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A New Era: Mandatory ESG and Climate Disclosures

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On Monday, March 21, 2022, the Securities and Exchange Commission ("SEC") voted to propose a rule designed to "enhance and standardize registrants' climate-related disclosures for investors."[1] Key components of the proposed rule include mandatory climate-related reporting, including on greenhouse gas emissions. This rulemaking follows years of investors seeking consistent and comparable disclosure of environmental, social, and governance ("ESG") risks. It also follows on the heels of similar efforts in Europe to develop uniform ESG disclosure requirements.

While climate activists and much of the investing community have been eagerly awaiting this announcement since the SEC indicated in early 2021 that changes to climate risk disclosures were likely forthcoming, others have been vocal in raising concerns around the possibility of mandatory climate-related disclosures. Businesses, a number of states' attorneys general, and certain lawmakers have flagged challenges in quantifying certain metrics, noted the cost of climate-related reporting, and questioned whether requiring climate-related reporting falls within the SEC's jurisdiction. Nonetheless, many companies have begun to prioritize their ESG-related reporting in light of demand for this type of information and the SEC's increased focus on the accuracy of companies' climate-related disclosures under the existing 2010 Guidance.[2] While interested parties and the public have an opportunity to submit comments on the SEC's proposed disclosure rules, and final rules are not expected to be issued in the near term, SEC-regulated companies should familiarize themselves with the proposed new rules, and continue to ensure that all requisite information is accurately, consistently, and transparently disclosed as the spotlight on ESG-related reporting is likely here to stay. This is especially critical given global developments, in particular those coming out of Europe as we address below.

I. SEC's Focus on Climate and ESG Reporting

In recent years, as the SEC has grown increasingly aware of investors' demand for ESG-related products and services, it has prioritized efforts to ensure that information disclosed by issuers is accurate and useful to investors' informed decision-making. This priority is reflected in both the statements of SEC leadership and recent SEC actions, culminating in the SEC's recent proposal for climate-related disclosure requirements.

The SEC has identified mandatory ESG- and climate-related disclosures as a mechanism through which to ensure investors are positioned to accurately assess potential risks in their investments. SEC Chairman Gary Gensler highlighted investors' appetite for additional ESG- and climate-related disclosures, stating that "[w]hen it comes to climate risk disclosures, investors are raising their hands and asking regulators for more."[3]

Despite hesitations from some within the Commission, the SEC's Division of Examination has become increasingly active in the ESG space, and its priorities for 2020 and 2021 included a focus on the accuracy and adequacy of ESG disclosures, particularly in relation to products widely available to investors.[4] In line with this priority, in March 2021, the SEC established a Climate and ESG Task Force in the Division of Enforcement (the "Task Force") to identify ESG-related misconduct under existing 2010 Climate Guidance.[5] The Task Force's mission is to "proactively identify ESG-related misconduct" through use of data analysis, and it is focused on identifying material gaps or misstatements in issuers' disclosures, particularly with regard to climate risks. It will simultaneously analyze disclosure and compliance issues relating to investment advisors' and funds' ESG strategies. In April 2021, the Division of Examinations also released a Risk Alert that sheds light on the Division's areas of focus in reviewing financial firms' ESG practices, further underscoring its emphasis on ensuring sufficiently fulsome and accurate disclosures.[6]

In February 2021, then Acting Chair Allison Herren Lee directed the SEC's Division of Corporation Finance to "enhance its focus on climate-related disclosure in public company filings."[7] Gensler subsequently reiterated that SEC staff was developing mandatory climate risk disclosure rules, and has consistently indicated that disclosures should be consistent, comparable, and sufficiently detailed to be useful in making an investment decision.

However, others within the SEC have lingering concerns regarding mandatory ESG-related reporting requirements. Commissioner Peirce has publicly objected to a "new SEC disclosure framework for ESG information" as "our existing securities disclosure framework is very good at handling all types of material information."[8] She has specifically raised concerns about the SEC's jurisdiction and around the cost of requiring disclosures under a single global set of ESG metrics, noting that ESG factors continue to evolve and are not readily comparable across companies and industries.[9]

While the SEC has been steadily moving towards new rules requiring that all public companies disclose certain ESG- and climate-related disclosures, SEC commissioners have also reportedly struggled to determine the scope of reporting requirements, resulting in a delay in the release of the proposed disclosure requirements until March 21, 2022.[10]

II. Prioritization of Climate-Related Reporting Globally

The SEC's recent proposed rule requiring standardized climate-related disclosures aligns in many ways with similar proposals made across Europe. While there are a number of existing voluntary frameworks and certain stock exchanges set climate-related requirements, efforts are underway to consolidate and streamline climate-related reporting requirements.

In November 2021, the International Financial Reporting Standards ("IFRS") Foundation, which develops globally accepted reporting standards, announced the formation of the International Sustainability Standards Board ("ISSB").[11] The ISSB will seek to develop sustainability disclosure standards that provide consistent reporting standards to satisfy investors' call for "high quality, transparent, reliable and comparable reporting" on climate and ESG. ISSB seeks to deliver a "comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions." ISSB will build on existing initiatives, including the Task Force for Climate-related

Disclosures. ISSB is focusing at the outset on climate matters, and expects to submit proposed standards for feedback in 2022.[12]

In April 2021, the EU released its Corporate Sustainability Reporting Directive proposal ("CSRD"), replacing the Non-Financial Reporting Directive ("NFRD"), in order to both provide investors with relevant ESG-related information and meet the requirements under the Sustainable Finance Disclosure Regulation. In February 2022, the European Council agreed to the European Commission's proposal which revises the NFRD to require: (1) an extension of the scope to all large companies and companies listed on a regulated market (except micro-companies); (2) a certification requirement for sustainability reporting; (3) more detailed and standardized requirements on the information to be published by companies; and (4) improved accessibility of information, by requiring its publication in a dedicated section of company management reports. Through these changes, European authorities are seeking to increase company accountability, prevent divergent national standards, and ease the transition to a sustainable economy.[13]

On February 23, 2022, the European Commission published a draft directive on "Corporate Sustainability Due Diligence" (the "Draft Directive").[14] Similar to the SEC's efforts, the European Commission sought to standardize rules to establish "a corporate sustainability due diligence duty to address negative human rights and environmental impacts." Under the proposal, large European Union companies are required to develop due diligence policies, identify actual or potential adverse human rights and environmental impacts, prevent or mitigate such impacts, establish a grievance mechanism, monitor the effectiveness of these efforts, and disclose their due diligence. These requirements apply not only to the company's operations, but also their subsidiaries' operations, and the value chains of their established business relationships. Moreover, these requirements apply to companies incorporated outside the European Union with a net EU turnover of more than EUR 150 million or with an EU turnover of more than EUR 40 million where at least 50 percent of the net worldwide turnover was generated in a high impact sector. The goal of these enhanced requirements is to level the playing field, provide transparency to both consumers and investors, and further limit adverse environmental impacts. Further approvals are required before the Draft Directive is formally adopted.[15]

As the global trend towards mandatory standardized ESG-reporting has progressed, companies have protested that data collection can be challenging, and that certain climate-related metrics are difficult to accurately quantify and reflect via traditional accounting. Though concerns around mandatory ESG reporting requirements persist, the SEC's newest corporate disclosure rules align in many ways with similar efforts occurring across the globe.

III. SEC's Climate Disclosure Rules

On Monday, March 21, 2022, the SEC released significant proposed climate change disclosure requirements.[16] Under the SEC's proposed rule, registrants would be required to provide certain climate-related information in their registration statements and annual reports. The proposed rules will affect both domestic registrants and foreign private issuers.

The proposal puts forth three significant changes: (1) companies would be required to disclose climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition; (2) companies would be required to include certain climate-related financial metrics and narrative in their audited financial statements; and (3) companies would be required to disclose their greenhouse gas emissions, including, in certain cases, "Scope 3" emissions.

Required disclosures include:

Details regarding how climate-related risks have had or are likely to have a material impact on the company's business or consolidated financial statements, which may manifest over the short-, medium-, or long-term.

- These disclosure requirements focus on material impacts, or instances where there is a "substantial likelihood that a reasonable investor would consider it important when determining whether to buy or sell securities or how to vote." Companies would therefore be required to disclose any climate-related risks reasonably likely to have an actual or potential negative material impact on their business or consolidated financial statements, business operations, or value chains (upstream and downstream activities).

  - Under the proposal, "upstream activities" include activities by a party other than the company related to the early stage production of goods and services, for instance, materials sourcing, materials processing, and supplier activities. In contrast, "downstream activities" include activities by another entity related to finishing or delivering the product, or providing a service to the end user.

- The proposed rule is far reaching, and includes both physical risks—or issues arising from the physical impacts of climate change—and risks that arise due to the global transition to a less carbon intensive economy, including costs attributable to changes in governing laws and shifts in demand for certain products. The proposed rules call for significant disclosure of detail, requiring companies to specify whether an identified climate-related risk is a physical or transition risk. In the case of physical risks, companies must describe the nature of the risk, including the location of the properties, processes, or operations subject to the physical risk. For transition risks, details must be provided regarding whether the risk is due to regulatory, technological, market, liability, reputational, or other transition-related factors.

- The SEC did not define the meaning of short-, medium-, or long-term time horizons. While this grants companies flexibility, it also creates potential uncertainty around how to best define time horizons.

How identified climate-related risks have affected or are likely to affect the company's strategy, business model, and outlook.

- Companies must describe physical and transition risks and the impact of such risks on their operations, including the types and locations of operations, products or services, suppliers and other parties in their value chain, activities to mitigate or adapt to climate-related risks, including adoption of new technologies or processes, expenditure for research and development, and any other significant changes or impacts. Companies must then convey whether the identified impacts were incorporated into their business strategy, financial planning, and/or capital allocation.

- **The proposed rules also require the company to provide a narrative describing whether and how any of its identified climate-related risks, including any financial statement metrics disclosed pursuant to proposed changes to Regulation S-X discussed in more detail below, have affected or are reasonably likely to affect its consolidated financial statements.**

- If, as part of its net emissions reduction strategy, a company uses carbon offsets or renewable energy credits or certificates ("RECs"), the proposed rules would require it to disclose the role that carbon offsets or RECs play in its climate-related business strategy.

- Some companies may use an internal carbon price—the estimated cost of carbon emissions used internally within an organization—when assessing climate-related factors. If it does so, it must disclose the price and describe how it uses its disclosed internal carbon price to evaluate and manage climate-related risks.

- To the extent that the company uses analytical tools such as scenario analysis—the process for identifying and assessing a potential range of outcomes of future events under conditions of uncertainty—the proposed rules would require a description of those analytical tools, including the assumptions and methods used.

A description of the company's processes for identifying, assessing, and managing climate-related risks and whether any such processes are integrated into the company's overall risk management system or processes.

- When describing the processes for identifying and assessing climate-related risks, companies are required to disclose details around how they determine the relative significance of climate-related risks as compared to other risks, how they consider regulatory requirements in identifying risks, how qualitative factors such as shifts in customer preferences and technological changes are accounted for, and how they determine the materiality of climate-related risks, including assessment of the potential size and scope of any identified climate-related risk.

- Companies should also discuss how they decided to prioritize addressing climate-related risks and whether to mitigate, accept, or adapt to a particular risk. Companies will also be expected to disclose whether and how climate-related risks are integrated into the company's overall risk management system or processes.

- If a company has adopted a transition plan to mitigate or adapt to climate-related risks, the plan must be described, including the relevant metrics and targets used to identify and manage physical and transition risks. Companies with transition plans should discuss how they plan to mitigate or adapt to any identified transition risks, including relevant laws and changing demands.

The oversight and governance of climate-related risks by the company's board and management.

- In relation to the board, and similar to the Draft Directive, the SEC's proposal would require that companies identify board members or board committees responsible for oversight of climate-related risks and their climate-related risk expertise. Disclosures should also include how the board is informed as to such risks, whether the board considers climate-related risks as part of its business strategy, risk management, and financial oversight role, and how the board sets climate-related targets and oversees progress against those targets or goals.

- Likewise, companies are required to disclose information about management's role in this process, including who is responsible for assessing and managing climate-related risks and their expertise in this space. Companies should also disclose how managers monitor climate-related risks.

Certain climate-related financial statement metrics and related disclosure to be included in a note to the company's audited financial statements (per a new Regulation S-X article).

- The proposed rules would require companies to disclose certain disaggregated climate-related metrics in their existing financial statements. As part of the company's financial statements, the financial statement metrics would be subject to audit by an independent registered public accounting firm. Subjecting additional disclosures to audit procedures is likely to complicate the audit process and may impact the timing of the auditor's review. For certain metrics, including financial impact metrics, expenditure metrics, and financial estimates and assumptions, the proposed rules would require the company to disclose contextual information to enable the reader to understand how it derived the metric, including a description of significant inputs and assumptions used to calculate the specified metrics.

The proposed rule also focuses on greenhouse gas ("GHG") emissions. Under the proposed rule, a registrant would be required to disclose its GHG emissions for its most recently completed fiscal year and, to the extent reasonably available, for the historical fiscal years included in its consolidated financial statements in the applicable filing. The proposed rule identifies three categories of GHG emissions:

- Scope 1 emissions, or direct emissions, that result from sources owned or controlled by a company;
- Scope 2 emissions, or indirect emissions, that result from the generation of electricity, steam, heat, or cooling consumed by operations owned or controlled by a company; and
- Scope 3 emissions, which include all other indirect emissions not accounted for in Scope 2 emissions that can occur in the upstream (e.g., acquisition of goods and services, employee business travel and commuting) and downstream (e.g., use of the registrant's sold products) activities of a company's value chain.

Key components of GHG emission requirements include:

- Under the proposed rule, all registrants would be **required to separately disclose their total Scope 1 and total Scope 2 emissions**, both in gross terms and in terms of intensity.
- **A registrant would also be required to disclose its total Scope 3 emissions, both in gross terms and in terms of intensity, if those emissions are "material," or if the registrant has set a GHG emissions reduction target that includes its Scope 3 emissions.** According to the SEC, this materiality standard requires a registrant to determine whether there is a substantial likelihood that a reasonable investor would consider certain information important when making an investment or voting decision.
  - *Accommodations for Scope 3 Emissions Disclosure:* Recognizing the challenges of obtaining or verifying activity data from suppliers and other third parties in a company's value chain, the SEC proposed a number of accommodations for Scope 3 emissions disclosure, including: (1) a safe harbor from certain forms of liability under the federal securities laws; (2) an exemption for smaller reporting companies ("SRCs") from the

Scope 3 emissions disclosure provision; and (3) a delayed compliance date for Scope 3 emissions disclosure.

- *Attestation*: A registrant, including a foreign private issuer, that is an accelerated filer or large accelerated filer **would be required to include an attestation report** covering the disclosure of its Scope 1 and Scope 2 emissions and to provide certain related disclosures about the service provider. **Under the proposed rule, the report needs to be signed by an independent GHG emissions attestation provider.** Following the GHG disclosure compliance date, both accelerated filers and large accelerated filers would be provided one fiscal year to transition to providing limited assurance and two additional fiscal years to transition to providing reasonable assurance.

- The proposed rule also states that a registrant would need to describe the methodology, significant inputs, and significant assumptions used to calculate its GHG emissions metrics, including the registrant's organizational boundaries, operational boundaries, calculation approach, and any tools used to calculate its GHG emissions. Importantly, each registrant is required to set the organizational boundaries for its GHG emissions disclosure using the same scope of entities, operations, assets, and other holdings within its business organization as those included in its consolidated financial statements to ensure consistency and enhance comparability across registrants.

- The table below summarizes the SEC's proposed phase-in periods. It assumes that the proposed rule will become effective by December 2022, and that a registrant has a December 31st fiscal year-end.

Registrant Type	Disclosure Compliance Date	
	All proposed disclosures, including Scope 1 and Scope 2 GHG emissions metrics	*Scope 3 GHG emissions metrics*
Large Accelerated Filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)
Accelerated Filer and Non-Accelerated Filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)
SRC	Fiscal year 2025 (filed in 2026)	Exempted

IV. Next Steps

Now that the long-awaited proposed climate-related disclosure rules have been released, they will be subject to a public comment period. The public's input will be considered, and the proposal may be further revised; the SEC will then vote on a final rule, a process that could take months.[17]

The SEC estimated that in recent years, only 33% of annual reports contained some disclosure related to climate change. As such, if the final rule is approved, issuers that had not previously engaged in climate-related reporting will likely face the most substantial costs under the SEC's proposed climate-related reporting requirements, including building out a staff capable of addressing the requirements, conducting the requisite climate-related risk assessments, collecting data, measuring emissions, obtaining assurance of applicable disclosures, and preparing reports. For non-SRCs, the SEC estimated that the costs in the first year of compliance would be $640,000.

Notably, Commissioner Hester Peirce voted against the proposed rule, arguing that the proposal "will undermine the existing regulatory framework that for many decades has undergirded consistent, comparable, and reliable company disclosures."[18] And it is anticipated that there will be legal challenges to the SEC's proposed climate disclosure rules, as a number of State Attorneys General have already questioned whether the SEC has the statutory authority to mandate climate-related reporting.[19] Other objections, such as claims that requirements are overly burdensome, can also be expected, and efforts to block the new rule are almost certainly forthcoming.

V. Actions to Take

While many companies have begun to voluntarily incorporate ESG-related disclosures into their reporting in recent years, SEC's proposed mandated reporting requirements only serve to up the ante as companies would be required to disclose certain data points. This both creates risk exposure for companies that fail to disclose all required data points and increases the likelihood that companies report inaccurate or incomplete information.

Reporting on ESG-related criteria is nuanced, and specific to each company's operations. To ensure compliance with evolving ESG-related reporting requirements, companies should:

1. **Engage with an expert.** The proposed climate-related reporting requirements are very thorough, and would require detailed reporting. In grappling with new reporting requirements, companies should ensure that they fully understand the disclosure requirements, and how such requirements apply to their business(es).

2. **Evaluate required resources.** Depending upon a company's current understanding of and controls around its climate-related risks, the resources to comply may be significant, both financial and in terms of manpower required, and will likely require the retention of both internal and external experts. For instance, GHG emission requirements call for third-party attestation, which to address will likely require advance planning, management time and attention, and expenditures.

3. **Identify existing reporting and experience/knowledge gaps.** Companies must evaluate their current reporting practices, and determine how new reporting requirements apply to their operations, identifying areas where they previously failed to report, or reported insufficiently.

4. **Evolve existing policies and procedures.** Companies' existing reporting policies and procedures should be revised to incorporate ESG-related reporting requirements. As reporting expectations evolve, company policies should be sufficiently flexible to encompass new requirements to ensure ongoing compliance.

5. **Consider impact on board composition.** The proposed rule would require disclosures regarding board members' climate-related expertise and the role of the board in relation to addressing climate-related risks. Other recent developments, such as Nasdaq board diversity disclosure requirements, are similarly likely to result in board composition changes. Companies should be intentional in recruiting board candidates to ensure that all requirements are met, that there is an appropriate governance structure at the board and management level to

understand the company's ESG-related risks, and that there are appropriate oversight, controls, and reports. This is particularly important given more recent court decisions regarding a board's duty of care under the *Caremark* standard.

The SEC's proposed climate-related disclosure requirements reflect the significant and ongoing evolution of ESG reporting expectations. Paul Hastings is experienced in working with companies to identify tangible steps and develop a tailored plan to ensure that companies are effectively addressing ESG-related requirements. Diligent and proactive efforts to ensure compliance with reporting requirements best protect companies against regulatory inquiries while simultaneously satisfying investor and stakeholder expectations. As the SEC's proposed climate-related reporting requirements are substantial and will require significant efforts to fully address, companies should act soon to ensure ongoing compliance and a more manageable transition period if the final rule is adopted.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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