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FAQ: The SEC's Proposed Rule on the Enhancement and Standardization of Climate Related-Disclosures

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On March 21, 2022, the U.S. Securities and Exchange Commission (SEC) released its much-anticipated proposed rule titled "The Enhancement and Standardization of Climate-Related Disclosures for Investors." The proposed enhanced disclosure requirements draw from groups dedicated to developing effective climate-related disclosures, including the Task Force on Climate-Related Financial Disclosures and the Greenhouse Gas Protocol. SEC Chair Gary Gensler believes the enhanced disclosure requirements will provide consistent, comparable, and reliable climate-risk information to investors. Environmentally-focused investors appear to agree that the rule, if finalized, will provide much needed guidance, but not everyone is convinced.

Ready or not, the SEC's proposed rule may well be finalized this year and, if so, would begin applying to certain filings as soon as FY 2023. In this alert, we answer some commonly asked questions regarding disclosure requirements the proposed rule would add, the SEC's authority to require climate disclosures, and the potential impact of the disclosure requirements.

1. What disclosure requirements does the SEC's proposed rule add?

Charged with protecting investors and maintaining investor confidence, the SEC's existing regulatory framework requires that public companies, broker-dealers, and certain company insiders disclose "material" information, or information that a "reasonable shareholder" would likely consider important.[1]

In 2010, the SEC issued guidance on pertinent non-financial disclosure rules that required some disclosures related to climate change, including the disclosure of material effects of compliance with federal, state, and local provisions regulating the discharge of materials into the environment and environmental litigation. The SEC noted then that, depending on the facts and circumstances of a particular registrant, certain items *may* require disclosures regarding the impact of climate change.

The newly proposed rule clarifies that a registrant would be required to disclose the following:

How any climate-related risks identified by the registrant have had or are likely to have a material impact on its business and consolidated financial statements;

How any identified climate-related risks have affected or are likely to affect the registrant's strategy, business model, and outlook;

The registrant's processes for identifying, assessing, and managing climate-related risks and whether such processes are integrated into the registrant's overall risk management system or processes;

The impact of climate-related events (severe weather events and other natural conditions as well as physical risks identified by the registrant) and transition activities (including transition risks identified by the registrant) on the registrant's consolidated financial statements and related expenditures, in addition to the disclosure of financial estimates and assumptions impacted by such climate-related events and transition activities;

Scope 1 GHG emissions metrics, which include the direct emissions from the registrant's owned or controlled resources;

Scope 2 GHG emissions metrics, which include the indirect emissions from the generation of purchased electricity, steam, heating, and cooling consumed by the registrant;

Scope 3 GHG emissions and intensity metrics, which include any material value chain emissions that are the result of activities not owned or controlled by the reporting organization, or if the registrant has set a GHG emissions reduction target or goal that includes its Scope 3 emissions; and

Any material indirect emissions from upstream and downstream activities in a registrant's value chain.

Further, if the registrant has publicly set climate-related targets or goals, the registrant must disclose information about:

1. the scope of activities and emissions included in the target, including the timeframe by which the target is intended to be achieved;
2. how the registrant intends to meet its climate-related targets or goals;
3. relevant data to indicate whether the registrant is making progress toward meeting the targets or goals; and
4. information about carbon offsets or renewable energy certificates if they are used to achieve the climate-related targets or goals.

When responding to any of the proposed rules' provisions concerning governance, strategy, and risk management, a registrant may also disclose information concerning any identified climate-related opportunities. A registrant that qualifies as a "large accelerated filer" or "accelerated filer" will also be required to obtain a third-party attestation report on its Scope 1 and 2 emissions disclosures.

2. What is the SEC's authority to require climate disclosures?

Major legislation that provides the framework for the SEC's oversight of the securities markets includes the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Sarbanes-Oxley Act, the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the Jumpstart Our Business Startups Act. SEC Chair Gensler maintains that the proposed rule lies within the scope of the SEC's authority to regulate the information material to investors, while critics of the SEC's proposed rule, including SEC Commissioner Hester Peirce, argue that the rule exceeds the authority of SEC. Two of the most likely legal challenges to the proposed rule pertain to (a) the materiality standard and (b) the First Amendment.

Regarding **materiality**, in *TSC Industries v. Northway*[2], the Supreme Court explained that, under the Securities Exchange Act of 1934, information is only material to investors, and therefore requiring disclosure, if there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information available." Some law professors and scholars have noted that, while climate-related disclosures may be material to *some* investors, the disclosures may be completely irrelevant to others. This may lead companies to challenge the proposed rule as requiring immaterial disclosures.

As for the **First Amendment**, the Supreme Court has closely scrutinized disclosure requirements in several cases and has explained that there must be a substantial relationship between the government interest and the information required to be disclosed such that the strength of the government interest reflects the seriousness of the burden on First Amendment rights.[3] And so, certain law professors, among other critics of the proposed rule, have suggested that the government interest does not reflect the burden on First Amendment rights since the proposal is not limited to materials that interest all investors. It is therefore likely the SEC will face challenges on the basis of the registrants' First Amendment rights.

3. How might the disclosure requirements affect me/my company?

If adopted as proposed, public companies will have to present much more detailed disclosures regarding climate-related matters in their SEC filings, including in their financial statements. Many larger public companies have already been disclosing these matters, albeit perhaps not at the level of detail contemplated in the SEC's proposed rule. These larger companies should further refine their reporting processes and controls so that they are in a position to effectively compile and present the climate-related information in a manner subject to attestation by third parties. Smaller companies should also begin assessing their reporting processes as they relate to climate-related matters so the companies will be prepared to comply with the proposed new disclosure requirements. Form 10-K and proxy season is already a busy time for companies, and it looks like aggregating detailed, climate-related information could now be a substantial part of that busy season.

As far as timing is concerned, **Large Accelerated Filers** will have until FY 2023 (for their Form 10-K filed in 2024) to comply with all proposed disclosures, including Scope 1 and Scope 2 GHG emissions metrics and until FY 2024 (for their Form 10-K filed in 2025) to comply with Scope 3 metrics. **Accelerated Filers and Non-Accelerated Filers** will have until FY 2024 (for their Form 10-K filed in 2025) to comply with all proposed disclosures including Scope 1 and Scope 2 GHG emission metrics and until FY 2025 (for their Form 10-K filed in 2026) to comply with Scope 3 metrics. **Smaller Reporting Companies** will have until FY 2025 (for their Form 10-K filed in 2026) to comply with all proposed disclosures including Scope 1 and Scope 2 GHG emission metrics and are exempt from complying with Scope 3 requirements. There is also a transition period for the attestation requirements. **Large Accelerated Filers** and **Accelerated Filers** will have to provide third-party attestation at a limited assurance level for fiscal years 2 and 3 after the Scope 1 and Scope 2 GHG emissions compliance date and at a reasonable assurance level for fiscal years 4 and beyond after the Scope 1 and Scope 2 GHG emissions compliance date.

With extensive Corporate Governance and Securities Litigation & Enforcement experience, Baker Donelson has the tools to help clients navigate potential challenges posed by the SEC's proposed rule. If you have questions or need assistance, please contact one of the authors or any member of Baker Donelson's Securities Team or Government Enforcement and Investigations Team.

[1] *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[2] 426 U.S. at 448.

[3] *See*, *e.g.*, *Nat'l Ass'n of Mfrs. v. Taylor,* 582 F.3d 1, 9 (D.C. Cir. 2009).