

Insights: Alerts

The SEC's Proposed Climate Change Rule: What Should Your Next Steps Be?

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Described as “a watershed moment for investors and financial markets” by Commissioner Allison Herren Lee, on March 21, 2022, the U.S. Securities Exchange Commission (SEC or Commission) released [a 506-page proposed rule](#) requiring public companies to disclose their direct and indirect carbon emissions and climate-related physical and transitional risks in their registration statements and annual reports. The proposed rule reflects a growing trend for more consistent, comparable, and reliable information concerning “environmental, social and governance” (ESG) matters. Although many companies have been voluntarily disclosing information regarding climate risks, uncertainties, impacts and opportunities, some have questioned the accuracy and adequacy of this information. The rules proposed by the Commission are intended to increase the sufficiency, reliability, consistency and comparability of material climate-related disclosures. The Commission hopes to finalize the rule by December 2022, but legal challenges may delay implementation.

What Should My Company Do In Response to the Proposed Rule?

The proposed rule is far-reaching – virtually every public company has a carbon footprint and will need to develop and implement a strategy to respond to the rule. This response will need to be coordinated between the company's environmental, compliance, financial and legal divisions and should involve outside counsel. The response should begin with understanding the implications of the proposed rule to your company and preparing and submitting comments. Your company should also begin developing a strategy to implement actions in response to the rule, including steps to avoid and minimize potential legal liability.

1. Prepare and Submit Comments. The Commission should expect to receive extensive comments both from opponents of any regulation and groups that want more stringent regulations. Comments on the proposed rule are due the later of May 20, 2022 or thirty (30) days after the proposed rule is published in the Federal Register.

2. Develop and Implement Strategy. Companies that have been waiting for the Commission's proposed rulemaking before implementing an ESG program should act now. Companies that already have an ESG program should evaluate their program to ensure it aligns with the Commission's proposed requirements and the company's investor and other stakeholder expectations. This strategy should include measures to avoid and minimize potential legal liability.

a. Avoid and Limit Liability. If adopted as a final regulation, the Commission's proposed disclosure requirements may increase enforcement and litigation risk. Even before the Commission released its

proposed rule, the Commission clearly signaled its intent to investigate greenwashing. The Commission established an ESG Task Force that is closely evaluating disclosures for misstatements, overstatements and omissions. The Commission's proposed disclosure framework will increase the Commission's ability to investigate and enforce greenwashing. Not only will the Commission scrutinize these disclosures, investors will do so as well, possibly resulting in a new wave of federal securities lawsuits arising from climate change disclosures. Companies should consider the following actions to avoid or reduce potential legal liability.

- i. The proposed rules would require increased disclosures concerning the effects of climate change on their operations and results. When characterizing any climate-related information in a positive light, companies should consider disclosure of any contrary material facts.
- ii. Net zero or decarbonization plans will need to be more than talk. The Commission's proposed rule would require those plans and any progress made toward achieving the plans' goals to be more detailed. A lack of sufficient detail or inconsistent information would result in potential liability risks.
- iii. Sustainability reports will continue to be a source of potential alleged misrepresentations. Companies need to ensure the accuracy of all their statements about the effects of climate change, not just mandated disclosures and filings.

b. Consider Scope 3 Emissions. Although the proposed rule attempts to balance the complexity of disclosing Scope 3 emissions (indirect upstream and downstream emissions – i.e., emissions from a company's supply chain and emissions from a company's product used by its customers) and the uncertainties and costs of disclosing these emissions, the proposed requirement to disclose Scope 3 emissions will be problematic for many companies.

Companies that have material Scope 3 emissions (the proposed rule does not set a quantitative threshold for determining materiality, but suggests a 40% threshold of a company's total GHG emissions) should assess and quantify their Scope 3 emissions to understand the financial impacts of climate-related risks and opportunities. Companies that have included Scope 3 emissions in a decarbonization plan should ensure that its plan meets the requirements of the proposed rule by identifying:

- i. Whether the reduction target is expressed in absolute terms or is intensity-based;
- ii. The scope of activities and emissions included in the target;
- iii. The defined time horizon by which the target is intended to be achieved, and whether the time horizon is consistent with one or more goals established by a climate-related treaty, law, regulation, policy or organization;
- iv. The defined baseline time period and baseline emissions against which progress will be tracked, with a consistent base year set for multiple targets;
- v. Any interim targets; and
- vi. How the company intends to meet its climate-related targets or goals.

Companies that would not be subject to the proposed rule Scope 3 emissions requirements should either document that it is a “smaller reporting company” or collect and analyze data to determine the significance of its Scope 3 emissions and document that these emissions are not material.

Conclusion

As stated by the Commission Chair Gary Gensler in support of the proposed rule: “Our core bargain from the 1930s is that investors get to decide which risks to take, as long as public companies provide full and fair disclosure and are truthful in those disclosures. That principle applies equally to our environmental-related disclosures.” The Commission, however, is likely to extend its reach beyond climate-related risks and promulgate additional rules for other ESG issues, including workforce-related disclosures such as workplace safety and employee diversity, equity, pay and other benefits. Companies should take immediate steps to ensure that they have measures in place to comply with the Commission's proposed rule if it is adopted as a final rule.

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