to include the time horizon for each described impact;
- Whether and how any of these impacts are taken into account as part of its strategy, financial planning, and capital allocation, and to provide both current and forward-looking disclosures to help investors understand how the implications of these risks have or have not been integrated into the business model or strategy, and how resources are being used to mitigate climate risks; and
- Whether and how any of these climate-related risks have affected or are reasonably likely to affect the registrant's financial statements.

A registrant would also be required to describe the resilience of its business strategies in light of potential future changes in climate-related risks and to describe any analytical tools, including scenario analysis, that it uses to assess the impact of climate-related risk and to support the resilience of its strategy and business model. The proposed rules would require a registrant to disclose the scenarios considered and to present a variety of qualitative and quantitative information under each scenario.

The proposal indicates that these requirements are designed to result in a narrative analytical discussion similar to what is required in a registrant's management discussion and analysis ("MD&A") section.

Oversight and Governance of Climate-Related Risks by the Registrant's Board and Management

The proposed rules would require certain disclosure about the oversight of climate-related risks by a registrant's board of directors and management with the aim of providing investors sufficient information to determine to what extent a registrant is addressing its climate-related risks.

With respect to a registrant's board of directors, the proposed rules would require disclosure, as applicable, regarding:

- The board members or committees responsible for the oversight of climate-related risks and whether any relevant member has expertise in climate-related risk;
- How and how often the board is informed of climate-related risks, and the processes by which and frequency with which the board or board committee discusses climate-related risks;
- Whether and how the board or 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.

With respect to a registrant's management, the proposed rules would require disclosure, as applicable, regarding:

- Whether certain management positions or committees are responsible for assessing and managing climate-related risks, including identifying the positions or committees and disclosing the relevant expertise in sufficient detail;
- The processes by which the responsible managers or committees are informed about and monitor climate-related risks; and
- Whether and how often the responsible positions or committees report

to the board or board committee on climate-related risks.

Risk Management System or Processes Regarding Climate-Related Risks

To help investors understand how a registrant identifies, evaluates and addresses material climate-related risks, the proposed rules would require a registrant to disclose, as applicable, its process for identifying, assessing and managing climate-related risk.

When describing the processes, a registrant would be required to disclose, as applicable, how it:

- Determines the relative significance of climate-related risks compared to other risks;
- Considers existing or likely changes in laws or regulations when identifying climate-related risks;
- Considers potential changes in consumer or counterparty behaviors, technological advancements or changes in market prices in assessing potential transition risks;
- Determines the materiality, size and scope of climate-related risks;
- Decides whether to mitigate, accept or adapt to a particular risk;
- Prioritizes addressing climate-related risks; and
- Determines how to mitigate high-priority risk.

The proposal indicates that if a registrant uses insurance or other financial products to manage its exposure to climate-related risks, it may need to describe its use of those products. Further, a registrant would be required to disclose whether and how these climate-related risk management processes are integrated into its overall risk management environment, including how and with what frequency those responsible for climate-related risk management interact with management and the board of directors.

When providing disclosure of climate-related governance, strategy and risk management matters as required by the proposed rules, a registrant would also be permitted to disclose information concerning any identified climate-related opportunities.

It is worth observing that the proposed rules are notable for the extensive level of prescribed detail that would be required to be disclosed about a registrant's climate-related risk oversight, strategy, and risk assessment and management. In many respects, the level of detail contemplated by the proposed requirements is more extensive than what is generally required by other SEC disclosure rules applicable to these areas.

GHG Emissions Metrics

The SEC points out in the release that it aims to provide investors with more comprehensive and tailored information than what is currently publicly available through other sources. The proposed rules would mandate disclosure of certain GHG emissions metrics, both absolute metrics and intensity metrics, for the most recently completed fiscal year and the historical fiscal years included in the report. When disclosing emissions, registrants would be required to exclude the impact of any purchased or generated offsets. Further, a registrant would be required to describe the methodology, significant inputs and significant assumptions used to calculate its GHG emissions.

The defined terms for Scope 1, Scope 2 and Scope 3 are substantially similar to those used by the GHG Protocol.

Scope 1 emissions are direct GHG emissions from operations owned or controlled by a registrant.

Scope 2 emissions are indirect GHG emissions from the generation of purchased or acquired energy consumed by the registrant.

Scope 3 emissions are all other indirect GHG emissions not otherwise included in a registrant's Scope 2 emissions that occur in the upstream or downstream activities of a registrant's value chain.

Scopes 1 and 2 GHG Emissions Metrics

The proposed rules would require all registrants to disclose their total Scope 1 and 2 emissions, separately, in absolute terms, both disaggregated by each constituent greenhouse gas and in the aggregate expressed in terms of CO_2e. Additionally, using the sum of their Scope 1 and 2 emissions, all registrants would be required to disclose GHG intensity in terms of metric tons of CO_2e per unit of total revenue and per unit of production relevant to the registrant's industry (disclosing the basis for the unit of production used). A registrant would be permitted to exclude emissions from investments that are not consolidated, are not proportionately consolidated, or that do not qualify for the equity method of accounting in the registrant's consolidated financial statements.

The proposed rules would also require, after a one-year or two-year phase-in period applicable to large accelerated filers and accelerated filers, respectively, that these filers obtain and include in their filings an attestation report covering the Scope 1 and 2 emissions disclosure. For the first two fiscal years for which this requirement applies, a "limited assurance" attestation would be required and, thereafter, a "reasonable assurance" attestation would be required. The proposed rules require that the attestation report be prepared and signed by an

independent GHG emissions attestation provider and also prescribe certain content for the attestation report, including certain information about the service provider. Non-accelerated filers and smaller reporting companies would not be subject to the attestation requirement.

It is worth observing that the requirement to obtain independent, third-party assurance in the form of an attestation report is a noteworthy development. Investors and other market participants have expressed concerns about the reliability and accuracy of certain voluntary emissions and similar disclosures, and many have called for "audit-like" review and attestation of these measures; but, in the past, the SEC has not generally required registrants to obtain assurance over disclosure outside of the financial statements. Although many companies that voluntarily disclose GHG emissions data obtain some third-party verification of that data, practice varies, including with respect to the standards used, the types of service providers and the scope of disclosures covered by the verification/assurance. The proposed rules would require that the assurance be provided pursuant to attestation standards that are publicly available at no cost and are established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment, and would also require certain minimum qualifications for a GHG emissions attestation provider.

We expect this requirement to be a challenge for many public companies, especially those that have not previously calculated their GHG emissions or obtained any level of assurance on those calculations.

Additionally, even for those companies that are advanced as it relates to tracking and disclosing their GHG emissions, many publish that information in a different form and according to a different timeline than their annual reports.

If this disclosure and attestation requirement comes into effect, it will take time for assurance standards to be developed and service providers to develop the necessary expertise in both GHG emissions and attestation practices, as well as to design and implement due diligence processes and practices appropriate to take on the potential liability associated with rendering a report included in a securities filing.

Scope 3 GHG Emissions and Intensity, If Material, or If the Registrant Has Set a GHG Emissions-Reduction Target or Goal That Includes Its Scope 3 Emissions

The proposed rules would also require disclosure of Scope 3 emissions (separately from Scope 1 and 2 emissions), but only if (i) the registrant's Scope 3 emissions are material, or (ii) the registrant has set a GHG emissions-reduction target or other climate-related goal that includes Scope 3 emissions.

As with Scope 1 and 2 emissions, the registrant would be required to disclose absolute emissions both disaggregated by each constituent greenhouse gas and in the aggregate expressed in terms of CO_2e, excluding the impact of any offsets, as well as Scope 3 GHG intensity in terms of metric tons of CO_2e per unit of total revenue and per unit of production relevant to the registrant's industry (disclosing the basis for the unit of production used).

Additionally, a registrant would be required to identify the categories of upstream and downstream activities that have been included in its Scope 3 emissions, the intensity of its Scope 3 emissions and describe its data sources, which may include emissions reported by parties in the registrant's value chain, whether or not those reports have been verified by the registrant or a third party, data concerning specific activities reported by parties in the value chain, and data derived from third-party sources such as industry associations or government statistics.

In recognition of the substantial complexity in calculating Scope 3 emissions, the proposed rules provide for a delayed (by one year) compliance date for the Scope 3 disclosure requirement compared to Scope 1 and 2 disclosure.

Further, smaller reporting companies would be exempt from the Scope 3 disclosure requirement.

The proposed rules also include a safe harbor for any Scope 3 emissions disclosures such that a statement regarding Scope 3 emissions would not be deemed a fraudulent statement under the securities laws unless it is shown that the statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith.

It is worth observing that, as mentioned above, the proposal clarifies that the concept of "materiality," including for purposes of disclosing material Scope 3 emissions, is consistent with the existing materiality standard under federal securities laws. In other words, a registrant would be required to disclose Scope 3 emissions if there is a substantial likelihood that a reasonable investor would consider them important when making an investment or voting decision.

The proposal notes that the SEC chose not to propose a quantitative threshold for assessing the materiality of Scope 3 emissions and further states that a quantitative analysis may not be sufficient. A registrant would be required to consider the totality of the information available to investors, including qualitative factors, when making such a determination. The proposal also indicates that if a registrant determines Scope 3 emissions are not material, it may be useful to investors to explain the basis for determination.

The Scope 3 emissions materiality assessment required by the proposed rules would introduce significant complexity for registrants, as these emissions are indirect and may be difficult to calculate, and many companies have not previously calculated these emissions.

Targets and Transition Plans

Climate-Related Targets or Goals, and Transition Plan, If Any

The proposed rules would require a registrant that has adopted a transition plan as part of its climate-related risk management strategy to describe the plan as part of its overall climate-related risk management disclosure. The registrant would be required to present the relevant metrics and targets used to identify and manage those risks and to update that disclosure each year describing the actions taken during the year to achieve the plan's targets or goals.

Additionally, in a separate section, or as part of the climate-related strategy or risk management disclosure, the proposed rules would require a registrant that has set any climate-related targets or goals to disclose those targets or goals and how it intends to meet them. The registrant would be required to disclose the scope of activities and emissions included in the target, the unit of measurement, and the defined time horizon for achievement of the targets or goals. The registrant would also be required to disclose the baseline against which progress will be measured, any interim targets, how it intends to meet these targets or goals, and data showing any progress toward achieving these targets, including how that progress was achieved and details about reliance on carbon offsets.

It is worth observing that although companies are increasingly publicizing "net zero" targets and goals, and some companies have also begun to publish interim goals, it is far less common to disclose transition plans. That practice is an area of increasing focus and criticism from investors and environmental groups and has led to questions regarding the credibility and viability of these pledges and concerns about "greenwashing." These proposed requirements are designed to address those concerns, and the degree of specificity and breadth of disclosure that would be required exceeds what most companies have voluntarily disclosed to date.

CLIMATE-RELATED FINANCIAL MEASURES AND RELATED DISCLOSURE IN FINANCIAL STATEMENTS

In addition to the Regulation S-K Item 1500 disclosures, the proposed rules would add a new Article 14 to Regulation S-X, governing the requirements for a company's financial statements, and requiring disclosure of financial impact measures, expenditure measures, and financial estimates and assumptions. Disclosure called for by Article 14, which would be required to be presented in

a note to the audited financial statements, would be required in any filing that must include both climate-related disclosure under Item 1500 and the registrant's audited financial statements.

These financial disclosures would be required for the most recently completed fiscal year as well as the other historical years presented in the report and, generally, must report the required information separately for physical risk items (severe weather events and other natural conditions) and for transition risk items.

Financial Impact Metrics

A registrant would be required to present the financial impacts of (i) severe weather events and other natural conditions (such as flooding, wildfires and extreme temperatures), and (ii) transition activities (such as efforts to reduce GHG emissions or otherwise mitigate exposure to transition risks) on the line items of its financial statements during the fiscal years presented.

For each of these types of impacts, the proposed rules would require, at a minimum, disclosure on an aggregated line-by-line basis for all negative impacts and, separately, at a minimum, on an aggregated line-by-line basis for all positive impacts. Disclosure of the aggregated amount would not be required if the impact on the line item is less than one percent of the total line item for the relevant fiscal year.

Expenditures Metrics

A registrant would also be required to disclose the aggregate amount expensed and the aggregate amount of capitalized costs incurred during the fiscal years presented (i) to mitigate the risks from severe weather events and other natural conditions, and (ii) to reduce GHG emissions or otherwise mitigate exposure to transition risks. A registrant that has disclosed GHG emissions targets or other climate-related commitments must disclose any expenditures and costs related to achieving those targets in the fiscal years presented. Disclosure of the aggregated amount would not be required if the impact on the line item is less than one percent of the total line item for the relevant fiscal year.

A registrant would also be required to include the financial statement disclosure of the impact of any climate-related risks identified by the registrant under Item 1500 of Regulation S-K, separately by physical risks and transition risks, on any of the disclosed financial impact and expenditures metrics. A registrant would also be permitted to disclose the impact of any climate-related opportunities on any of these financial impact and expenditures metrics, but would be required to do so consistently for all fiscal years presented.

Financial Estimates and Assumptions

The proposed rules would also require a registrant to disclose whether the estimates and assumptions it used to prepare its financial statements were impacted by risks and uncertainties, or known impacts, from exposures to risks from (i) severe weather events and other natural conditions, and (ii) a potential transition to a lower carbon economy or any climate-related targets disclosed by the registrant. If so, the registrant would be required to provide a qualitative description of how the development of the estimates and assumptions were impacted by those events.

It is worth observing that, as noted in the proposal, the proposed financial statement metrics would be required in the financial statements, and therefore would be:

- Included in the scope of any required audit of the financial statements in the relevant disclosure filing;
- Subject to audit by an independent registered public accounting firm; and
- Within the scope of the registrant's internal control over financial reporting.

The proposed rules would require registrants to provide contextual information describing how each specific metric was derived, including inputs and assumptions used, and policy decisions made by the registrant to calculate the metric. The proposal indicates that this context should provide necessary transparency to facilitate investors' understanding and peer comparisons.

PHASE-IN PERIODS FOR COMPLIANCE AND ACCOMMODATION

The accompanying table summarizes phase-in periods required by companies depending on status as large accelerated filer, accelerated filer, non-accelerated filer or smaller reporting company. The table assumes a December 31 fiscal-year end.

Phase-In Periods for Compliance With Proposed Climate Change Rules

(Assuming Rules Adopted in 2022)

	Large Accelerated Filer	Accelerated Filer	Non-accelerated Filer	Smaller Reporting Company
All proposed disclosures, including Scopes 1 and 2 GHG emissions metrics and associated intensity metric *(but excluding Scope 3)*	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)		Fiscal year 2025 (filed in 2026)

Attestation report—limited assurance (Scopes 1 and 2)	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	N/A	N/A
Attestation report—reasonable assurance (Scopes 1 and 2)	Fiscal year 2026 (filed in 2027)	Fiscal year 2027 (filed in 2028)	N/A	N/A
Scope 3 GHG emissions metric and associated intensity metric (attestation report not required)	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)		Exempted

Registrants would also be required to block-text-tag and detail-tag narrative and quantitative disclosures provided pursuant to Subpart 1500 of Regulation S-K and Article 14 of Regulation S-X in Inline XBRL.

SCRUTINY AND COMMENTARY

The climate-related proposed rules have already attracted significant attention, scrutiny and commentary. We expected that the proposal would generate a substantial number of comments from a variety of wide-ranging perspectives. Several notable figures have also characterized the proposed rules as exceeding the SEC's authority. Other notable voices—including investors with substantial assets under management—support implementation of climate-related disclosure rules.

If adopted, the new rules may face legal challenges that might delay or otherwise impact their implementation. Although, at this point, it is not clear what provisions of the proposed rules will be adopted, the final form the proposed rules may take or when new rules may be made final, companies may wish to evaluate their existing risk management and governance practices regarding climate-related issues, and continue to consider and refine their approaches to climate-related disclosure within the context of the proposed rules. We also suggest below some preparatory steps to consider taking now.

PREPARATION STEPS TO TAKE NOW

Although the exact content and timing of any final rules remains uncertain, we believe that many companies would benefit from taking preparatory steps in anticipation of enhanced climate-related disclosure and oversight requirements. The following list provides suggestions for some initial steps, all of which should be tailored to the company's particular situation:

- *Form an Internal Working Group*—A good first step is to form an internal, cross-disciplinary working group to start analyzing the poten-

tial requirements and their applicability to the company. Many companies have already organized such a group (and now may be a good time to reassess whether the group's composition remains appropriate), which often includes employees representing product development/design, procurement, legal, accounting/finance, internal audit and communications/investor relations, among others.

- *Inventory Existing Processes and Disclosures*—The working group can start by taking stock of the company's existing activities and disclosures related to climate-related matters that affect its products, services and supply chain. This analysis may include determining what information the company is already tracking, identifying information requests it receives from customers and investors, and understanding the scope of its existing disclosures.
- *Identify Existing Resources to Capture Data*—The working group can also identify available resources and those that may still be needed to comply with the proposed rules or other required or desirable reporting. For example, the working group could seek to identify the support the company obtains through its supply chain and logistics vendors and consultants, or to identify consultants that may be helpful to enhance reporting. Conducting this review should help enable the company to formulate a budget for the costs related to enhancing data collection and reporting.
- *Learn More About TCFD*—If your company has not already become familiar with the TCFD reporting framework, charge the working group members with building that internal knowledge. TCFD offers several online training programs through its website.
- *Engage With Industry Groups*—Connect with industry groups and consider whether to participate in comment letters on the proposal and, more broadly, to develop an understanding of the proposed rules in the context of your company's industry, and what industry practices and resources may aid compliance.
- *Engage With Your Supply Chain*—If your company is not already doing so, as part of meetings and requests for information from suppliers, begin including climate change and GHG emissions topics.
- *Educate the Board of Directors*—Brief the board on the proposed rules and review the company's existing oversight framework for climate-related issues and, to the extent your company is not already doing so or determines certain changes to existing oversight practices are merited, identify whether the full board or one or more board

committees will oversee the company's efforts in this area and develop a cadence and format for reporting regularly on the company's initiatives and activities.