Securities Regulation Daily Wrap Up, TOP STORY—SEC proposes historic climate risk regulation, (Mar. 21, 2022)

Securities Regulation Daily Wrap Up

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The SEC's proposal would address Scope 1 and Scope 2 emissions but would address Scope 3 emissions only to the extent they are material or if a company includes them in its emissions target.

By a vote of 3-1, with Commissioner Hester Peirce being the lone dissenter, the SEC proposed amendments to Regulations S-K and S-X that would, if adopted, require public companies to formally incorporate climate risk disclosures in their annual and periodic reports. The proposal appears to leverage at least some of the concepts developed for standards published by the Task Force on Climate-Related Financial Disclosures (TCFD) and the GHG Protocol (The Enhancement and Standardization of Climate-Related Disclosures for Investors, Release No. 33-11042, March 21, 2022).

A quick overview. The Commission's climate risk disclosure proposal is divided into two main parts—updates for and a new Rule to be added to the requirements contained in Regulation S-X, and a new Item to be added to Regulation S-K. Both parts of the climate risk regulation would work in tandem, with the Regulation S-X portion largely referencing aspects of the Regulation S-K amendments.

Under the proposed regulation, companies would have to provide information about Scope 1 and Scope 2 emissions and provide a related attestation report from an independent attestation service provider if the company is an accelerated or large accelerated filer. The proposal also would include Scope 3 disclosures to the extent they are material or if a company has such an emissions target. With respect to Scope 3 emissions, the proposal also would exempt smaller reporting companies from this requirement, would afford companies a longer phase-in time, would provide for a safe harbor, and would not require attestation. The proposal also would include forward-looking statement safe harbors under the Private Securities Litigation Reform Act.

The next two sections of this report look in greater detail at some of the specific requirements that would be imposed under Regulation S-X and Regulation S-K regarding climate risk disclosures.

Regulation S-X amendments. The proposal would create a new Article 14 within Regulation S-X. A company would have to disclose contextual information about how each climate metric used was derived, including inputs and assumptions. Moreover, disclosure thresholds would help companies determine when certain disclosures are not required. For example, disclosure of the financial impact on a line item in a registrant's consolidated financial statements would not be required if the sum of the absolute values of all the impacts on the line item is less than one percent of the total line item for the relevant fiscal year. Likewise, disclosure of the aggregate amount of expenditure expensed or the aggregate amount of capitalized costs incurred is not required if the amount is less than one percent of the total expenditure expensed or total capitalized costs incurred, respectively, for the relevant fiscal year.

New Article 14 of Regulation S-X would otherwise require disclosures of:

- The impact of severe weather events and other natural conditions, such as flooding, drought, wildfires, extreme temperatures, and sea level rise on any relevant line items in the registrant's consolidated financial statements during the fiscal years presented.
- The impact of any efforts to reduce GHG emissions or otherwise mitigate exposure to transition risks on any relevant line items in the registrant's consolidated financial statements during the fiscal years presented.

- The aggregate amount of expenditure expensed and the aggregate amount of capitalized costs incurred during the fiscal years presented to mitigate the risks from severe weather events and other natural conditions, such as flooding, drought, wildfires, extreme temperatures, and sea level rise.
- The aggregate amount of expenditure expensed and the aggregate amount of capitalized costs incurred during the fiscal years presented to reduce GHG emissions or otherwise mitigate exposure to transition risks.
- Whether the estimates and assumptions the registrant used to produce the consolidated financial statements were impacted by exposures to risks and uncertainties associated with, or known impacts from, severe weather events and other natural conditions, such as flooding, drought, wildfires, extreme temperatures, and sea level rise.
- Whether the estimates and assumptions the registrant used to produce the consolidated financial statements were impacted by risks and uncertainties associated with, or known impacts from, a potential transition to a lower carbon economy or any climate-related targets disclosed by the registrant.
- The impact of any climate-related risks (separately by physical risks and transition risks), identified by the registrant pursuant, on any of the financial statement metrics disclosed pursuant to paragraphs (c) through (h) of proposed Rule 14-02, i.e., financial impacts of severe weather events and other natural conditions and financial estimates and assumptions impacted by transition activities, respectively.

Moreover, proposed Rule 14-02 would allow a registrant some discretion to make additional disclosures. Specifically, a registrant *may* also include the impact of any opportunities arising from severe weather events and other natural conditions (emphasis added).

Regulation S-K amendments. The proposal would add a new Item 1500, et. seq. to Regulation S-K. Items 1501 through 1506 would address a variety of issues, including board and management oversight of GHG emissions, business strategy, risk management, GHG emissions metrics, and attestation. The following discussion summarizes key provisions in the SEC's proposed climate risk regulation:

- ***Item 1501—***With respect to a company's board and management, the company must describe: (1) the board of director's oversight of climate-related risks; and (2) management's role in assessing and managing climate-related risks (a registrant may also describe management's role in assessing and managing climate-related opportunities).
- ***Item 1502—***For purposes of a company's strategy, business model, and outlook, a company would have to describe, among other things: (1) any climate-related risks reasonably likely to have a material impact on the registrant, including on its business or consolidated financial statements, which may manifest over the short, medium, and long term; and (2) the actual and potential impacts of any climate-related risks identified in response to the disclosure in item (1) on the registrant's strategy, business model, and outlook.
- ***Item 1503—***The proposal would require risk management disclosures, including a description of any processes the registrant has for identifying, assessing, and managing climate-related risks. If applicable, a registrant may also describe any processes for identifying, assessing, and managing climate-related opportunities when responding to any of the provisions in the proposed Item.
- ***Item 1504—***With respect to GHG emissions, the proposal would require disclosure of: (1) a registrant's GHG emissions for its most recently completed fiscal year, and for the historical fiscal years included in its consolidated financial statements in the filing, to the extent such historical GHG emissions data is reasonably available; (2) for each required disclosure of a registrant's Scopes 1, 2, and 3 emissions, disclosure of the emissions in both disaggregated and aggregate format; (3) disclosures of a registrant's Scopes 1, 2, and 3 emissions, must exclude the impact of any purchased or generated offsets; and (4) disclosure of a registrant's Scope 3 emissions must be separate from disclosure of its Scopes 1 and 2 emissions.
- ***Item 1505—***The proposal establishes a phased-in standard for the attestation engagement such that: (1) if a company must disclose its Scope 1 and Scope 2 emissions, and the company is either an accelerated filer or a large accelerated filer, then it must include an attestation report in the relevant filing;

and (2) the level of assurance required for the attestation engagement will vary depending on the length of time elapsed from the proposed regulation's compliance date such that: (a) for fiscal years 2 and 3, assurance must be at the limited assurance level; and (b) for the fourth and subsequent fiscal years, assurance must be at the reasonable assurance level. Moreover, the attestation report must be prepared and signed by a GHG emissions attestation provider that has: (1) expertise in GHG emissions; and (2) is independent from the registrant and the registrant's affiliates. Separate requirements would apply to voluntary attestation reports provided before the first required fiscal year for disclosure following the compliance date (e.g., among other things, identify the provider, the standard used, and the level and scope of attestation or verification provided).

- ***Item 1506—***Under the proposal, disclosure would be required regarding any targets or goals related to the reduction of GHG emissions, or any other climate-related target or goal such as actual or anticipated regulatory requirements, market constraints, or other goals established by a climate related treaty, law, regulation, policy, or organization. A company also must disclosure data about its use of any carbon offsets.

Commissioner remarks. SEC Chair Gary Gensler, perhaps anticipating a forthcoming critique that the proposal may go beyond the SEC's current authorities, emphasized the grand bargain struck nearly 90 years ago when Congress enacted the first federal securities laws. "Our core bargain from the 1930s is that investors get to decide which risks to take, as long as public companies provide full and fair disclosure and are truthful in those disclosures," said Gensler. "That principle applies equally to our environmental-related disclosures, which date back to the 1970s."

Gensler also spoke to the inclusion of Scope 3 emissions in the proposal, a topic that was an open question in the year leading up to today's action by the Commission. Said Gensler: "As the release notes, Scope 3 disclosure 'may be necessary to present investors a complete picture of the climate-related risks—particularly transition risks—that a registrant faces and how [greenhouse gas] emissions from sources in its value chain … may materially impact a registrant's business operations and associated financial performance.'"

Commissioner Peirce, who voted against the proposal, read a lengthy statement that, among other things, raised concerns about compelled speech under the First Amendment and questioned whether the SEC needed additional Congressional authority to issue climate risk regulations. Peirce also suggested that the TCFD standard is less commonly used by companies than the proposal may assume and, thus, the proposal may not achieve its economic cost goals by using standards with which market participants and investors are already familiar. With respect to Scope 3 emissions, Peirce said the SEC was attempting to recast the materiality standard.

Commissioner Lee called the proposal a "watershed moment" but suggested areas for public comment on the proposal. One area of concern for Lee is whether to impose across-the-board internal control over financial reporting (ICFR) requirements for emissions disclosures and, if not, where specifically to place such disclosure requirements in Regulations S-K and S-X, the latter regulation being where ICFR would be required. Lee also asked for public comment about whether limited assurance or reasonable assurance is the appropriate attestation standard. Lastly, Lee asked the public to tell the Commission if the proposal does enough to explain how companies should make disclosures about Scope 3 emissions.

Commissioner Caroline Crenshaw said the climate proposal is the result of what she has heard from industry and investors regarding their inability to grasp companies' climate risk and, thus, is an acknowledgement that "it's time to modernize and standardize."

Crenshaw also noted the rising number of companies that are making net-zero pledges. "Investors have noted that without more specific, standardized, and reliable disclosures, it will be difficult to assess and measure the progress companies make toward achieving what they have pledged," said Crenshaw. In a footnote to this remark, Crenshaw noted: "Today's release would require a company that has set a climate-related goal, such as emissions reduction, to disclose information about the target along with the unit of measurements, the defined time horizon, the baseline the target would be tracked against, and relevant data to indicate whether the registrant is making progress."

Congressional reaction. Representative Sean Casten (D-Ill), co-author of legislation that would largely codify portions of the SEC's climate risk disclosure proposal, issued a statement calling for mandatory climate disclosures. "For any climate disclosure rule to have teeth, it must fully mandate disclosure of 'Scope 3' emissions embedded in a company's supply chain—including emissions caused when customers use its products," said Casten. "I applaud the SEC for releasing this critical proposal and urge them to thoroughly evaluate feedback to ensure the strongest possible final rule that will empower investors to make smarter decisions and harness the power of the free market to help us win the race against the climate crisis before it's too late."

The Climate Risk Disclosure Act (S. 1217; H.R. 2570), sponsored by Sen. Elizabeth Warren (D-Mass) and Rep. Casten would address: (1) physical risks; (2) transition risks; (3) corporate governance processes and structures to identify, assess, and manage climate-related risks; (4) specific actions that the covered issuer is taking to mitigate identified risks; (5) the resilience of any strategy for addressing climate risks when differing climate scenarios are taken into consideration; and (6) how climate risk is incorporated into the overall risk management strategy of the covered issuer. The bill was previously reported on party lines by the House FSC July 16, 2019 by a vote of 34-25 and reported again by the House FSC on May 12, 2021 by a vote of 28-24. The bill also was included in Title IV of the Corporate Governance Improvement and Investor Protection Act (H.R. 1187), which passed the House on June 16, 2021 by a vote of 215-214. The bill also was included in Sections 851-853 of the Climate Leadership and Environmental Action for our Nation's (CLEAN) Future Act (H.R. 1512), sponsored by Rep. Frank Pallone (D-NJ).

While House Financial Services Committee Chair Maxine Waters (D-Calif) echoed Rep. Casten's remarks, House FSC Ranking Member Patrick McHenry (R-NC) called the proposal a regulatory "overreach" in an op-ed co-authored with former SEC Chair Jay Clayton that recently appeared in *The Wall Street Journal*.

In separate remarks following the issuance by the Commission of its climate risk proposal, McHenry reiterated his concern that the Commission was conducting an end run of Congress. "The Biden Administration is pushing its climate agenda through financial regulators because they don't have the votes to pass it in Congress," said McHenry. "The SEC's proposal to require disclosure of information related to climate change that is not material for most companies is tone-deaf and misguided."

The release is No. 33-11042.

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