<u>MCG Talks ESG – Part 3: "The SEC's Climate-Related Proposed Rules are Here. Now What?"</u>

Admittedly it has been a bit longer than anticipated between the first two installments of the "MCG Talks ESG" series that were issued last fall and this third installment discussing the SEC's recently proposed rules on climate disclosures. The SEC's actions in early 2021 indicated an aggressive focus on addressing climate disclosure issues, including the SEC's hiring a Senior Policy Advisor for Climate and ESG and directing the Division of Corporation Finance to focus on climate disclosures in company filings. A number of practitioners (including us) expected proposed rules before the end of 2021, but it is easy to see why the 534-page proposal that was issued on March 21, 2022 took the SEC a bit longer to publish – the proposed rules cover everything from oversight of climate-related risks to mandatory disclosure of greenhouse gas (GHG) emissions to climate-related financial metrics. Although the SEC's issuance of the proposed rules was only the second most exciting thing to happen last week[1], this installment of the "MCG Talks ESG" series will highlight the most significant proposed rules and suggest how you might start preparing for the final rules.

<u>It feels like everyone has been talking about the SEC's climate rules forever. Can you remind us how we even got here?</u>

Public companies have to look all the way back to 2010 for guidance from the SEC related to their existing disclosure requirements as they apply to climate matters. In response to increasing pressure from environmental activists, institutional investors and other stakeholders, the SEC published interpretive guidance clarifying that companies were required to make climate disclosures in their SEC filings under Regulation S-K, particularly in the description of the business, discussion of legal proceedings, risk factors, and MD&A sections, if the effects of climate-related regulations, legislation and business trends, as well as the physical effects of climate change, could have a material effect on the company's business. However, the impact of this 2010 guidance was limited, as the SEC staff reported to Congress in 2012 that there had not been any notable changes in climate-related disclosures since the guidance was issued.[2] A study conducted by a non-profit organization in 2014 found that most climate-related disclosures were "very brief, provide little discussion of material issues, and do not quantify impacts or risks."[3] The SEC proposing release notes that the staff "has observed significant inconsistency in the depth and specificity of disclosures by registrants across industries and within the same industry."[4] Furthermore, since 2010, public companies have faced increasing pressure to take action in the areas of corporate social responsibility and sustainability and, in turn, the SEC has faced increasing pressure to adopt rules requiring public companies to include climate-related information in their filings.

In addition to the actions taken in early 2021 mentioned above, the SEC requested public comment on potential climate disclosures in March 2021. The SEC asked 15 multi-part questions addressing such topics as the potential content of disclosure, the feasibility of quantification of climate

[1] Of course, I'm referring to what Entertainment Insider is calling "one of the most shocking moments in award season history," when, during Sunday's broadcast of the 2022 Oscars, Will Smith walked on stage and smacked presenter Chris Rock in the face for making a joke about Smith's wife.
[2] United States Government Accountability Office Report to Congressional Requests, "Climate-Related Risks: SEC Has Taken Steps to Clarify Disclosure Requirements," February 2018.
[3] Ceres, "Cool Response: The SEC & Corporate Climate Change Reporting (SEC Climate Guidance & S&P 500 Reporting – 2010 to 2013)," February 2014.
[4] SEC Proposing Release No. 33-11042, "The Enhancement and Standardization of Climate-Related Disclosures for Investors," March 21, 2022.

risks, and the benefits of establishing industry-specific requirements. One of the topics most heavily-commented on was whether and to what extent the SEC should draw on existing voluntary reporting frameworks when developing its rules. SEC Chair Gensler directed the staff to draw on the recommendations made by the Task Force on Climate-related Financial Disclosures (TCFD), an approach advocated in many of the comment letters received by the SEC in early 2021, including those from BlackRock, Chevron, Walmart and Uber. The SEC proposing release states that, because the TCFD framework "has been widely accepted by issuers, investors, and other market participants," the SEC chose to base the proposed rules on the TCFD framework in order to elicit better disclosure but also limit compliance costs. The TCFD initially published disclosure recommendations in 2017 that are designed to help a company evaluate material climate-related risks and opportunities by assessing their financial impacts on the company, and the framework is based on the four core themes of governance, strategy, risk management, and metrics and targets. According to the SEC proposing release, the TCFD is supported by more than 2,600 organizations, 1,069 financial institutions and a number of countries around the world and, therefore, seemed like a logical choice for a source of well-developed "concepts and vocabulary."

The proposed rules also incorporate the Greenhouse Gas Protocol (GHG Protocol), which many commenters argued was the most widely-used global GHG accounting standard. The GHG Protocol's Corporate Accounting and Reporting Standard provides methods to measure and report the seven GHGs covered by the Kyoto Protocol, and this standard is actually the source of the concept of "scopes" of emissions. Scope 1 emissions are direct GHG emissions that occur from sources owned or controlled by the company, Scope 2 emissions result from the generation of electricity purchased and consumed by the company, and Scope 3 emissions are all other indirect emissions that are a consequence of the company's activities. Examples of Scope 3 emissions are those associated with a company's production and transportation of goods purchased from third parties, employee commuting or business travel, and the use of the company's products by third parties. The SEC's proposing release indicates that the SEC was attempting to reduce the burden of compliance by basing their disclosure requirements on an "established GHG emissions reporting framework."

<u>I'm not going to read the 534-page proposing release. What do I need to know?</u>

The SEC's reasoning for adopting the climate disclosure rules are two-fold: (i) to provide investors with "more consistent, comparable, and reliable information" about how a company is addressing climate-related risks in order to inform investors' decision-making and (ii) to help issuers wade through the plethora of disclosure frameworks and provide a "more standardized framework to communicate their assessments of climate-related risks as well as the measures they are taking to address those risks." The proposed rules would add a new Subpart 1500 to Regulation S-K requiring companies to disclose, under a separately captioned section of its registration statement or Form 10-K, the following information:

- Oversight and governance of climate-related risks by the board and management, including details on how they engage in setting climate-related targets and climate-related expertise on the board of directors
- How any climate-related risks have had or are likely to have a material impact on their business and financial statements, whether over the short-, medium-, or long-term
- How any climate-related risks have affected or are likely to affect their strategy, business model and outlook, including how identified impacts are considered as part of the strategy
- The process for identifying, assessing and managing climate-related risks and whether such processes are integrated into the overall risk management system

- Scopes 1 and 2 GHG emissions, separately disclosed, expressed both by disaggregated GHGs and in the aggregate, and in absolute and intensity terms
- Scope 3 GHG emissions and intensity, if material, or if the company has set a GHG emissions reduction target that includes Scope 3 emissions
- Any climate-related targets, goals or transition plans, including the baseline year and progress
- Any analytical tools used to assess the impact of climate-related risks on the business (e.g., scenario analysis)

The rules would also add a new article to Regulation S-X requiring disclosure of the impact of climate-related events (i.e., severe weather events) and transition activities (i.e., actions taken to prepare for a transition to a lower carbon economy) on the line items of the consolidated financial statements and disclosure of financial estimates and assumptions impacted by such events and activities, all of which would appear in a note to the financial statements. The financial statement metrics would be subject to audit by the independent registered public accounting firm and come within the scope of the company's internal control over financial reporting. All of the new quantitative and qualitative information required by Regulations S-K and S-X would be electronically tagged using Inline XBRL, and this information would be filed instead of furnished with the SEC.

Anyone can submit a comment to the SEC on the proposed rules, and the proposing release contains over 200 requests for comment. The comment period is open until May 20, 2022, but it is not clear if the final rules will be adopted in 2022. Even if the rules are finalized in 2022, there is a phase-in period for all registrants, with the compliance dates depending on the company's filer status. Assuming the rules become effective in December 2022 and the filer has a December 31st fiscal year-end, the following disclosure deadlines will apply:

Registrant Type	**Disclosure Compliance Date**	
	All proposed disclosures, including Scopes 1 and 2 emissions, but excluding Scope 3	*Scope 3 emissions*
Large Accelerated Filer	FY 2023 (filed in 2024)	FY 2024 (filed in 2025)
Accelerated and Non-accelerated Filer	FY 2024 (filed in 2025)	FY 2025 (filed in 2026)
Smaller Reporting Company	FY 2025 (filed in 2026)	Exempted

There is also a phase-in period for the Scopes 1 and 2 assurance requirement and the level of assurance required. Large accelerated filers would be required to provide limited assurance for FY 2024 and reasonable assurance for FY 2026 and accelerated filers would be required to provide limited assurance for FY 2025 and reasonable assurance for FY 2027 (again, based on final rules becoming effective in December 2022 and assuming a December 31st fiscal year-end).

Which aspects of the proposed rules might not be adopted and which should I go ahead and prepare for?

Practitioners are conceding that the proposed rules likely will be subject to intense debate and extensive legal challenges, with Commissioner Hester Peirce's detailed dissent (titled "We Are Not the Securities and Environment Commission – At Least Not Yet") providing a clear roadmap for the forthcoming attacks. Commissioner Peirce identifies and discusses a number of criticisms, including that the existing rules already require disclosure of material climate risks, the proposed rules dispense with the longstanding "materiality qualifier," the SEC lacks authority to propose the rules, and the SEC underestimates the costs of the proposed rules. One of the most contentious aspects of the rules is likely to be the requirement to disclose Scope 3 GHG emissions, which information might be difficult for companies to obtain given that it will need to come from upstream suppliers, downstream customers and various other third parties. Commissioner Peirce's dissent argues that some companies' customers and suppliers may not even track this information and most companies will have to hire a third-party consultant to help them with the calculations. The proposed rules include a safe harbor covering the Scope 3 emissions statements unless they were "made or reaffirmed without a reasonable basis or disclosed other than in good faith," but companies might not want to include this information in their SEC filings in the first place. Additionally, larger companies are likely going to push back on the requirement that their Scopes 1 and 2 GHG emissions disclosures be subject to an attestation report provided by an independent third party. Commissioner Peirce's dissent notes that these attestation reports are likely to be expensive, with auditing firms "likely to be the biggest winners…reminiscent of the [wins] given them by Section 404(b) of the Sarbanes-Oxley Act." While it is likely that some form of Scopes 1 and 2 emission disclosures will be included in the final rules, we would not recommend that a company rush to begin calculating its Scope 3 emissions data if it does not already do so or hire a third-party attestation firm before the rules are finalized.

On the other end of the spectrum are what are likely the least controversial aspects of the proposed rules – the new discussions regarding climate-related risks, including how they are managed and how they affect the company's business. As discussed previously, these required disclosures are based on the TCFD recommendations, and there appears to be wide support among both investors and companies for this framework. Given that the TCFD's recommendations have been adopted by and incorporated into other frameworks such as the Carbon Disclosure Project, the Global Reporting Initiative, and the Sustainability Accounting Standards Board, and that the TCFD framework is the starting point for the International Sustainability Standards Board consolidation project, it's clear that the TCFD isn't going anywhere. We would recommend that your company consider TCFD's recommended disclosures if you haven't done so already, and if you make some but not all of the disclosures, maybe you should consider progressing on the others. The fourth installment of our "MCG Talks ESG" series will discuss the basics of TCFD reporting, including practical steps for getting started and sample disclosures made by other companies.