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Dechert LLP

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On March 21, 2022, the U.S. Securities and Exchange Commission (the "SEC") **released** its new and long-anticipated proposed rules for the enhancement and standardization of climate-related disclosures. The proposed rule amendments were approved by a three-to-one vote of the SEC's four current commissioners and are subject to a public comment period and final rulemaking.

It bears emphasizing at the outset that the sheer length and complexity of the proposed rules, if ultimately adopted in their current form, can be expected to impose significant disclosure burdens and related expenses on issuers, particularly those that do not yet have processes in place to accumulate the information necessary to provide the required disclosures.

Background

The SEC maintains in its rule proposal that while it has adopted various rules and guidance addressing disclosure of material environmental issues since the early 1970s, investors continue to be concerned about the impact of climate-related risks on a company's financial results and therefore wish to see more consistent, comparable and reliable information to help them make fully informed investment decisions. Issuers as well seek to provide the information that investors want, yet find current disclosure practices to be fragmented and inconsistent. To meet these challenges, the SEC contends that its proposed framework will help issuers more efficiently and effectively disclose environmental risks, to the benefit of investors and issuers alike.

The SEC also states that it believes that it has struck a balance between eliciting better disclosure and limiting compliance costs, by proposing rules based on the recommendations of the Task Force on Climate-Related Financial Disclosures[1] — a framework that the SEC says has been widely accepted by issuers, investors and other market participants. Yet the SEC also acknowledges in its rule proposal that the direct costs of meeting the new disclosure requirements could "potentially be significant" for registrants that do not yet have a system in place for measuring and disclosing environmental risks, while indirect costs such as "heightened litigation risk" and the risk of potentially disclosing propriety information would be borne by registrants as well.

Proposed Regulatory Framework

The proposed amendments would require new climate-related disclosures in a registrant's registration statements and annual reports,[2] in a separately captioned "Climate-Related Disclosure" section, and in the notes to financial statements, by adding the following sections to the current disclosure regulations:

- A new subpart 1500 of Regulation S-K, which would require registrants to disclose information about climate-related risks that are reasonably likely to have material impacts on the business or consolidated financial statements, as well as greenhouse gas ("GHG") emissions metrics that could help investors assess

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[1] *See* https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf.

[2] The proposed climate-related disclosure rules would apply to a registrant with Exchange Act reporting obligations pursuant to Exchange Act Section 13(a) or Section 15(d) and companies filing a Securities Act or Exchange Act registration statement. Specifically, a registrant would be required to include the new disclosures in Securities Act or Exchange Act registration statements (Securities Act Forms S-1, F-1, S-3, F-3, S-4, F-4, and S11, and Exchange Act Forms 10 and 20-F) and Exchange Act annual reports (Forms 10-K and 20-F). The rule proposal notes that Form F-1 is not being formally amended since it already requires the registrant to include the disclosures to be required in Form 20-F. Similarly, Forms S-3 and F-3 are not being formally amended since they can incorporate by reference the disclosures to be required in the registrant's Form 10-K or 20-F annual report, respectively.

those risks. This new subpart would include an attestation requirement for accelerated filers and large accelerated filers regarding certain proposed GHG emissions metrics disclosures.

- A new Article 14 of Regulation S-X, which would require certain climate-related financial statement metrics and related disclosure to be included in a note to a registrant's audited financial statements. The proposed financial statement metrics would consist of disaggregated climate-related impacts on existing financial statement line items. As part of the registrant's financial statements, the financial statement metrics would be subject to audit by an independent registered public accounting firm, and would come within the scope of the registrant's internal control over financial reporting.

A registrant would be able to incorporate by reference disclosure from other parts of the registration statement or annual report (e.g., Risk Factors, MD&A, or the financial statements) or, in most cases, from other filed or submitted reports into the Climate-Related Disclosure item if the disclosure is responsive.

New Disclosure Requirements

The proposed rules would mandate the disclosures summarized below:

- **Board and management oversight *(Item 1501).*** The proposed rules would require a registrant to disclose, as applicable, certain information regarding the board's oversight of climate-related risks and management's role in assessing and managing those risks. Concerning board oversight, a registrant would be required to: (i) identify any board members or board committees (whether a standalone committee or an existing one such as the audit or risk committee) responsible for the oversight of climate-related risks; (ii) describe in detail those board members' expertise in managing climate-related risks; (iii) disclose how the board is informed about climate-related risks and how frequently the board considers them, as well has how the board or board committee considers these risks in the context of its business strategy, risk management and financial oversight; and (iv) disclose whether and how the board sets climate-related targets and oversees progress against those targets, e.g., a target of net-zero carbon emissions by a particular year. The proposed rules contain similar disclosure requirements with respect to management, such as disclosing what managers or management committees are responsible for monitoring climate-related risks, the managers' relevant expertise, and the processes by which they stay informed of climate-related risks and report on those risks to the board or board committee. If these rules become final, registrants will need to reassess their governance practices as well as their board committee charters and other corporate governance documents to allocate responsibility at the board level for oversight of climate-related risks so that the required disclosures can be made with confidence.
- **Climate-related risks *(Item 1502(a)).*** The proposed rules would require disclosure of climate-related risks that have had or are likely to have a material impact on a registrant's business and consolidated financial statements, which may manifest over the short-, medium-, or long-term. The proposed rules distinguish between "physical risks" such as harm to the business arising from climate-related disasters, and "transition risks" to the business associated with a potential transition to a less carbon-intensive economy.[3] Registrants would be required to specify whether an identified climate-related risk is a physical or transition risk, the registrant's plan to mitigate or adapt to the identified transition risks, and the nature of any physical risk, including whether it may be categorized as an acute or chronic risk.
- **Climate-related impacts on the business *(Item 1502(b)).*** Having disclosed the material climate-related risks to the business, a registrant would be required to describe the actual and potential impact of those risks on its strategy, business model and outlook. The types of impacts to be disclosed include, as applicable, impacts on business operations, products or services, suppliers and other parties in its value chain, activities for mitigating or adapting to climate-related risks, and R&D expenditures. In a similar vein,

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[3] These risks include, but are not limited to: increased costs attributable to climate-related changes in law or policy; reduced market demand for carbon-intensive products leading to decreased sales, prices, or profits for such products; the devaluation or abandonment of assets; risk of legal liability and litigation defense costs; competitive pressures associated with the adoption of new technologies; reputational impacts (including those stemming from a registrant's customers or business counterparties) that might trigger changes to market behavior; changes in consumer preferences or behavior; or changes in a registrant's behavior.

the registrant must provide a narrative description of the impacts of severe weather or other natural conditions on its consolidated financial statements, as well as on the financial estimates and assumptions used in the financial statements *(Item 1502(d))*.

- **Risk management *(Item 1503(a))*.** Registrants would be required to disclose their internal processes for managing climate-related risks, including how the registrant:
  - Assesses the significance of climate-related risks in comparison to other risks or regulatory requirements, such as GHG emissions limits;
  - Considers changes in customer or counterparty preferences, technological changes, or changes in market prices in assessing transition risks;
  - Decides whether to accept, mitigate, or adapt to a certain risk; and
  - Prioritizes climate-related risks and mitigates high-priority climate-related risks.
- **Transition plans *(Item 1503(c))*.** If the registrant has adopted a transition plan in the context of its climate-related risk management, it must describe the plan along with the relevant metrics and targets used to identify physical and transition risks. These disclosures are meant to be specific to each registrant and its business operations rather than boilerplate responses. By way of example, they include disclosures related to:
  - Reduction of GHG emissions as required by commitments a business has made in line with a registrant's commitments or commitments of jurisdictions within which it has significant operations (e.g., the Paris Agreement);[4]
  - Mitigation of risks related to facilities exposed to extreme weather events;
  - Adaption to the imposition of a carbon price; and
  - Adaption to changing demands or preferences of consumers, investors, employees and business counterparties.

  A registrant that has adopted a transition plan would be required to update its disclosure about its transition plan each fiscal year by describing the actions taken during the year to achieve the plan's targets or goals. A registrant can also use this section to describe how it plans to achieve any identified climate-related business opportunities.
- **Carbon offsets or renewable energy credits ("RECs") *(Item 1502(c))*.** If, as part of its net emissions reduction strategy, a registrant uses carbon offsets[5] or RECs,[6] the proposed rules would require it to disclose the role that carbon offsets or RECs play in the registrant's climate-related business strategy.
- **Maintained internal carbon price *(Item 1502(e))*.** Under the SEC's proposed definition, an internal carbon price is an estimated cost of carbon emissions used internally within an organization. Internal carbon pricing may be used by a registrant, among other purposes, as a planning tool to help identify climate-related risks and opportunities, as an incentive to drive energy efficiencies to reduce costs, and to quantify the potential costs the company would incur should a carbon price be put into effect. If a registrant uses an internal carbon price, the proposed rules would require it to make various pricing disclosures, including the rationale

[4] 191 countries plus the European Union have signed the Paris Climate Agreement (Dec. 12, 2015, entered into force Nov. 4, 2016). The central aim of the Paris Climate Agreement is to strengthen the global response to the threat of climate change by keeping a global temperature rise this century to well below 2º Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5º degrees Celsius.

[5] Under the proposed rules, carbon offsets represent an emissions reduction or removal of greenhouse gases in a manner calculated and traced for the purpose of offsetting an entity's GHG emissions.

[6] REC would be defined to mean a credit or certificate representing each purchased megawatt-hour (1 MWh or 1000 kilowatt-hours) of renewable electricity generated and delivered to a registrant's power grid.

for selecting the applied internal carbon price, and to disclose how it uses its internal carbon price to evaluate and manage climate-related risks.

- **Scenario analysis** ***(Item 1502(f)).*** A registrant must describe the resilience of its business strategy in light of potential future changes in climate-related risks. In making this description, the registrant must describe any analytical tools, including scenario analysis, that it uses to assess the impact of climate-related risks on its business and consolidated financial statements, or to support the resilience of its strategy and business model in light of foreseeable climate-related risks. Of note, the SEC is not actually mandating that registrants conduct scenario analysis.

- **GHG emissions** ***(Item 1504).*** The proposed rules mandate disclosure devoted specifically to a registrant's GHG emissions, requiring that a registrant disclose its GHG emissions for its most recently completed fiscal year and for the historic fiscal years included in its consolidated financial statements. The GHG emissions disclosure rules are based on a concept of scopes as developed by the Greenhouse Gas Protocol,[7] the leading accounting and reporting standard for GHG emissions, as follows:

  - Scope 1 emissions, consisting of a registrant's direct GHG emissions.
  - Scope 2 emissions, consisting of a registrant's indirect GHG emissions under the control of a registrant, such as electricity, heating, cooling, or steam obtained from other sources.
  - Scope 3 emissions, consisting of all other indirect GHG emissions of a registrant (upstream or downstream) that are not contained in a registrant's Scope 2 emissions.[8]

  A registrant would be required to separately disclose both its total Scope 1 emissions and its total Scope 2 emissions after calculating them from all sources that are included in the registrant's organizational and operational boundaries. These disclosures must be expressed both by disaggregated constituent greenhouse gases (e.g., carbon dioxide, methane, hydrofluorocarbons, etc.) and in the aggregate; in absolute terms, not including offsets; and in terms of intensity (per unit of economic value or production). A registrant would also be required to disclose separately its total Scope 3 emissions for the fiscal year if those emissions are material, or if it has set a GHG emissions reduction target or goal that includes its Scope 3 emissions. These figures also must be provided in absolute terms, not including offsets, and in terms of intensity.

  The SEC notes its belief that the relevant data for calculating Scopes 1 and 2 emissions should be reasonably available to registrants, and that the relevant methodologies are fairly well-developed. Scope 3 emissions, by contrast, though potentially valuable information for investors, are not within a registrant's control, making their data accumulation more difficult. For this reason, the proposed rules require disclosure of Scope 3 emissions only if those emissions are material or if the registrant has set a GHG emissions reduction target or goal that includes its Scope 3 emissions. We note, however, that the required materiality judgment with respect to Scope 3 emissions will be difficult for registrants to make without first acquiring the necessary information from third parties.

  Of note, registrants that are smaller reporting companies ("SRCs") are exempt from making Scope 3 emissions disclosures altogether.

Attestation of Scope 1 and Scope 2 Emissions Disclosure

New Item 1505 of Regulation S-K requires any registrant (including a foreign private issuer) required to provide Scope 1 and Scope 2 emissions described above and that is an accelerated filer or a large accelerated filer to include an attestation report covering such disclosure in the relevant filing. For filings made by an accelerated filer or a large

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[7] *See* http://www.ghgprotocol.org.

[8] Upstream emissions include emissions attributable to goods and services that the registrant acquires, the transportation of goods (for example, to the registrant), and employee business travel and commuting. Downstream emissions include the use of the registrant's products, transportation of products (for example, to the registrant's customers), end of life treatment of sold products, and investments made by the registrant.

accelerated filer for the second and third fiscal years after the compliance date for GHG emissions disclosure, the attestation engagement must, at a minimum, be at a limited assurance level[9] and cover the registrant's Scope 1 and Scope 2 emissions disclosure. For filings made by an accelerated filer or large accelerated filer for the fourth fiscal year after the compliance date and thereafter, the attestation engagement must be at a reasonable assurance level and, at a minimum, cover the registrant's Scope 1 and Scope 2 emissions disclosures.

For illustrative purposes, the following table assumes that the proposed rules will be adopted with an effective date in December 2022 and that the filer has a December 31 fiscal year-end:

Filer Type	GHG Scopes 1 and 2 Disclosure Compliance Date	Limited Assurance	Reasonable Assurance
Large Accelerated Filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)	Fiscal year 2026 (filed in 2027)
Accelerated Filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	Fiscal year 2027 (filed in 2028)

Financial Statement Metrics

The new Article 14 of Regulation S-X would require registrants making disclosures under subpart 1500 of Regulation S-K in an annual report or any registration statement that requires audited financial statements to disclose in a note to its financial statements certain disaggregated climate-related financial statement metrics. These metrics are mainly derived from existing financial statement line items.

In particular, the proposed rules would require disclosure falling under the following three categories of information:

- **Financial impact metrics.** These include impacts from severe weather events and other natural conditions, and transition activities, in the same vein as the physical risks and transition risks for which narrative disclosure is required under Regulation S-K. The proposed rules would also require disclosure of the impacts of any climate-related risks identified pursuant to proposed Item 1502(a) as discussed above—both physical risks ("identified physical risks") and transition risks ("identified transition risks").

- **Expenditure metrics.** These 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. As proposed, the expenditure metrics would require a registrant to separately aggregate amounts of (i) expenditure expensed and (ii) capitalized costs incurred during the fiscal years presented. For each of those categories, the registrant would be required to disclose separately the amount incurred during the fiscal years presented (i) toward positive and negative impacts associated with the climate-related events and (ii) toward transition activities, specifically, to reduce GHG emissions or otherwise mitigate exposure to transition risks (including identified transition risks).

- **Financial estimates and assumptions.** A registrant would be required to disclose whether the estimates and assumptions used to produce the consolidated financial statements were impacted by exposures to risks and uncertainties associated with, or known impacts from, climate-related events, such as flooding, drought, wildfires, extreme temperatures, sea level rise. If so, the registrant would be required to provide a qualitative description of how those events have impacted the development of the estimates and assumptions used by the registrant in the preparation of its financial statements. Similar to the other proposed financial statement metrics, the proposed rules would include a provision that would require separate disclosure focused on transition activities (including identified transition risks).

[9] The proposed rules do not define the terms "limited assurance" and "reasonable assurance," instead leaving those terms to their marketplace understanding. Generally, limited assurance is given after a review of financial statements to the effect that they are free from material misstatements. Reasonable assurance means a high but not absolute level of assurance, as attained after an audit of financial statements.

As with the disclosure of GHG emissions, the proposed rules would require disclosure 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 applicable filing. For example, if the company is an emerging growth company or SRC, only two years would be required. The proposed rules also include an accommodation if providing a corresponding historical metric for a fiscal year preceding the current fiscal year would prove too burdensome, such as if the historical information is not reasonably available to the registrant.

The proposed financial statement metrics would be required in the financial statements, and therefore would be (i) included in the scope of any required audit of the financial statements in the relevant disclosure filing, (ii) subject to audit by an independent registered public accounting firm, and (iii) within the scope of the registrant's internal control over financial reporting.

Phase-In Periods and Safe Harbors

In addition to the phase-in period described above specifically regarding the attestation for Scopes 1 and 2 emissions disclosure, the proposed rules provide a phase-in for compliance with the entire disclosure regime. The following table illustrates the various compliance dates, again assuming that the proposed rules will be adopted with an effective date in December 2022 and that the filer has a December 31 fiscal year-end:

Registrant Type	Disclosure Compliance Date		Financial Statement Metrics Audit Compliance Date
	All proposed disclosures, including GHG Scope 1 and 2 emissions metrics, but excluding Scope 3	GHG Scope 3 emissions metric	
Large Accelerated Filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)	Same as Disclosure Compliance Date
Accelerated Filer and Non-Accelerated Filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	
Smaller Reporting Company	Fiscal year 2025 (filed in 2026)	Exempted	

Expected Costs of Compliance

The SEC has provided an estimate of the costs of compliance with the new disclosure regime, based on a recognition that the disclosures will carry both direct and indirect costs. The primary direct costs that the proposed rules would impose on registrants are compliance costs. The SEC acknowledges that those registrants not already doing so may need to re-allocate in-house personnel, hire additional staff, and/or secure third-party consultancy services. Registrants may also need to conduct climate-related risk assessments, collect information or data, measure emissions (or, with respect to Scope 3 emissions, gather data from relevant upstream and downstream entities — which, we note, it may not have the power to compel), integrate new software or reporting systems, seek legal counsel, and obtain assurance on applicable disclosures (i.e., Scopes 1 and 2 emissions).

Bearing those sources of expenses in mind, the SEC estimates costs for non-SRC registrants in the first year of compliance to be $640,000 — $180,000 for internal costs and $460,000 for outside professional costs. Annual costs for the subsequent five years (the temporal limit of the SEC's estimate) are estimated to be $530,000 — $150,000 for internal costs and $380,000 for outside professional costs. For SRC registrants, the costs in the first year of compliance are estimated to be $490,000 — $140,000 for internal costs and $350,000 for outside professional costs, and $420,000 — $120,000 for internal costs and $300,000 for outside professional costs — in subsequent years.

Additional Considerations and Takeaways

The SEC in its proposal release and associated statements stresses that climate-related risks have a material impact on capital markets and the financial results of individual businesses and thus warrant the comprehensive disclosure requirements that it has proposed. This posture, perhaps taken with an eye toward potential future legal challenges against the rule proposal, is a counterargument to the view that the SEC is engaging in political policymaking with no bearing on the impact to financial markets, burdens to capital formation or the reasonable investor's decision-making. With that said, the rule proposal is remarkable for its length, detail and potential cost of compliance. It would represent the most significant expansion of the disclosure regime in quite some time.

With this in mind, the **statement in dissent** by Commissioner Hester Peirce expresses several concerns, including that (i) material climate risks are a subject for already-existing rules, (ii) the data to be provided under the proposed rules is largely unreliable, and (iii) the SEC lacks the authority to propose this rule.

The comment period will remain open for 30 days after publication in the Federal Register, or 60 days after the date of issuance and publication on sec.gov, whichever period is longer.

Implications for U.S. Asset Managers

If adopted and implemented, the proposed rules would provide additional (and arguably standardized) data for asset managers and their clients to consider when making investment and voting decisions, and could lead to greater standardization of investment strategies and models. This would likely also impact methodologies used by related data providers.

With regard to the proposed rules' scope, as discussed above in "Proposed Regulatory Framework," the disclosure rules would apply to (i) any registrant that has a reporting obligation pursuant to Section 13(a) or 15(d) of the Exchange Act and (ii) companies that file a registration statement on certain Securities Act or Exchange Act registration statement forms and Exchange Act periodic reports. The proposal does not distinguish between operating companies and business development companies (BDCs)[10] that meet this standard. Accordingly, BDCs would currently become subject to the disclosure rules, even though it is not clear that the content of the rules was drafted with BDCs in mind. In fact, the proposal release requests comment on whether certain registrants — including BDCs — should be excluded from all or a portion of any final rulemaking.[11]

If BDCs are not excluded from the final rules, it is not currently clear how, as a practical matter, they would be able to comply. For example, BDCs do not have any physical operations, may not have employees, and rely on external service providers, all of which makes it infeasible for BDCs to calculate their Scope 1 and 2 emissions.

In light of these potential challenges, BDC sponsors should evaluate whether to submit a comment letter to the SEC to identify the practical challenges of complying with the proposed requirements and/or request interpretive guidance as part of any final rulemaking.

The SEC's current regulatory agenda indicates that ESG-related rulemaking proposal(s) for asset managers and registered funds may be adopted soon. It will be important to compare the disclosure rules discussed in this OnPoint to these other proposals.

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[10] A BDC is a "closed-end investment company that has a class of its equity securities registered under, or has filed a registration statement pursuant to, Section 12 of the Exchange Act, and elects to be regulated as a business development company. See Section 54 of the Investment Company Act, 15 U.S.C. 80a-53. Like other Section 12 registrants, BDCs are required to file Exchange Act annual reports." *See* Release at n. 699.

[11] *See* Request for Comment 175.