Professional Perspective

SEC Climate-Related Disclosure Rules

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The US Securities and Exchange Commission (SEC) proposed new rules in March 2022 aimed at standardizing and increasing transparency around how public companies disclose climate-related risks that would materially impact their business, results of operations or financial condition. After nearly two years of consideration and analyzing over 16,000 public comments, the SEC finalized such rules on March 6, 2024, with some prominent changes from the initially proposed rules.

The article delves into the SEC's recently finalized climate-related disclosure rules, providing an overview of the disclosure requirements and materiality considerations. It further delineates the expectations that public companies should anticipate in order to comply with such rules, including some of the challenges.

Softened Requirements

The final rules are comprised of a long list of climate-related disclosure standards for public companies. The SEC significantly softened them compared to the proposed rules to reflect feedback the Commission received during the public notice and comment period. The SEC discarded all Scope 3 emission reporting requirements (greenhouse gas emissions that come from a company's value chain for which companies are indirectly responsible), narrowing the climate-related disclosures to only Scope 1 and Scope 2 emissions (greenhouse gas emission categories for which companies are directly responsible).

The SEC further softened the disclosure requirements for Scope 1 and Scope 2 emissions by now only compelling disclosure of material emissions. If a public company determines that a reasonable shareholder would not consider such disclosure important, then the company is not required to disclose the Scope 1 or Scope 2 emission-related information.

While this gives public companies discretion, if a company commits, or has already committed, to climate-related goals, then these disclosures will mostly likely become required. This also may be a double-edged sort, as regulators, investors or other private plaintiffs may seek to challenge a company's materiality assessment.

Materiality

According to the final rules, if it is material to, or self-selected by, a public company, then the company must disclose how its board and management oversee and govern climate-related risks, including the processes for identifying, assessing, and managing such risks and such processes' relation to the company's overall risk management system.

These public companies must also identify and disclose the climate-related risks that have had or are likely to have a material impact on their business strategy, result of operations or financial condition. This is a key point, as many companies already consider their impacts on climate—e.g., their own carbon footprint—but many do not contemplate how climate impacts their operations—e.g., the loss of access to raw material suppliers due to severe weather incidents in other parts of the world.

Identified climate-related risks should incorporate an analysis on the actual and potential material impacts on the company's strategy, business model and outlook. If a company has undertaken activities to mitigate or adapt to a material climate-related risk, which include transition plans, scenario analysis or internal carbon prices, then such activities must be disclosed along with a description of incurred material expenditures and other material financial impacts.

The financial statements of these public companies are also impacted. If the financial statements, including the financial estimates and assumptions used in the statements, were materially impacted by severe weather events and other natural conditions or any disclosed climate-related targets, then the company must describe how such statements were impacted.

Financial statements must also disclose capitalized costs, expenditures expensed and losses associated with severe weather events, other natural conditions, or carbon offsets and renewable energy certificates (RECs) that are used as a material component to reach climate-related targets.

Large-accelerated filers and non-exempt accelerated files must disclose material Scope 1 and Scope 2 emissions, which includes an assurance report at the applicable assurance level.

Many companies have already publicly disclosed their climate-related goals and reduction targets, whether voluntarily, in response to investors or due to other legal requirements. The SEC is now requiring such companies whose climate-related targets materially affect the company's business to provide information regarding material expenditures and impacts on financial estimates and assumptions as a direct result of the target or actions taken to meet such target.

The final rules will be phased in for all public companies. The specific dates of compliance vary upon filer status. Large accelerated filers must be compliant with most disclosures by fiscal year 2025, with phase in reporting for Scope 1 and 2 emissions starting in fiscal year 2026. Accelerated filers must be compliant with most disclosures by fiscal year 2026, with phase in reporting for Scope 1 and 2 emissions starting fiscal year 2028. Smaller reporting companies, emerging growth companies and non-accelerated filers must be compliant with most disclosures by fiscal year 2027.

Safe Harbors

The final rules provide a safe harbor for certain disclosures. Except to the extent they provide historical facts, required climate-related disclosures regarding transition plans, scenario analyses, internal carbon prices and targets and goals are generally considered forward-looking statements. The SEC declined to extend the safe harbor to financial statements or disclosures of Scope 1 and Scope 2 emissions.

With that, public companies should keep the following in mind:

- Public companies could face legal and reputational risks for deciding not to comply with the final climate-related disclosure rules.
- Non-compliance could result in SEC enforcement action, including fines and other legal action, as is standard for non-compliance with SEC regulations. Legal consequences can also extend to shareholder backlash, lawsuits and investigations by regulatory bodies.
- Inadequate or non-compliant climate-related disclosures can erode investor confidence. While the public comment period provided significant changes to the final rules, shareholders and other investors still increasingly consider climate-related risks as material factors that can impact a company's long-term performance and sustainability.
- A lack of transparency could lead to a loss of shareholder trust and damage to a company's reputation. Consequentially, the company's stock price could also be impacted, affecting market valuation and access to capital.
- Conversely, robust and reliable climate-related disclosures can attract socially responsible investors and positively impact a company's reputation and market perception so reporting companies will definitely need to weigh the benefits and risks.

Cost of Compliance

Ensuring compliance with the final rules and avoiding potential legal and reputational risks may require significant resources and expertise.

While the cost and complexity of disclosing Scope 3 emissions is no longer a current concern, complying with the finalized climate-related disclosure rules still poses some challenges for public companies. And compliance with the final rules will also require consideration of California's SB 253, which does require disclosure of Scope 3 emissions.

In general, the disclosure standards force public companies to collect and verify accurate climate-related data, which imposes both monetary and time-related costs on companies. Even if a public company determines the data does not meet the materiality threshold such that it will need to be disclosed, the data will still need to be collected, and decisions on materiality documented in the event of future challenges.

Public companies will need to leverage a significantly larger amount of data to obtain the comprehensive information regarding greenhouse gas emissions, energy usage and sustainability needed for disclosure. This is especially true for public companies that span multiple regions.

Another challenge lies in accurately forecasting and assessing future climate risks. Since many companies are already providing disclosures in some manner, it will be interesting to see how many will conform to this new standard, and whether those who fail to comply will be subject to increased scrutiny from the investment community or regulators.

Predicting the potential impacts of climate change on a company's operations and financial performance requires sophisticated modeling techniques. This entails analyzing various scenarios and accurately anticipating physical and transitional risks and their financial implications, which is challenging due to the multi-faceted and dynamic nature of climate change.

While these challenges have created public backlash seen during the notice and comment period and may lead to litigation, public companies should prepare now by devising a plan to bring their current practices, data gathering process and reporting in line with the final climate-related disclosure rules.

