# SEC Climate-Related Disclosures Proposal: Transparency or Regulatory Burden?

## Part 2 of 3

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This is the second part of a three-part publication regarding the SEC's proposed climate-related rules and disclosures. Part 1 can be found here.

As described in Part 1 of this series, the proposal includes climate-related disclosures in Regulation S-K and Regulation S-X under the rationale that the required disclosure is fundamental to investors' understanding of the nature of a registrant's business and its operational prospects as well as financial performance and, therefore, should be presented together with other disclosure of the registrant's business and financial condition.

Registrants will be required to include climate-related disclosures in their Securities Act or Exchange Act registration statements and Exchange Act annual reports in a separately captioned "Climate-Related Disclosure" section and in the financial statements.

This article highlights some of the surprising elements of the SEC's proposal, including the affirmative disclosure of a company's estimated greenhouse gas (GHG) emissions, which is typically under the jurisdiction of the Environmental Protection Agency (EPA) and the expectations for management oversight of the fairly extensive proposed climate-related risk management disclosures, over the short-, medium- and long-term, is a challenging exercise for even the most scientifically-minded executives.

### Proposed Governance Disclosures

The following disclosures are proposed with respect to the registrant's governance:

- Identification of any Board members or Board committees responsible for the oversight of climate-related risks, including establishment of a dedicated Board committee or identification of members from an audit or risk committee. Also, required disclosure of whether any Board member has expertise in climate-related risks.

- Method of informing the Board about climate-related risks and the frequency of consideration of 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.

- 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.

Management's oversight role on climate-related risks includes the following proposed disclosures:

- Whether certain management or management committees are responsible for assessing and managing climate-related risks, including their expertise to do so.

- Processes by which the responsible managers or management committees are informed about and monitor climate-related risks.

- Whether responsible positions or committees report to the Board or Board committee on climate-related risks and how frequently this occurs.

### Proposed Risk Management Disclosure

A central focus of the SEC's proposed rules is the identification and disclosure of a registrant's material climate-related risks defined as any climate-related risks reasonably likely to have a material impact on the registrant's business or consolidated financial statements.

The definition of materiality in this context would be consistent with Supreme Court precedent and include the likelihood that a reasonable investor would consider it important when determining whether to buy or sell securities or how to vote their shares.

Registrants would be required to distinguish identified material climate-related risks as either physical risks (and further classified as "acute risks" or "chronic risks") or transition risks and disclose their actions to mitigate or plan to adapt to the risk.

Other risk management proposed disclosures would include:

- **Materiality Assessment Across Various Time Periods** – The proposed required risk disclosures would require the registrant to assess the materiality (included in business and financial statements) over short-, medium- and long-term. The description is expected to include the definition of the various time horizons and detail the impact and the probability of the risk over the various time horizons.

- **Use of Internal Carbon Price** – If a registrant uses their own internal carbon price in their risk analysis, certain properties regarding the determination of that price would be required. However, the proposed guidelines recognize that a robust carbon market does not currently exist and, therefore, disclosure of a carbon price is only required when a registrant has used their own model-driven carbon price.

- **Disclosure of Scenario Analysis** – Registrants would be expected to provide disclosures about any scenario analysis they perform from both a quantitative and qualitative perspective. The quantitative disclosure would include a description of the analytical tools used to assess climate-related risks on business and consolidated financial statements and to support the resiliency of the strategy and business model. The qualitative disclosures would include the assumptions incorporated into the climate-related models to provide investors with more context for the analysis and results.

- **Safe Harbor** – Due to the difficulty in forecasting climate-related risks, a safe harbor for forward looking statement disclosures pursuant to the Private Securities Litigation Reform Act (PSLRA) would apply (assuming conditions for safe harbor are met). Climate-related disclosures would be required in registration statements for IPOs and excluded from the aforementioned protections.

### GHG Emissions Metrics Disclosure

The GHG Protocol would govern the disclosures required for greenhouse gas emissions. The proposed guidelines require registrants to disclose their Scope 1 and Scope 2 emissions, both by disaggregated constituent greenhouse gases and in the aggregate, in the industry standard format in terms of metric tons of carbon dioxide. Registrants would also be required to provide their disclosures in terms of intensity, such as their emissions as a ratio of total revenue. All registrants, regardless of size, would be required to provide these disclosures, although the timelines for disclosure are more extended for smaller reporting companies.

Although the reporting of these emissions seems straightforward on the surface, a prudent company would need internal controls over a mechanism for collecting, analyzing and reviewing this information and the systems infrastructure to accomplish this task. For many companies, this would involve internal departments not typically accustomed to sharing data with one another and a reliance on external data in the case of leased facilities or office space. While the required disclosures do not include a discussion of internal controls, the notion that a company would seek to obtain any level of attestation over figures not subject to robust internal controls is surprising.

The more complex Scope 3 emissions would be required to be disclosed by accelerated and large accelerated registrants, if material or if the registrant has set GHG emissions reduction goals or targets that include Scope 3 emissions. Scope 3 emissions refer to all other indirect emissions (both upstream and downstream activities in the value chain) not included in Scope 2 emissions. The proposed rule defines the “value chain” as upstream and downstream activities related to a registrant’s operations. Upstream activities include activities by a party other than the registrant that relate to the initial stages of a registrant’s production of a good or service (e.g., materials sourcing, materials processing and supplier activities). Downstream activities are defined to include activities by a party other than the registrant that relate to processing materials into a finished product and delivering it or providing a service to the end user (e.g., transportation and distribution, processing of sold products, use of sold products, end-of-life treatment of sold products and investments).

Due to the complexity associated with the determination of Scope 3 emissions, the Scope 3 emissions disclosure would be subject to a safe harbor.

The proposed rules provide an exclusion from more complex Scope 3 emissions disclosures for smaller reporting companies (SRCs) as described earlier in this series.

At this point, the SEC is not requiring GHG emissions attestation providers' assurance of the effectiveness of controls over GHG disclosures. The SEC is also not requiring that management include a statement in their annual report about the design and evaluation of controls over GHG emissions disclosures and a conclusion of the effectiveness of such controls.

The rationale for this approach is likely to provide companies with some time and latitude to develop a set of internal controls that are appropriate given their particular set of circumstances. However, a reasonable investor might question the usefulness of disclosures not subject to robust internal controls, in addition to the questionable point of seeking assurance from emissions attest service providers for data not carefully compiled and analyzed by management.

## Renewable Energy Certificates and Offsets

Reporting companies would be required to disclose the use of renewable energy certificates (RECs) and offsets (such as investment in a reforestation project) which may be used to mitigate a company’s carbon footprint during the transition phase. General industry practice is to strive to mitigate emissions to the extent possible and then seek to offset those emissions through the purchase of RECs and offsets.

The SEC included a surprising comment in this section that a registrant that offsets some of its emissions through the use of a reforestation project investment would then be subject to monitoring the long-term viability of that reforestation project and, potentially, writing it down and replacing it at a later date if it suffers future damage. If this process were in place, it would defeat the purpose of providing private capital to public lands susceptible to adverse impacts from climate change, defeating the spirit of many offset projects in the first place.

We expect the generally accepted practices for measuring and monitoring RECs and offsets and for handling complex topics, such as the impact of remote work, to continue to evolve through the comment period of both the SEC’s and International Sustainability Standard Board’s proposals.

## Contact Us

We continue to monitor the potential implications of the quickly evolving climate risk and carbon measurement disclosures required by global regulatory entities, including the SEC.

If you have any questions about this article, please contact your client engagement partner or:

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