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Understanding the SEC Rule Proposal on Climate Change Disclosure

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Today’s Panelists

Aaron Briggs is a partner in Gibson Dunn’s San Francisco office and a member of the firm’s Securities Regulation and Corporate Governance practice group. Mr. Briggs’ practice focuses on advising technology, life sciences and other companies and their boards of directors on a wide range of securities and governance matters, including ESG, corporate governance, SEC disclosure and compliance, shareholder activism, executive compensation, investor communications, disclosure effectiveness and stakeholder engagement matters. Prior to re-joining the firm in 2018, Mr. Briggs served as Executive Counsel – Corporate, Securities & Finance at General Electric. In addition, Mr. Briggs was named Corporate Governance Professional of the Year by *Corporate Secretary Magazine*.

Anne Champion is a partner in Gibson Dunn’s New York office and a member of the firm’s Transnational Litigation, Environmental Litigation, Media Law, and Intellectual Property Practice Groups. Ms. Champion has played a lead role in a wide range of high-stakes litigation matters, including trials. Her practice focuses on complex international disputes, including RICO, fraud, and tort claims, and includes federal and state court litigation and international arbitration. She also has significant experience in First Amendment and intellectual property disputes.

Tom Kim is a partner in Gibson Dunn’s Washington, D.C. office and a member of the firm’s Securities Regulation and Corporate Governance Practice Group. Mr. Kim focuses his practice on a broad range of SEC disclosure and regulatory matters, including capital raising and tender offer transactions and shareholder activist situations, as well as corporate governance, environmental social governance and compliance issues. He also advises clients on SEC enforcement investigations involving disclosure, registration and auditor independence issues. Mr. Kim served at the SEC for six years as the Chief Counsel and Associate Director of the Division of Corporation Finance, and for one year as Counsel to the Chairman.

Lori Zyskowski is a partner in Gibson Dunn’s New York office and Co-Chair of the firm’s Securities Regulation and Corporate Governance Practice Group. Ms. Zyskowski advises clients, including public companies and their boards of directors, on corporate governance and securities disclosure matters, with a focus on Securities and Exchange Commission reporting requirements, proxy statements, annual shareholders meetings, director independence issues, proxy advisory services, and executive compensation disclosure best practices. She also focuses on advising companies on environmental, social and governance, or ESG, disclosures. Ms. Zyskowski also advises on board succession planning and board evaluations and has considerable experience advising nonprofit organizations on governance matters.

Brian A. Richman is an associate in Gibson Dunn’s Washington, D.C. office and a member of the firm’s Appellate and Constitutional Law, and Administrative Law and Regulatory practice groups. Mr. Richman focuses his practice on high-stakes appellate, administrative law, and complex litigation matters. He regularly litigates constitutional and statutory issues in courts around the country and represents clients in challenging and defending regulatory action by administrative agencies, with an emphasis on securities and financial services matters.

Webcast Agenda

I. Background to the Proposed Rules

II. Summary of Proposed Reg. S-K Amendments

III. Summary of Proposed Reg. S-X Amendments

IV. Potential Legal Challenges and Litigation Risk

V. Key Takeaways from the Proposed Rules

– Click here for Gibson Dunn's detailed client alert on the proposed rules –

I. Background to the Proposed Rules

Current U.S. Reporting Landscape

- Historically, a mostly voluntary regime with limited specific federal securities law requirements.
- In 2010, the Securities and Exchange Commission (the "SEC" or "Commission") issued principles-based climate change disclosure guidance.
  - The 2010 climate change guidance focused on how existing disclosure requirements (e.g., Risk Factors, MD&A) apply to climate change matters.
- U.S. public company climate disclosure has been mostly voluntary, included outside of SEC filings on websites, and driven primarily by the investment community, including institutional investors, proxy advisory firms and shareholder proposal proponents.
  - Voting policies and shareholder proposals created non-regulatory pressure to disclose information regarding board oversight of ESG risks, greenhouse gas emissions, climate transition plans and other ESG reporting.

SEC Increases Focus on ESG

Since 2020 ↓	The SEC's Division of Examinations makes ESG investing an examination priority
August 2020 ↓	SEC adopts rules requiring human capital management disclosure
March 2021 ↓	New SEC Climate and ESG Task Force created within Division of Enforcement; focused in part on ESG-related misconduct; then-Acting Chair solicits public input on need for climate change disclosure requirements
April 2021 ↓	Division of Examinations releases Risk Alert observing "deficiencies and internal control weaknesses from examinations of investment advisers and funds regarding ESG investing"
May 2021 ↓	SEC Chair Gary Gensler announces climate disclosure a top priority & early focus
Spring/Fall 2021 ↓	SEC Reg-Flex agendas include climate change disclosure
Fall 2021 ↓	Comment letters issued on 2020 10-Ks exclusively focused on absence of climate change disclosures
March 21, 2022	**SEC approved rule proposal for new climate change disclosure requirements for both U.S. public companies and foreign private issuers**

II. Summary of Proposed Reg. S-K Amendments

Proposed Reg. S-K Amendments

The proposed rules would require a new, separately captioned "Climate-Related Disclosure" section in applicable SEC filings covering a wide range of climate-related information:

Risks	How any climate-related risks have had or are reasonably likely to have material impacts on a company's business or consolidated financial statements
Impacts	How any climate-related risks have affected or are reasonably likely to affect a company's strategy, business model and outlook
Governance	Processes for identifying, assessing and managing climate-related risks, as well as board oversight of climate-related risks and relevant risk management processes
GHG Emissions Metrics	• Scope 1 and Scope 2, which, for LAFs and AFs only, would be subject to assurance by an independent GHG emissions attestation provider • Scope 3, but only if material or if the company has set a GHG emissions reduction target or goal that includes its Scope 3 emissions
Targets/Goals	Information regarding climate-related targets, goals, and transition plans, if any

Climate-Related Risks

- The proposed rules would require companies to describe "climate-related risks reasonably likely to have a material impact on the registrant, including on its business or consolidated financial statements, which may manifest over the short, medium, and long term"
- Detailed requirements include:
  - Categorization of each risk ("physical" v. "transition" risks), in accordance with the TCFD framework, plus significant detail regarding the nature of the risk
  - Materiality assessment must consider varied time horizons – short-, medium-, long-term – which company can define
  - Consideration of direct impact on business/financial statements as well as indirect impact on company value chains (both upstream and downstream)

Impacts on the Company from Climate-Related Risks

- The proposed rules would require companies to describe “the actual and potential impacts of any [identified] climate-related risks . . . on the registrant’s strategy, business model, and outlook”
- Detailed requirements include:
  - Nature of the impact
  - Time horizon for each impact
  - How each impact is integrated into the company’s business model and outlook
  - How identified climate change metrics and targets are integrated into the business model and strategy
  - Financial statement impact
  - Business strategy resilience in light of potential changes in climate-related risks
- Significant additional disclosure requirements if company uses carbon offsets, renewable energy credits, internal carbon price-setting or scenario planning

Climate-Related Governance: Risk Management and Oversight Processes

- The proposed rules would require companies to describe “the [board’s] oversight of climate-related risks” and “management’s role in assessing and managing climate-related risks”
- Detailed requirements include:
  - Who is responsible for oversight (Board/committee/director) and risk assessment and management (certain positions/committees), with relevant expertise of members
  - Process by which each is informed about climate risks, including frequency of Board reporting and discussion
  - Integration of climate risks into strategy/risk/financial oversight processes, and Board’s establishment of and monitoring of climate-related targets or goals
- The proposed rules also require description of “any processes the registrant has for identifying, assessing, and managing climate-related risks”
- Detailed requirements include (i) risk identification and assessment process, (ii) risk management process, and (iii) how these processes are integrated into overall risk management

GHG Emissions Reporting

- The proposed rules would require companies to disclose Scope 1, Scope 2, and in some cases Scope 3 "GHG emissions … for its most recently completed fiscal year, and for the historical fiscal years included in its consolidated financial statements in the filing, to the extent such historical GHG emissions data is reasonably available"

- The rule proposal contains detailed requirements for reporting Scope 1 (direct emissions) and Scope 2 emissions (indirect emissions from purchased electricity and other forms of energy), such as requiring disclosure of each in the aggregate and broken down into the disaggregated constituent GHGs, as well as in both absolute terms and in terms of intensity (based on emissions per dollar of revenue and unit of production)

- Large accelerated filers subject to phased-in attestation requirements regarding Scope 1 and Scope 2 emissions, with requirements for selecting a GHG emissions attestation provider and form and contents for report

- Scope 3 required for all non-smaller reporting companies if (i) material to company or (ii) company has set a GHG emissions target that includes Scope 3

Climate-Related Targets, Goals and Transition Plans

- The proposed rules would require companies to describe "targets or goals related to the reduction of GHG emissions, or any other climate-related target or goal (e.g., regarding energy usage, water usage, conservation or ecosystem restoration, or revenues from low-carbon products) such as actual or anticipated regulatory requirements, market constraints, or other goals established by a climate-related treaty, law, regulation, policy, or organization"

- Detailed requirements include:

  - Scope and calculation of the target

  - Progress achievement

  - Any use of carbon offsets or renewable energy credits or certificates ("RECs")

- Significant additional disclosure requirements if company has adopted a transition plan

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III. Summary of Proposed Reg. S-X Amendments

Proposed Reg. S-X Amendments

Proposed rules would require companies to provide certain climate-related financial statement metrics and related disclosures in a separately identified note to annual audited financial statements:

i. **financial impact metrics -** ***subject to a 1% threshold per line item***, disclosure of the financial impacts of severe weather events, other natural conditions and transition activities ***on any relevant line items in the company's financial statements***

Proposes detailed requirements for disclosure, including:

- ***Presentation requirements,*** disclosure be presented, at a minimum, on an aggregated, line-by-line basis for all negative impacts and, separately, positive impacts
- ***Scope of severe weather events and other natural conditions,*** including flooding, drought, wildfires, extreme temperatures and sea level rise, with potential impacts, including, revenue and cost changes from business disruptions, asset impairment charges, changes in loss contingencies or reserves, and changes in total expected insured losses
- ***Scope of covered transition activities,*** including efforts to reduce GHG emissions or mitigate exposure to transition risks, with potential impacts, including, revenue and cost changes from new emissions pricing or regulations, cash flow changes from changes in upstream costs, changes in asset carrying amounts due to reduction in useful life, and changes to interest expense due to climate-linked bonds with variable interest rates based on achievement of climate targets

Proposed Reg S-X Amendments (continued)

ii. **expenditure/cost metrics -** ***subject to a 1% threshold per line item,*** expenditures and capitalized costs to mitigate the risks of severe weather events or other natural conditions and expenditures related to transition activities

Proposes detailed requirements for disclosure, including:

- ***Presentation requirements,*** disclosure presented on an aggregated basis for expenditures expensed and, separately, capitalized costs incurred

- ***Scope of covered severe weather events and other natural conditions,*** including flooding, drought, wildfires, extreme temperatures and sea level rise, with potential expenses/costs related to, for example, increasing business resilience, retiring or shortening the useful life of assets, relocating at-risk assets or operations, and otherwise reducing the future impact of severe weather events and other natural conditions on the business

- ***Scope of covered transition activities,*** including efforts to reduce GHG emissions or mitigate exposure to transition risks, with potential expenses/costs related to, for example, R&D for new technologies, purchase of assets, infrastructure or products to reduce GHG emissions, increase energy efficiency, offset emissions (*e.g.*, energy credit purchases) or improve resource efficiency, and progress towards meeting disclosed climate-related targets or commitments

Proposed Reg S-X amendments (continued)

iii. **financial estimates and assumptions -** would require companies ***to disclose whether estimates and assumptions underlying the amounts reported in the financial statements were impacted by risks and uncertainties*** associated with, or known impacts from, severe weather events and other natural conditions, the transition to a lower-carbon economy and any disclosed climate-related targets. ***To the extent there was an impact, qualitative disclosure would be required*** as to how the development of any such estimate or assumption was impacted

General matters applicable to Financial Statement Disclosures:

- **Disclosure threshold**: ***only if the absolute values*** of all climate-related impacts or expenditures/costs, as applicable, with respect to the corresponding financial statement line item represents ***at least 1% of that line item***

- **Time Period Covered:** Information must be provided for the most recently completed fiscal year and other historical fiscal years included in the financial statements in the filing

  – **Example**: if company includes balance sheets as of the end of its two most recent fiscal years and three years of income and cash flow statements … required to disclose two years of climate-related metrics that correspond to balance sheet line items and three years of climate-related metrics that correspond to income or cash flow statement line items

IV. Potential Legal Challenges and Litigation Risk

Potential Challenges to the Proposed Rules

- The Commission voted on party lines three-to-one in support of the proposed rule amendments
- Commissioner Peirce’s dissent previewed legal arguments that challengers may raise in litigation challenging the rule once finalized:

    1. existing rules already cover material climate risks
    2. the proposed rules would not apply a materiality threshold in some places (e.g., Scope 1 and Scope 2 required disclosures) and would distort materiality in other places (e.g., the Scope 3 disclosure requirements)
    3. the proposal would not lead to comparable, consistent and reliable disclosures
    4. the proposal exceeds the Commission’s statutory limits of authority
    5. the proposed rules would be expensive for companies to implement
    6. the proposal would hurt investors, the economy and the reputation of the SEC

Potential Litigation Risk for Companies

- Rule proposal mandates detailed “line item” climate change disclosure requirements
- Although some of the mandated disclosures would be entitled to claim the safe harbor liability defense for forward-looking statements, the safe harbor is not available for disclosures appearing in the notes to the financial statements, disclosure in initial public offerings (IPOs) or disclosure of historical information
- New disclosures will be subject to the heightened liability provisions under the Securities Act (when included or incorporated by reference in registration statements and other offering documents), including Sections 11 and 12 liability for the company, executive officers, directors, underwriters and auditors
- Broad scope of required disclosures and the lack of existing mechanisms at some companies to conduct the analysis required creates inherent risks
- New requirements create inherent risk and there will be years of litigation before the parameters of that risk are settled

Potential Litigation Risk for Companies

- A trend in recent securities litigation has been to contrast specific events with broad statements in disclosures, and to allege that the broad statements were misleading. Even if not ultimately successful, such cases have the potential to advance beyond a motion to dismiss.

- Another trend has been to contrast generalized statements about a company's planning mechanisms with planning for specific projects by the company, *e.g.*, securities litigation against Exxon over statements about its use of a proxy "cost of carbon."

- These cases underscore the need to ensure that generalized statements about a company's environmental record, practices, and dedication to particular issues, as well as statements about the company's current practices are appropriately limited and caveated.

- Disclosure requirements are outpacing regulation – *i.e.*, companies are being required to make disclosures about business risks that are ill-defined in view of the continued lack of regulation in the climate change area.

V. Key Takeaways from the Proposed Rules

Next Steps for Public Companies

- Companies concerned about aspects of the proposed rules should consider participating in the rulemaking proceedings
- Conduct a gap analysis against any existing disclosures
- Assess sufficiency of internal and external climate change resources
- Evaluate disclosure controls and internal controls
- Revisit climate-related risk oversight and management practices
- Reassess board composition, focusing on climate change expertise
- Conduct a materiality assessment of climate-related risks on the business
- Begin considering potential significance of Scope 3 emissions for your company
- Discuss implications with your outside auditor

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