

SEC proposes climate disclosure regime

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The long-expected but controversial proposal would require disclosure of climate-related risks, greenhouse gas emissions and climate-related financial metrics. If adopted, the proposal would represent the most far-reaching public company disclosure and governance mandate to be introduced in decades.

After a year of anticipation, on March 21 the SEC [proposed a sweeping climate disclosure regime](#) for public companies in a 3-1 vote with the sole Republican commissioner issuing a separate [dissenting statement](#). In the words of the majority, the proposed rules are designed to “provide registrants with a more standardized framework to communicate their assessments of climate-related risks as well as the measures they are taking to address those risks.” In the words of the dissent, the proposal “turns the disclosure regime on its head” and will harm investors, the economy and the SEC.

The proposal, which would apply to both domestic companies and foreign private issuers, aims to supersede, extend and regulate in prescriptive detail the largely voluntary disclosure practices that have grown organically over the last several years as many public companies have responded to demands from prominent institutional shareholders and climate advocates, and as part of companies’ own efforts to showcase their commitment to sustainability.

The proposal is likely to draw fire from organizations advocating on behalf of businesses who believe the SEC is exceeding its authority and imposing costs on companies not commensurate with benefits to investors, impairing capital formation. But companies themselves, who would directly bear the significant disclosure burden, may find it awkward to criticize the proposal publicly—even though it may represent the most significant augmentation of public-company reporting requirements in decades.

The proposal is open for public comment through at least May 20, 2022, and if adopted this year will apply to most public companies beginning with the 2023 annual report.

We plan to file a comment letter on the proposal and look forward to discussing our clients’ concerns.

The proposal

Disclosures required by the proposal would be included in periodic reports (Forms 10-K, 10-Q and 20-F) and registration statements (Forms S-1, S-3, F-1 and F-3). Disclosure would be required both outside the financial statements and within financial statement footnotes, although GAAP accounting rules would not be directly impacted.

- **Outside the financial statements.** The proposal would require companies to make extensive quantitative and qualitative disclosure of climate-related matters outside of the financial statements, including:
 - **Climate-related risks**, whether physical or transitional, reasonably likely to have a material impact over the short, medium and long term. Companies would also be required to disclose processes that are in place for identifying, assessing and managing climate-related risks.

Companies are able to define their own time horizons, and must describe the impact on the company's strategy, financial planning, capital allocation, business model and outlook. The disclosure is required to be both current and forward-looking, including a narrative discussion of likely effect on the financial statements and the resilience of the company's business strategy in light of potential future changes in climate-related risks.

Companies must weigh an extensive list of considerations in providing the risk-management disclosures, including the use of scenario analyses (for companies that conduct such analyses), and must discuss their internal processes for making these determinations.

- **Greenhouse gas (GHG) emissions** metrics for the fiscal years included in the financial statements in the filing (generally two or three years, depending on EGC status), including a description of the methodology, significant inputs and significant assumptions used to calculate GHG emissions. The disclosures cover emissions categorized as Scope 1 (a company's direct emissions), Scope 2 (emissions from the company's consumption of energy purchased from third parties) and, for all but smaller reporting companies, Scope 3 (emissions from a company's supply chain).
 - *Scope 1 and Scope 2 disclosure*—all companies would be required to disclose Scope 1 and Scope 2 emissions (exclusive of any purchased or generated offsets) on both a disaggregated and aggregated basis, to the extent such data is reasonably available.
 - *Scope 3 disclosure*—all companies except smaller reporting companies would be required to disclose Scope 3 emissions produced in the company's supply chain:
 - if material to the company and
 - whether or not material to the company, if the company has included Scope 3 emissions as part of a public GHG emissions reduction target or goal.

Scope 3 emissions may be reported as a range, so long as the reason for using the range and the underlying assumptions are disclosed. Each category of upstream or downstream activity that is included in the calculation of Scope 3 emissions would need to be described and, to the extent significant, separately disclosed. Companies providing Scope 3 information would also be required to identify the data sources used in compiling the disclosure.

Under the proposal, Scope 3 emissions disclosure would have the benefit of a safe harbor, and therefore be deemed not to be materially misleading, if the disclosure is not made or reaffirmed without a reasonable basis or disclosed other than in good faith.

- Although a safe harbor makes sense in concept given the difficulty of obtaining accurate Scope 3 emissions data from third parties, as a practical matter it is not necessarily clear what a company would need to do to ensure that it has a "reasonable basis" or has acted in "good faith." It is also not clear what a company's liability would be for inaccurate Scope 3 disclosures if its Scope 3 emissions are not material to it in the first place.
- **Attestation reports.** Accelerated filers and large accelerated filers would be required to include a third-party attestation report with respect to disclosure of Scope 1 and Scope 2 emissions data. The attestation would be at a "limited assurance" level beginning with the second fiscal year of reporting, and then rise to a "reasonable assurance" level beginning with the fourth fiscal year of reporting.

Providers of attestation reports must have significant experience in GHG emissions reporting and must be independent from the company.

- **Targets and goals** relating to GHG reduction or any other climate-related target that a company has set, including data to indicate progress made toward achieving the target, to be updated annually—along with specific disclosure on the use of carbon offsets and renewable energy credits, presumably to make it less attractive for companies to rely on these techniques for reducing their carbon footprint.
- **Climate-specific governance disclosure**, including the process by which the board exercises oversight and sets targets and goals, and the role of management in assessing and managing climate-related risks.

Similar to the SEC’s recent [cybersecurity proposal](#), the proposal would require identification of any director with expertise in climate-related risks—presumably in an effort to encourage companies to appoint board-level climate experts to sit alongside their new cybersecurity expert colleagues.

The proposal asks for detailed disclosure around the process followed by management and the board to assess and manage climate risks, not unlike guidance on board effectiveness and risk management issued by US banking regulators for the banking sector, and beyond what previously was customary in the SEC’s disclosure regime.

- In light of developing law under the *Caremark* line of cases, this prescriptive “best practice”-style disclosure may provide fodder for shareholder derivative lawsuits.
- **Financial statement footnote disclosure.** The proposal would require companies to disclose climate-related matters in the financial statement footnotes, including:
- **The financial impact of severe weather events and other natural conditions**, such as the impact of flooding, drought, wildfires, extreme temperatures and sea-level rise on any relevant line items in the financial statements.
 - Examples include changes to revenues or costs from disruptions to business operations or supply chains, and changes to reserves or impairment charges, associated with severe weather events.
 - **Expenditures to mitigate risks of severe weather events and natural conditions on business operations**, such as amounts incurred to relocate assets from areas at high risk from wildfires.
 - **The financial impact of transition activities**, such as efforts to reduce GHG emissions or otherwise mitigate exposure to transition risks on any relevant line items in the financial statements.
 - **Expenditures related to transition activities** to reduce GHG emissions or otherwise mitigate exposure to transition risks, such as amounts incurred to increase energy efficiency or to develop new technologies.
 - **Any impact on estimates and assumptions** as a result of severe weather events and other natural conditions or transition activities must be disclosed qualitatively.

These disclosures would be subject to highly detailed presentation requirements, including disaggregation of positive and negative impacts and a line-item breakout requirement triggered at an immaterial 1%. Whether or not the disclosure threshold is ultimately met, a company must at least undertake the analysis, which could be challenging to determine, especially as the proposal includes numerous examples that each need to be considered for impact.

Companies must also disclose climate-related risks (separately by physical risks and transition risks) and climate-related opportunities on any of the financial statement metrics.

- **Compliance phase-in.** The proposed disclosures would be phased in.

	Compliance date	
Registrant type	Disclosures other than Scope 3	Scope 3

<i>Large accelerated filers</i>	Beginning with the first full fiscal year following the effective date of the rules	Beginning with the second full fiscal year following the effective date of the rules
<i>Accelerated and non-accelerated filers</i>	Beginning with the second full fiscal year following the effective date of the rules	Beginning with the third full fiscal year following the effective date of the rules
<i>Smaller reporting companies</i>	Beginning with the third full fiscal year following the effective date of the rules	N/A

As a result, assuming the proposal is adopted in 2022, large accelerated filers would not be subject to the rules until filings made in 2024 that include 2023 financial statements.

Our takeaways

– Legal challenges are sure to follow adoption.

- **Challenges to the SEC’s statutory authority.** Nothing in the federal securities laws expressly authorizes the SEC to require the disclosures contemplated by the proposal. Instead, these laws generally permit the SEC to require disclosure that is “necessary or appropriate in the public interest or for the protection of investors.”

One of the SEC’s central arguments in support of its authority is that many investors—including certain large institutional investors—have expressed a desire to receive climate-related disclosure. However, public interest alone may not be enough to meet the statutory threshold, if a hypothetical “reasonable investor” would not find the required disclosure necessary for investment or voting purposes. This may also make it more difficult for the SEC to demonstrate that it has met its obligation to show that the benefits of the new requirements outweigh their costs.

This challenge is likely to be bolstered by the “major questions” doctrine, which provides that agency rules of major significance be the subject of a clear delegation of Congressional authority (and was relied on by the Supreme Court to nix the Biden Administration’s COVID-19 vaccine and eviction moratorium policies).

- **First Amendment challenges.** The proposal is also likely to be challenged as violating the First Amendment, by compelling speech. This topic has received close scrutiny by the Supreme Court in recent years in other cases involving corporate speech.

– Some companies may back away from announcing “net zero” and similar GHG targets.

- The proposal penalizes companies who have announced GHG targets. For example, a company with public climate targets or goals is required to disclose data regarding its progress towards achieving them. Perhaps more significantly, the disclosure burden is exacerbated if the company’s targets include Scope 3 emissions, as the company would then be required to disclose those emissions whether or not material.
- Although these increased disclosure burdens (and the attendant litigation and enforcement risks) may caution some companies against the wisdom of publicly announcing targets, other companies are likely to feel compelled to announce or maintain public goals due to their own climate objectives or stakeholder interests, or pressure from commercial counterparties who are themselves subject to climate activist influence. Indeed, the SEC may be counting on this sort of pressure to achieve its disclosure goals.

– In departing from longstanding principles of materiality, the proposal raises the question of how the SEC might use its authority to mandate disclosure on other hot-button environmental, social and governance topics.

- Scope 3 disclosures would be required for many companies regardless of materiality. Materiality has traditionally been core to the SEC’s disclosure philosophy, and the few instances where arguably immaterial information is

required (certain related party transactions and certain environmental proceedings) are fairly simple for companies to track and report.

As one of the approving commissioners stated, this rule is motivated by “clear and alarming science” about climate change, which is certainly important to society but less clearly relevant to purchasers of securities of public companies.

- By showing a willingness to impose the cost and complexity of reporting immaterial Scope 3 emissions data, the proposal may herald a new philosophy of mandating corporate disclosures designed to further societal goals beyond the financial concerns of the investing public, even where such disclosures could significantly impede capital formation.
- **The proposed rules are highly complex, and compliance costs are likely to be significant, which may impact the willingness of private companies to go public.**
- Although the proposal is modeled in large part on existing climate disclosure frameworks such as the Task Force on Climate-Related Financial Disclosure (TCFD), the proposal includes five pages of highly technical definitions and other provisions which may not necessarily correspond to the TCFD. Additionally, companies who have voluntarily disclosed under TCFD have typically done so with respect to certain matters only. As a result, a company that reports according to TCFD criteria would likely have to rework its approach or disclose significantly more climate-related information.
 - The proposal also does not include any incremental phase-in allowance for newly public companies, which could have the impact of discouraging or delaying plans of private companies to go public in the United States. In particular, foreign companies (who have in recent years flocked to the United States to raise capital) may be deterred from doing so in view of the burdens associated with the proposal.
 - Internal costs associated with the proposed rule will likely be significant due to the need to build in disclosure controls and create board, management and risk processes and procedures. Moreover, tracking and verifying the required data for Scope 1 and Scope 2 disclosures will require significant investments in talent and technology. In addition, professional expenses associated with required disclosures will likely be significant due to the third-party attestation report requirement, as well as the inclusion of climate-related disclosure in financial statements subject to audit review.

Not for nothing did Commissioner Peirce, in her dissent, exclaim “[*Score one for the climate industrial complex!*](#)”

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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