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The SEC's Proposed Climate-Related Disclosure Rules: Are They the "Core Bargain," a "Watershed Moment," or "Undermin[ing] the Existing Regulatory Framework"?

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By: Alexander J. May

By Alexander J. May, Charles D. Riely, Gabrielle Sigel, Michael R. Greubel, and TaeHyung Kim

Earlier this week, the Securities and Exchange Commission ("SEC") approved the issuance of proposed new disclosure rules [cited as "PR, p. __"], titled *The Enhancement and Standardization of Climate-Related Disclosures for Investors*, that would require both domestic and foreign public companies to provide certain climate-related information in their registration statements and annual reports and certain ongoing updates in their quarterly reports. The long-awaited proposed rules are the SEC's most direct move yet to transform disclosure requirements related to Climate and ESG issues and passed only after what appears to have been significant internal debate. The SEC's lone Republican Commissioner, Hester M. Peirce, dissented from the proposed rule, and the Chair and the other two Democratic commissioners released statements in support of the proposed rules. Their accompanying statements previewed the wide range of debate—in the courts, political sphere, and public discussion—destined to accompany these rules through the likely lengthy administrative process before (or if) they become final.

This Client Alert previews the disclosure obligations for public companies if the proposed rules are ultimately adopted, summarizes the ongoing debate about the wisdom of the proposed changes and previews the potential legal challenges to the proposed rule. For additional details regarding the proposed amendments, the SEC has posted a press release summarizing the proposal and public comment period, a fact sheet, and the text of the proposed amendments.

I. Summary of Proposed Disclosure Requirements

The SEC emphasized that its goal in proposing the rules was to enhance and standardize climate-related disclosures for investors. To do so, the SEC would impose a number of new and enhanced disclosure requirements for public companies. These new proposed disclosure requirements include information about a company's climate-related risks (and opportunities) that are reasonably likely to have a material impact on its business or consolidated financial

statements, as well as disclosure of the company's Scopes 1 and 2 (direct and indirect) greenhouse gas ("GHG") emissions, regardless of their materiality, and Scope 3 GHG emissions if material or relied upon by the company. The SEC also proposed new rules that would require companies to disclose certain climate-related financial metrics in their audited financial statements and information about the company's internal governance with respect to climate-related issues.

A. <u>Climate-Related Disclosures</u>

The proposed new Item 1500 of Regulation S-K would require registrants to disclose certain climate-related information ranging from governance, business strategy impact and risk management of climate-related risks, to GHG emissions and climate-related goals and targets. "Climate-related risks" are defined as "the actual or potential negative impacts of climate-related conditions and events on a registrant's consolidated financial statements, business operations, or value chains, as a whole." PR, p. 61. Those risks include both acute and chronic "physical risks," such as extreme weather events and longer-term decreased availability of water supply, as well as "transition risks," defined as "risks related to a potential transition to a lower carbon economy." PR, pp. 61-62. The disclosure required by Item 1500 of Regulation S-K must be included in the domestic company's registration statements and annual report on Form 10-K, and material updates are required to be provided in Form 10-Q. Broadly, the categories of required information include:

• **<u>Governance and oversight:</u>** Board of directors' oversight of climate-related risks and, if applicable, opportunities; management's role in assessing and managing climate-related risks and if applicable, opportunities.[1]

• **<u>Strategy, business model, and outlook:</u>**

- Climate-related risks (and opportunities) reasonably likely to have a material impact, including on the company's business or consolidated financial statements and business activities, which may manifest over the short, medium, and long term, with each registrant defining how many years are encompassed within each of those terms.

- Actual and potential impacts of any climate-related risks on the company's strategy, business model, and outlook, including the time horizon of such impact.

- Whether and how any such impacts are considered as part of the company's business strategy, financial planning, and capital allocation.

- Whether and how any identified climate-related risks have affected, or are reasonably likely to affect, the company's consolidated financial statements.

- Information on the company's internal carbon price, if available, but the use of a carbon price is not required.

- Resilience of the company's business strategy considering potential future changes in climate-related risks. If the registrant utilizes a scenario analysis to assess the impact of climate-related risks on its business and financial

statements, and to support the resilience of its strategy and business model, companies must disclose the scenarios considered, providing both qualitative and quantitative information.

• **Risk management:**

- The company's processes for identifying, assessing, and managing climate-related risks (and opportunities).

- Whether and how any such processes are integrated into the company's overall risk management system or processes.

- The company's transition plan as part of its climate-related risk management strategy, if applicable.

• **Targets and goals:** If the company has set any targets or goals related to GHG emissions reduction, or any other climate-related target or goal, it must provide information on the scope of activities and emissions included in the target, unit of measurement, time horizon, baseline targets, interim targets, and strategy for meeting the target or goal.

- If carbon offsets or renewable energy credits ("RECs") have been used as part of the company's plan to achieve climate-related targets or goals, the company must disclose certain information including carbon reduction from such offsets or RECs and related costs.

B. GHG Emissions

In addition to the overall governance, oversight, and risk evaluation disclosures, proposed Item 1504 of Regulation S-K would require all registrants to disclose certain GHG emissions, regardless of their materiality to the company. The proposed rules do not mandate a specific methodology that registrants must use for calculating emissions, with described exceptions including as summarized below. A company's GHG emissions disclosures must include:

• *Disclosure period:* The applicable GHG emissions from most recently completed fiscal year, as well as the historical fiscal years included in the company's consolidated financial statements in the filing, to the extent reasonably available.

• *GHG categories:* Emissions disclosure must be both disaggregated by each of the seven constituent GHGs addressed in the Kyoto Protocol, and in the aggregate, expressed in terms of carbon dioxide equivalents ("CO2e"), including as described in the GHG Protocol.

• *Scopes 1 and 2 emissions:* Scopes 1 and 2 emissions must be disclosed separately and may exclude emissions from certain investments and entities that are not consolidated into the company's financial statements.

• *Scope 3 emissions:* Disclose if material, or if the company has set a GHG emissions reduction target or goal that includes its Scope 3 emissions. Smaller reporting companies ("SRCs") are exempt from the requirement to report Scope 3 emissions.

• *GHG Intensity:*

- Scopes 1 and 2 – disclose GHG intensity based on the sum of Scopes 1 and 2 emissions, in terms of metric tons of CO2e per unit of total revenue and per unit of production.

- Scope 3 – if otherwise disclosed, separately disclose GHG intensity using Scope 3 emissions only.

• *Attestation of GHG Emissions Disclosures:*

In addition to the disclosures discussed above, accelerated filers and large accelerated filers must include an attestation report for Scopes 1 and 2 GHG emissions at a minimum, prepared and signed by a GHG emissions attestation services provider, to be included in a separately captioned "Climate-Related Disclosure" section in the filing. The proposed rules do not have a specific attestation standard for assuring GHG emissions, nor do they require that the attestation service provider be a registered public accounting firm. Instead, the proposed rule includes minimum standards for attestation service providers and scale up over time, specifically:

- "limited" assurance, or the equivalent of a review of the disclosure, for Scopes 1 and 2 emissions disclosure will transition to "reasonable" assurance, or the equivalent of an audit of the disclosure, after a phase-in period;

- minimum qualifications and independence requirements for the attestation service provider (which potentially may limit the ability to use a company's independent registered public accounting firm in such attestations);

- minimum requirements for the attestation report.

Additionally, companies would have a safe harbor from certain liability for their Scope 3 emissions disclosure, where such disclosure would be deemed not to be a fraudulent statement unless such statement was made or reaffirmed without a reasonable basis or was not disclosed in good faith.

C. Climate-Related Financial Metrics

The SEC also proposed a new Article 14 to Regulation S-X ("Article 14 of Regulation S-X"), that would require companies to disclose in a note to their financial statements climate-related metrics impacting their consolidated financial statements beyond a one percent threshold. The disclosure required by Article 14 of Regulation S-X is proposed to be required in annual reports and registration statements. The proposed metrics include, for example, the financial impact of severe weather events and other natural conditions, as well as expenditures to mitigate and financial estimates and assumptions impact by such weather events. The rules also propose similar metrics as efforts related to mitigating climate risks and related to transition activities, such as to reflect changes in revenues and costs due to emissions pricing or impacts to the balance sheet due to climate issues. Further, companies would be required to disclose the impact of climate-related risks and opportunities.

D. Phase-In Periods

The proposed rules provide for a phase-in for all reporting companies, with the compliance date depending on each company's filing status. For example, if the proposed rules were adopted effective December 2022, and the company has a December 31 fiscal year-end, compliance dates would be as follows:

• Large Accelerated Filer: Fiscal year 2023 (filed in 2024)

• Accelerated Filer: Fiscal Year 2024 (filed in 2025)

• SRC: Fiscal Year 2025 (filed in 2026)

Companies subject to Scope 3 disclosure requirements would have an additional year to comply.

E. Addressing Materiality

Finally, we highlight that, notably, the proposed rules do not include a quantitative definition of materiality in any of the disclosure requirements within the climate disclosure framework. The SEC made one reference indicating that it considered including a quantitative materiality standard with respect to Scope 3 emissions, but decided against a bright-line rule, reasoning: "because whether Scope 3 emissions are material would depend on the particular facts and circumstances, making it difficult to establish a "one size fits all" standard." PR, p. 183. The absence of a clearer definition of materiality in the proposed rules is not unusual for SEC disclosure rules, but will be a challenge to many companies and may affect the SEC's goals of comparability and consistency in climate-related disclosures.

II. Next Steps, Potential Implications and Considerations

The controversial proposed rules signify a substantial change to existing law and have wide-ranging implications with respect to companies' approach to climate change disclosure. In recent years, the SEC has moved toward reducing and simplifying disclosure burdens on public companies.[2] The proposed rules would impose a series of new obligations and are the most sweeping disclosure requirements since Dodd-Frank in substance, cost, and potential liability. We would expect a significant number of comments from a broad range of stakeholders and interested parties that the SEC will be required to consider in crafting final rules. Similar to other rules that were perceived to be beyond the scope of the SEC's mandate of protecting investors and regulating markets,[3] we would expect legal challenges to the rules once they are promulgated in final form and in particular the attestation requirements for GHG emissions.

To frame the comments and set the discussion for the final rule, the lone Republican Commissioner and the Democratic Commissioners both have advocated for their respective positions. In connection with the announcement of the rule, the Commission emphasized that the proposed rules, if adopted, would "provide investors with consistent, comparable, and decision-useful information for making their investment decisions, and it would provide consistent and clear reporting obligations for issuers." Echoing the notion that climate-related disclosure within the proposed framework should be (a) useful for investors and easily comparable and (b) establish clear-cut reporting obligations for issuers, the SEC indicates throughout the proposed rules that the disclosure framework is based on the existing and globally-accepted Task Force

on Climate-Related Financial Disclosures (“TCFD”) framework, with the justification for this manner of implementation being that relying on an already widely-accepted framework could help relieve the compliance burden on issuers and improve the comparability and usefulness of the climate-related disclosures for investors. Notwithstanding that justification, it is clear from the sheer breadth of the disclosure obligations outlined in the proposed rules that companies' compliance burdens will generally be, at some level, increased.

In addition, Chairman Gensler stated that, with respect to the SEC's reliance on the TCFD framework, “Today's proposal draws on our existing rules…as well as from the [TCFD], an international framework that many companies and countries have already started to adopt, including Brazil, the European Union, Hong Kong, Japan, New Zealand, Singapore, Switzerland, and the United Kingdom.” From this statement, among others, it appears that the SEC has taken an expansive, international view of climate-related disclosure obligations by indicating that the U.S. will, and should, be aligned with the countries that have already adopted the TCFD framework.

Another key message in the statements of Chairman Gensler, and Commissioners Lee and Crenshaw is that the necessity of the proposed climate-disclosure framework is driven by demand from investors themselves. Specifically, Chairman Gensler implicated the concept of materiality as a justification for the proposed rules—with the implicit idea being that investors have widely demanded issuers to disclose their climate risks, and, thus, climate-related disclosure is material and should be substantially incorporated in issuers' SEC-filed statements. Similarly, Commissioner Crenshaw invoked materiality in stating, “As a Commissioner, it is not my job to decide for millions of investors what information is material to them. Rather, it is my job to listen and engage with investors and the markets.”

In response, Commissioner Peirce released a dissenting statement, bluntly entitled, “We are Not the Securities and Environment Commission - At Least Not Yet”. Her statement included the following arguments against the proposed rules:

• The existing SEC rules already require companies to disclose material climate-related risks. Notably, Peirce expresses concern that, as a result of the proposed rules, companies will dispense with thoughtful consideration of what is financially material in their unique circumstances in favor of “ticking off a preset checklist based on regulators' prognostication of what should matter….”

• The proposed rules include some disclosure requirements that dispense with a materiality qualifier altogether, and other requirements that distort the SEC's traditional approach to materiality.

• The proposed rules will *not* lead to comparable, consistent, and reliable disclosures, due to, for example, the assumptions and speculation required to meet the disclosure requirements related to physical risks and transition risks.

• In contrast to the notion that relying on the TCFD framework (described above) will reduce the compliance burden on companies, the implementation of the proposed rules will be costlier than the SEC Commission anticipates.

• The proposed rules will hurt the economy and investors because a company's financial performance will likely suffer if its executives are focused on climate initiatives instead of financial metrics. In addition, the SEC itself will be harmed because the agency does not have expertise in the area of climate change, and the proposed rules go beyond the SEC's statutory authority (discussed in more detail below).

III. Potential Legal Challenges

Given the broad-reaching nature of the disclosure framework in the proposed rules, there is a substantial likelihood that the proposal, if adopted, would be challenged on the basis that the SEC exceeded its statutory authority.

Commissioner Peirce previews one potential basis for such a challenge in her statement, reasoning that the disclosure framework may violate First Amendment limitations on compelled speech. Specifically, Peirce describes that Congress' mandate to the SEC is "for us to regulate in the public interest and for the protection of investors is to protect investors in pursuit of their returns on their investments, not in other capacities." Accordingly, if the SEC enacts disclosure mandates that go beyond information that would be considered material to financial returns, then it may be compelling speech in violation of the First Amendment. Commissioner Peirce's overall message, which she reflects in the title of her statement, is that the SEC is not the agency charged by Congress with regulating the *environment* and, as a result, it is possible that the proposed rules may not pass muster.

Commissioner Peirce also foreshadows that the proposed rules, issued without specific statutory direction like Dodd-Frank, will be subject to the same type of challenge that recently felled the Occupational Safety and Health Administration's COVID-19 vaccination/test emergency temporary standard ("ETS"). In *Nat'l Federation of Independent Business v. Dep't of Labor*, *OSHA*, 595 U.S. ___, Nos. 21A244 and 21A247 (Jan. 13, 2022), the U.S. Supreme Court found that OSHA's ETS was a "significant encroachment into the lives – and health – of a vast number of employees." (Slip op. at 6.) Given the Court's finding that the ETS had such vast impact, the Court applied the rule that: "We expect Congress to speak clearly when authorizing an agency to exercise powers of vast economic and political significance." *Alabama Assn. of Realtors v. Department of Health and Human Servs.*, 594 U. S. ___, ___ (2021)." *Id*. (internal quotation marks and citations omitted). The Court granted a stay of the ETS because OSHA was unlikely to show that Congress had clearly authorized the agency to issue the ETS as written. Similarly, Commissioner Peirce's statement contains the same quoted language when she finds that the climate disclosure rules stem from "an unheralded power to regulate 'a significant portion of the American economy,'" without having Congress "speak clearly" to authorize the rules.

IV. Concluding Thoughts

In the short term, the proposed rules may lead companies to take a harder look at their existing disclosures. While the rules are not final and there are applicable carve-outs for SRCs, the rules may give pause to companies who do not now wish to comply with the administrative burdens of GHG reporting and attestation. Given that some form of the proposed rules may well be adopted, companies may decide to incur these costs now.

Companies are in various states on their climate-related journey. For companies that have yet to fully consider GHG emissions in their risk model, board governance and oversight, those topics will be ripe for consideration. In addition, for companies considering various climate-related goals, such as net zero emissions or similar targets, the proposed rules provide a framework for evaluating the cost and impact of settin

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