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ALERT
ENVIRONMENTAL

SEC Proposes Stringent Environmental Climate-Related Risk Disclosure Obligations for Public Companies

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In an overhaul of reporting requirements 10 years in the making, the Securities and Exchange Commission on March 21, 2022 proposed far-reaching and controversial climate-related disclosure obligations for publicly-traded companies as part of the Biden administration's emphasis on climate change. The SEC is proposing to force companies to formally disclose their exposure to and management of climate-related risks that are reasonably likely to have a material effect on their business, operations and financial condition. SEC's goal is to provide investors with "consistent, comparable, and decision-useful information for making their investment decisions." If finalized, the rule would require publicly-traded companies to provide climate-related financial references as notes to their audited financial statements and disclose their direct Scope 1 greenhouse gas emissions and their indirect Scope 2 GHG emissions. They also may have to disclose their upstream and downstream Scope 3 GHG emissions if they are material to the business or if they have established a GHG emissions target. Reporting obligations would begin in 2024 for large accelerated filers and be phased in for all covered companies by 2026.

Overview of the Proposed Rule

The proposed rule would add a new subpart to Regulation S-K of the SEC's regulations (17 CFR Part 229) that would require a registrant to disclose climate-related risk information in its registration statements and periodic reports, such as on annual Form 10-K submissions and quarterly Form 10-Q reports. The proposed rule draws heavily from existing disclosure frameworks including the Task Force on Climate-Related Financial Disclosures (regarding climate-related reporting) and the Greenhouse Gas Protocol (regarding accounting standards). Key areas for disclosure include:

- the oversight and governance of climate-related risks by the registrant's board and management;
- how any climate-related risks identified by the registrant have had or are likely to have a material effect on its business and consolidated financial statements;
- the registrant's processes for identifying, assessing and managing climate-related risks, and how to integrate those processes into the company's overall risk management;
- whether the company has adopted a transition plan to deal with climate-related risks and how to measure any physical or transition risks to its operations; and
- the effect of severe weather events and related natural conditions on the registrant's consolidated financial statements, together with financial estimates and assumptions used in the financial statements.

The proposal requires registrants to disclose information about their Scope 1 and Scope 2 greenhouse gas emissions. Scope 1 refers to direct GHG emissions that occur from sources the registrant owns or controls, such as emissions from fuel combustion in the registrant's boilers, furnaces, vehicles, and manufacturing activity. Scope 2 emissions are indirect GHG emissions from the generation of electricity, steam, heat, or cooling the registrant buys or acquires and consumes in its operations. Scope 2 emissions physically occur at the offsite point of generation but are accounted for in the registrant's GHG inventory because they result from its energy use.

A registrant also would be required to disclose its Scope 3 GHG emissions from upstream and downstream activities in its value chain *if material* or if the registrant has set a GHG *emissions target* or *goal* that includes Scope 3 emissions. Scope 3 emissions result from activities and assets the registrant does not own or control but indirectly affects in its value chain, either upstream in the form of raw materials it buys to make its products and downstream as emissions from its customers' use of its products. Sometimes referred to as "value chain emissions," Scope 3 emissions often represent the majority of a company's total GHG emissions. As a safe harbor, a Scope 3 emissions disclosure would not be considered to be a fraudulent statement unless it was shown to have been made without a reasonable basis or disclosed other than in good faith. SEC-defined smaller reporting companies (generally those with less than $100 million in annual revenue) would be exempt from disclosing Scope 3 emissions.

Issues for Comment and Clarification

The SEC is asking registrants to do a top to bottom review of their impact on climate, and while not mandating any changes to behavior, the agency apparently anticipates that by making this information available to investors, companies will attempt to reduce their GHG emissions. The SEC acknowledges that using financial statement metrics to estimate and disclose climate-related uncertainties is driven by judgment and assumptions, similar to other financial statement disclosures. Accordingly, for each type of financial statement metric, the proposed rule would require the 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 if applicable, policy decisions the registrant made to calculate the specified metrics.

The breadth of Scope 3 emissions reporting will be a key issue during the public comment period. Despite the safe harbor, it is unclear how companies should determine whether Scope 3 emissions from their upstream supply chain and from their downstream product life are "material" (and in particular which such emissions are material), and how that determination will align with current SEC requirements to disclose other material risks, defined as information a reasonable investor would consider important. The proposed rule also affects privately-held companies who will be asked by their publicly traded customers to estimate or account for their GHG emissions, something likely to be new to many privately-held organizations. Although intended to drive companies to become greener, the new required disclosures may burden companies with increased compliance costs and discourage private companies from going public.

Public Comment Period

The public comment period will be open for 30 days after publication in the *Federal Register* (which hasn't happened as of the date of this *Client Alert*) or May 20, 2022, whichever is later. There is a phase-in period for all registrants as the rules are currently proposed. Deadlines for filing disclosures including Scope 1 and Scope emissions metrics range from filing year 2024 for FY 2023 (for large accelerated filers) to filing year 2026 for FY 2025 (for smaller reporting companies). Both publicly-traded and privately-held companies should review the SEC's proposed rule and submit comments asking the SEC to revise or clarify the proposed rule as appropriate.

Babst Calland attorneys are closely following these and other climate-related developments. If you have questions or need additional information about SEC's proposed rule on disclosure requirements, please contact Kevin Garber at 412-394-5404 or kgarber@babstcalland.com; Ben Clapp at 202-853-3488 or bclapp@babstcalland.com; or Joe Yeager at 412-394-5698 or jyeager@babstcalland.com.