The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 29, NO. 8 • AUGUST 2022

SEC Proposes Climate Disclosure Rules (Part 1)

By Athena Eastwood, Denis A. (Archie) Fallon, Elizabeth P. Gray, Robert B. Stebbins, William J. Stellmach, and William L. Thomas

On March 22, 2022, the Securities and Exchange Commission (SEC or Commission) voted 3-1 to propose rules requiring registrants to provide additional climate-related information in their registration statements and annual reports, including in their financial statements.[1] The Proposing Release provides that disclosure of this information would provide consistent, comparable, and reliable information to investors to help them make judgments about the impact of climate risks on current and potential investments.[2] The proposed amendments are modeled in large part on the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD)[3] and the Greenhouse Gas Protocol.[4]

The Proposing Release provides that the proposed amendments set forth therein would supplement (rather than replace) the disclosures already required in SEC filings and that registrants should thus continue to assess whether disclosure of climate risks is still required in MD&A, Description of Business, Risk Factors or Legal Proceedings as per exiting guidance.[5]

Discussion of Proposed Amendments

Our article is presented in two parts. The Proposing Release sets forth proposed rules dealing with (i) Climate-Related Disclosure, (ii) Climate-Related Impacts, (iii) Governance, (iv) Risk Management, and (v) Financial Statement Metrics. We discuss each of these matters in this Part 1. Part 2, which will appear in an upcoming issue of *The Investment Lawyer*, will discuss the following additional items set forth in the Proposing Release: (i) GHG Emissions, (ii) Attestation of Scope 1 and Scope 2 Emissions Disclosures, and (iii) Targets and Goals. Part 2 also will discuss the dissenting statement by Commissioner Hester Peirce, and certain important takeaways.

Climate-Related Disclosure

General

The proposed climate-related disclosures described below would apply to a registrant with Exchange Act reporting obligations pursuant to Section 13(a) or Section 15(d) and companies filing a Securities Act or Exchange Act registration statement. Thus, the climate-related disclosures and the proposed financial statement metrics would be required in Securities Act or Exchange Act registration statements and Exchange Act annual reports. The proposed rules also would require registrants to disclose any material change to the climate-related disclosure provided in a registration statement or annual report in its Form 10-Q.[6]

The climate-related disclosures would be required to be included in such statements and reports in a separately captioned "Climate-Related Disclosure" section and in the financial statements.[7] A registrant would be able to incorporate by reference disclosure from other parts of the registration statement or annual report and, in most cases, from other filed or submitted reports into the "Climate-Related Disclosure" section.[8]

Disclosure of Risks

The proposed rules would require a registrant to disclose any climate-related risks reasonably likely to have a material impact on the registrant, including on its business or consolidated financial statements, which may arise over the short, medium and long term. "Climate-related risks" mean the actual or potential negative impacts of climate-related conditions and events on a registrant's operations, financial statements or value chains, as a whole. "Value chain" means the upstream and downstream activities related to a registrant's operations, with "upstream activities" defined to include activities by a third party that relate to the initial stages of production and "downstream activities" defined to include activities by a third party that relate to processing material into a finished product and delivery of a good or service to the end user.[9] Thus, as defined, climate-related risks extend beyond a registrant's own operations to those of its suppliers and distributors.

As to determinations of materiality, the Proposing Release provides that when assessing the materiality of a particular risk, management should consider the magnitude and probability of the risk over the short, medium, and long term.[10]

The proposed rules would require a registrant to specify whether an identified climate-related risk is a physical or transition risk and the registrant's plan to mitigate the risk. If a physical risk, the proposed rules would require a registrant to describe the nature of the risk, including whether it is as an acute or a chronic risk.[11] If an identified physical risk is likely to have a material impact on the registrant's business or financial statements, the registrant would be required to include in its description the location (by zip code or, if not available, by postal zone or geographic location) of the properties, processes, or operations subject to the physical risk.[12]

For example, if flooding presents a material physical risk, the proposed rules would require a registrant to disclose the percentage of buildings, plants, or properties that are located in flood hazard areas, and their location.

The proposed rules would also require a registrant to describe the nature of transition risks, including whether they relate to regulatory, market, technological, or other transition-related factors, and how those factors impact the registrant.[13]

A registrant is also permitted but not required to disclose information about any "climate-related opportunities" it may be pursuing. "Climate-related opportunities" are defined as the actual or potential positive impacts of climate-related conditions and events on the registrant's financial statements, business operations, or value chains, as a whole.[14]

Climate-Related Impacts

Material Impacts

Once a registrant has described the climate-related risks reasonably likely to have a material impact on the registrant's business or financial statements as manifested over the short, medium, and long term (as described above), the proposed rules would require the registrant to describe the actual and potential impacts (and the time horizon for each) of those risks on its strategy, business model, and outlook.[15]

The proposed rules would require a registrant to discuss how it has considered the impacts as part of its business strategy and capital allocation. The discussion also must include how any of the climate-related financial statement metrics discussed below or any of the climate-related targets or goals discussed below relate to the registrant's business model or business strategy.[16]

A registrant also would be required to disclose the material impacts of physical risks on its strategy, business model, and outlook. The proposed rules would require a registrant to provide a narrative discussion of whether and how any of its identified climate-related risks have affected or are reasonably likely to affect the registrant's consolidated financial statements.[17]

Carbon Offsets or Renewable Credits

If, as part of its net emissions reduction strategy, a registrant uses carbon offsets or renewable energy credits (RECs), the proposed rules would require it to disclose the role that carbon offsets or RECs play in the registrant's climate-related business strategy.[18] Also, a registrant that purchases offsets or RECs to meet its goals as it makes the transition to lower-carbon products would need to reflect this additional set of short-term and long-term costs and risks in its disclosure.[19]

Internal Carbon Price

Registrants may choose to use an internal carbon price when quantifying and assessing the financial impacts of climate-related risks and climate-related opportunities.

If a registrant uses an internal carbon price when assessing climate-related factors, the proposed rules would require it to disclose (1) the price in units per metric ton of carbon dioxide equivalent, (2) the total price, (3) the boundaries for measurement of overall carbon dioxide equivalent on which the total price is based, and (4) the rationale for selecting the internal carbon price applied.[20] A registrant would also be required to describe how it uses its disclosed internal carbon price to evaluate and manage climate-related risks.[21]

Scenario Analysis

A registrant would be required to describe any analytical tools, such as scenario analysis, that the registrant uses to (1) assess the impact of climate-related risks on its business and financial statements, or (2) support the resilience of its strategy and business model in light of foreseeable climate-related risks.[22] If a registrant uses scenario analysis, the proposed rules would require disclosure of the scenarios considered (including parameters, assumptions, and analytical choices), and the projected principal financial impacts on the registrant's business strategy under each scenario.[23]

Governance

Board Oversight

The proposed rules would require disclosure of (1) any board members or board committees responsible for the oversight of climate-related risks, (2) whether any board member has expertise in climate-related risks, (3) the processes and frequency by which the board discusses these risks, (4) how the board considers these risks as part of its business strategy, risk management and financial oversight, and (5) how the board sets climate-related targets or goals and oversees progress against those targets or goals.[24]

Management Oversight

The proposed rules would require disclosure of (1) the management positions or committees responsible for assessing and managing climate-related risks, (2) the relevant expertise of the position holders or committee members, and (3) the processes by which these position holders or committee members are informed about and monitor climate-related risks, and how frequently they report to the board about these risks.[25]

Risk Management

Identifying, Assessing, and Managing Climate-Related Risks

The proposed rules would require disclosure of any processes a registrant has for identifying, assessing, and managing climate-related risks.

When describing these processes, a registrant would be required to disclose: (1) how it determines the relative significance of climate-related risks compared to other risks, (2) how it considers existing or likely regulatory requirements or policies when identifying climate-related risks, (3) how it considers shifts in customer or counterparty preferences, technological changes, or changes in market prices in assessing potential transition risks, and (4) how it determines the materiality of climate-related risks, including the potential size and scope of any identified climate-related risk.[26]

A registrant would be required to disclose (1) how it decides whether to mitigate, accept, or adapt to any such climate-related risk, (2) how it prioritizes addressing climate-related risks, and (3) how it mitigates a high priority climate-related risk.[27]

The proposed rules would also require a registrant to disclose whether and how climate-related risks are integrated into the registrant's overall risk management processes, including how any separate committee addressing these risks interacts with the risk committee of the board or management.[28]

If a registrant has adopted a transition plan[29] as part of its climate-related risk management strategy, the proposed rules would require the registrant to describe its plan, including the metrics used to manage physical and transition risks.[30] In addition, the registrant would be required to describe (1) how it plans to mitigate or adapt to any physical risks identified in its SEC filings, and (2) how it plans to mitigate or adapt to any identified transition risks.[31] Further, the registrant would also be required to update its transition plan disclosure each year by describing the actions taken during the past year to achieve the plan's goals.[32]

Financial Statement Metrics

General

A registrant that is required pursuant to Regulation S-K to include a Climate-Related Disclosure section in a form that also includes audited financial statements, would be required to disclose in a note to these financial statements certain disaggregated climate-related financial statement metrics that generally are derived from existing financial statement line items. In particular, the proposed rules would require disclosure of "financial impact metrics," "expenditure metrics," and "financial estimates and assumptions." For each metric, the proposed rules would require a registrant to disclose contextual information to enable a reader to understand how it derived the metric (including a description of significant inputs and assumptions used and any policy decisions made to calculate the metric).[33]

A registrant would be required to calculate the metrics using financial information that is consistent with the scope of the rest of the registrant's consolidated financial statements included in the filing. Therefore, a registrant would have to include in any such calculation information from consolidated subsidiaries and would have to apply the same set of accounting principles that it is required to apply in preparation of the remainder of the financial statements included in the filing.[34] Disclosure would be required to be provided for the registrant's most recently completed fiscal year and for the historical fiscal years included in the financial statements in the filing, subject to exceptions for historical periods for information not known or reasonably available to the registrant.[35]

For example, a registrant that is required to include balance sheets as of the end of its two most recent fiscal years and income statements and cash flow statements at the end of its three most recent fiscal years would be required to disclose two years of the climate-related metrics that correspond to balance sheet line items and three years of the climate-related metrics that correspond to income statement or cash flow statement line items.[36]

Financial Impact Metrics

The SEC is proposing to amend Regulation S-X to require a registrant to include disaggregated information about the impact of climate-related conditions and events, and transition activities, on the consolidated financial statements included in the applicable filing. The proposed rules would require a registrant to disclose the financial impacts of severe weather events, other natural conditions, transition activities, and identified climate-related risks on the financial statements included in the relevant filing unless the aggregated impact of severe weather events, other natural conditions, transition activities, and identified climate-related risks is less than one percent of the total line item for the relevant fiscal year.[37]

A registrant would be required to determine the impacts of severe weather events, other natural conditions, transition activities, and identified climate-related risks on each financial statement line item. Within each category, impacts would be required to be disclosed on an aggregated, line-by-line basis for all negative impacts and, separately, on an aggregated, line-by-line basis for all positive impacts. However, for purposes of determining whether the disclosure threshold has been met, a registrant would be required to aggregate the value of the positive and negative impacts on a line-by-line basis.[38]

Expenditure Metrics

The proposed expenditure metrics refer to the positive and negative impacts associated with the same climate-related events, transition activities, and identified climate-related risks as the proposed financial impact metrics discussed above. The proposed expenditure metrics would require a registrant to separately aggregate amounts of (1) expenditure expensed and (2) capitalized costs incurred during the fiscal years presented.[39] The proposed expenditure metrics would be subject to the same disclosure threshold as the financial impact metrics.[40]

Financial Estimates and Assumptions

The proposed rules would require a registrant to disclose whether the estimates and assumptions used to produce the financial statements were impacted by exposures to risks and uncertainties associated with, or known impacts from, climate-related events. If so, the registrant would be required to provide a qualitative description of how such events have impacted the development of the estimates and assumptions used by the registrant in the preparation of the financial statements.[41]

Inclusion of Climate-Related Metrics

The proposed financial statement metrics would be required in the financial statements. Therefore, such metrics would be (1) included in the scope of any required audit of the financial statements, (2) subject to audit by an independent registered public accounting firm, and (3) within the scope of the registrant's internal control over financial reporting (ICFR).[42]

Ms. Eastwood is a partner in the Corporate & Financial Services Department at Willkie Farr & Gallagher LLP in Washington, DC. **Mr. Fallon** is a partner in Willkie Farr & Gallagher LLP's Corporate & Financial Services Department and Co-Chair of the firm's Power & Renewable Energy, Environmental, Social & Governance and Project Finance practice groups in Houston. **Ms. Gray** is a partner in the Litigation Department and Co-Chair of the Securities Enforcement Practice Group in Washington, DC. **Mr. Stebbins** is a partner in the Corporate & Financial Services Department and Co-Chair of Willkie Farr & Gallagher LLP's Corporate Governance practice in New York. **Mr. Stellmach** is a litigation partner and co-chair of Willkie Farr & Gallagher LLP's global White-Collar Defense Group in Washington, DC. **Mr. Thomas** is counsel and head of the Willkie Farr & Gallagher LLP's Environment, Health & Safety Practice in Washington, DC.

NOTES

1 *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors (Mar. 22, 2022) (the Proposing Release).

2 *Id.* at p. 7.

3 The TCFD was created in 2015 by the Financial Stability Board to develop climate-related financial risk disclosures for use by companies and investors. The TCFD has established a disclosure framework by which to evaluate material-climate-related risks through an assessment of their financial impacts on a registrant. *Id.* at p.37.

4 This is an accounting and reporting standard for greenhouse gas (GHG) emissions created through a partnership between the World Resources Institute and the World Business Center for Sustainable Development. *Id.* at p.40.

5 *See* Proposing Release at p.18. In 1971, the Commission first addressed disclosure of material environmental risks when it issued an interpretative release providing that registrants should consider disclosure of the financial impact of compliance with environmental laws. *See* Release No. 33-5170 (July 19, 1971). In 1982, the Commission adopted rules mandating disclosure of costs arising out of compliance with environmental laws. *See* Release No. 33-6383 (Mar. 3, 1982). In 2010, the Commission issued guidance as to how the SEC's existing disclosure rules may require disclosure of the impacts of climate change on a registrant's business or financial condition. *See Commission Guidance Regarding Disclosure Related to Climate Change*, Release No. 33-9106 (Feb. 2, 2010).

6 *Id.* at p.285. Many of the climate-related disclosure rules are also applicable to foreign private issuers. *Id.* at 286.

7 The climate-related disclosure rules would be included in Regulation S-K and Regulation S-X. *Id.* at p.55.

8 *Id.* at p.55.

9 *Id.* at pp.60-61.

10 *Id.* at pp.69-71.

11 "Physical risk," "transition risk," "acute risk," and "chronic risk" are defined in the Proposing Release. *Id.* at pp.61-63.

12 *Id.* at pp.61-64.

13 *Id.* at p.66.

14 *Id.* at p.67.

15 *Id.* at pp.76-77. A registrant would be required to disclose impacts on its business operations, products and services, parties in its value chain, activities to mitigate client-related risks, research and development expenditures, and any other significant changes or impacts.

16 *Id.* at p.78.

17 *Id.* at p.80.

18 *Id.* at p.82.

19 *Id.* at p.83.

20 *Id.* at pp.83-84.

21 "Scenario analysis" is defined as a process for identifying and assessing a potential range of future events under conditions of uncertainty. *Id.* at p.87.

22 *Id.* at p.88.

23 *Id.* at pp.91-92.

24 *Id.* at pp.98-100.

25 *Id.* at pp.100-101.

26 *Id.* at pp.104-105.

27 *Id.* at p.106.

28 *Id.* at pp.106-107.

29 A "transition plan" is defined broadly to mean "a registrant's strategy and implementation plan to reduce climate-related risks." *Id.* at p.107.

30 *Id.* at p.108.

31 *Id.* at pp.108-109.

32 *Id.* at p.110.

33 *Id.* at pp.115-116.

34 *Id.* at p.117.

35 *Id.* at p.118.

36 If the registrant is an emerging growth company or a smaller reporting company, only two years would be required. *Id.* at p.118.

37 *Id.* at p.126.

38 *Id.* at pp.127-129.

39 *Id.* at pp.138-139.

40 *Id.* at p.139.

41 *Id.* at pp.145-146.

42 *Id.* at p.150.