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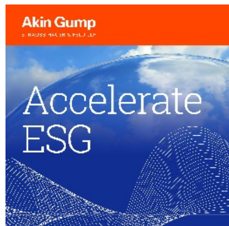

Ep. 3: SEC's Climate Disclosure Proposal: Part 1 – Impressions and Observations

June 9, 2022

Stacey Mitchell: Hello and welcome back to Akin Gump's *Accelerate ESG* podcast, featuring in-depth conversations on global ESG issues. I'm Stacey Mitchell, co-chair of Akin Gump's ESG and climate change cross-practice groups. And today, I'm joined by my partners and co-chairs of the climate change cross-practice group, Ken Markowitz and Cynthia Mabry. Welcome to the podcast.

Cynthia Mabry: Thanks, Stacey.

Ken Markowitz: Great to be here, Stacey.

Stacey Mitchell: On Monday, March 21st, the SEC in a three-to-one vote proposed amendments to require public companies to provide certain climate-related information in their registration statements and annual reports. The amendments are intended to enhance and standardize certain climate-related disclosures in order to address investor demands for more consistent and comparable information about climate-related risks and impacts and supporting emission disclosure.

In response to significant concerns raised by investors and other market participants, the SEC extended the initial 60-day public comment period on the proposed rulemaking by an additional 30 days, which runs on June 17th. The extension of the comment period, candidly, was not much of a surprise, and we don't believe it signals any change of heart or particular concern on the part of the Commission. Rather, the rule is extensive, at nearly 500 pages, and the extension was responsive to commenters pleas for additional time to make meaningful comment.

And while we certainly don't believe the rule will be shelved, the agency often makes changes based upon public feedback. Regardless, and as you'll hear Cynthia and Ken speak to more, we take the view that, even if the rules as drafted are not ultimately adopted, public and private companies need to begin

taking steps to prepare for enhanced climate-related disclosures due to worldwide demand for such information as well as similar regulatory initiatives across global financial markets.

In part one of this two-part series exploring the rules, we will review the content of the SEC's proposed rules and identify certain issues we believe to merit particular attention by stakeholders, evaluate potential intended—and, in certain circumstances, possibly unintended—consequences of the SEC's proposal, as well as some practical steps companies should consider undertaking now in anticipation of the proposal's implementation. In part two of the series, we will discuss the litigation risks to the rule if it is finalized as is.

Cynthia, I'd like to start by asking you for our listeners to summarize the key components of the SEC's proposals. What do stakeholders and potential commenters need to know?

Cynthia Mabry: Thanks, Stacey. But first, just to start off, the rules are guided by the SEC's three-part mission: to protect investors, to maintain fair and orderly and efficient markets, and to facilitate capital formation. So, the proposed rules, again, as Stacey mentioned, are not a surprise, but they do amount to a lot of additional disclosure for public companies, some of which is manageable, and some of which is potentially problematic. But, hopefully, you will get one step ahead with some actual steps we'll talk about today.

And just as a reminder and helpful backdrop, up until now, most ESG disclosure, including climate-related disclosure, has been voluntary. This has been voluntary in sustainability reports for proxy statements. And this is really the push by investors for investor-important information. And that's not going to change whether or not these proposals are adopted as written. In fact, this really just may accelerate calls from investors for companies to have additional disclosure through stockholder proposals or for requests for additional rulemaking. Now, while we're talking about the SEC's climate change proposed rules, we have to also remember that we anticipate that there will be SEC proposed rules on human capital disclosure, the other side of ESG, that will be forthcoming here soon.

So, as a short summary of, really, what are extensive and descriptive disclosure requirements, you can break these down into three buckets. The first being climate-related information, in a separately captioned sections of annual report and registrations. And this first bucket includes climate-related risk oversight in governance; climate-related risks and their impact to business strategy and outlook; Scope 1 and 2 GHG [*greenhouse gas*] emissions; and, for certain companies, Scope 3 emission.

The second bucket would be a new note to companies' audited financial statements addressing climate-related impacts on financial statement line items. And for large accelerated filers and accelerated filers, you would also be required to obtain independent third-party assurance on GHG emissions, which some

folks are doing now, but for the vast majority of reporting companies, this would be a new requirement.

Stacey Mitchell: That was a really helpful overview, Cynthia. I appreciate it. And Ken, having that overview as a backdrop, what in your view are some of the key issues of concern for both public and private companies as they think about SEC's proposal?

Ken Markowitz: That's a great question, Stacey, and Cynthia has given us a lot to unpack with that. You know, at a very high level, the biggest concern to me is the glide path to compliance with the proposed rule and the nature of, basically, taking the United States from a system of voluntary disclosures, which has not been fully embraced by the regulated community, to a mandatory system (and a very prescriptive mandatory system) that is going to be very resource-intensive to provide all of the types of information that the SEC is asking for here. And that is going to really require very fast track when the rule is requiring for large companies to compile data if the rule were to go in effect and be finalized the end of this year data for 2023 to be reported in 2024 for Scope 1 and Scope 2 emissions with Scope 3 emissions to follow. And that is just an incredibly granular undertaking and task.

And so, one, just the speed and the ramp up of taking the U.S. from a system of voluntary disclosure to mandatory disclosure in this tight timeline is going to be an incredible challenge based on, really, the granularity and resource-intensive nature of this.

A couple other things also jump off the page that could be of great concern to business, and that is disclosing too much about business secrets, business plans, business internal goals. So, the more that a company is doing currently to reduce their greenhouse gas emissions, set climate targets, come up with aggressive offset programs, the more information that the SEC is going to require. And a few of these examples could be concerning to business that they're going to disclose publicly information that would not normally go into the public domain. Things regarding how they're using an internal carbon price if they're using an internal carbon price to make decisions, or what are the company's transition plans that they've adopted as part of their climate-related risk strategy. And going deep granular into the plan, including relevant metrics and scenario analysis and assessing business resilience, these could be very company-specific approaches that they are working on internally that they may not want out fully in the public domain.

And then we can get down to one of the real challenges, which is going to be getting in line your supply chain and getting a better, clear, supportable, demonstrable understanding of Scope 3 emissions. As you know, Scope 1 are the direct emissions coming off your processes, and Scope 2 the indirect GHG emissions from purchased electricity and other forms of energy. But these Scope 3 emissions, which are the indirect emissions from upstream and downstream activities in your value chain, if material, are going to be really difficult to assess and require very highly technical and significant science and data skills.

And then there's all these different internal control issues, which, Cynthia, you are absolutely much in a better position than me to speak to, but we've discussed these in advance. So, I'd really like your opinion on what challenges, from wearing an auditor's hat formerly, how are they going to manage all this data and this granularity?

Cynthia Mabry: Thanks, Ken. That's absolutely right. These proposed rules, because it's such a shift in the terms of the volume disclosure being required, there's a real concern here of how companies are getting up to speed not only in their reporting, which is the outputs, but the inputs in terms of actually having your internal controls together to have that accurate data and the rigorous controls supporting that data that is typical for SEC-type filings.

And, so, in addition to your attestation provider, your consulting firm that's doing your carbon accounting, now you're engaging your internal auditors to really ensure that you have the reporting controls and the disclosure controls to ensure that that data is accurate over time. And that's not a switch that you can turn on. That takes time to get it right. And, so, there is definitely concern in terms of the aggressive timeline, in terms of the effectiveness of these rules. Are even the largest companies going to have time to address their internal controls matters and financial statement matters that these proposals implicate?

Stacey Mitchell: Yeah. And generally speaking, Cynthia, I think I certainly have been hearing—and would love to hear what you've heard—with respect to the availability of consultants to help companies get up to speed on these issues, as Ken said, in the zero-to-60 model.

Cynthia Mabry: Yeah, absolutely. So, for the folks that have been working on ESG reporting, especially with the sheer volume of requests coming from every single person in the value chain, so your financial service providers, your insurance companies, your vendors, your customers, there's been just a surge of requested information in terms of questionnaires, all sorts of information on the ESG side. So, the folks that have been working very diligently internally within their companies to address the sheer volume of ESG matters, now they are being asked to put more on their plate.

And, so, some folks have engaged consultants to help them with both the infrastructure associated with sustainability reporting that is implicated by these rules, but also with the actual carbon accounting. And that can be, depending on what your industry is, you're talking about folks that in a challenging environment to recruit and retain people where there's just a sheer volume needed to support the reporting and the controls and the measurement behind these, it's going to be, for the folks that have not already engaged the experts, it's going to be very difficult to find them. And the cost of these experts is just going to increase.

To the extent that audit firms are doing this type of work, you just have to think about the strain on resources and the existing audit firms. And if you think back to the Sarbanes-Oxley implementation, accounting firms were pulling from every

resource that they could think of, including hiring new temps, working with smaller consulting companies. And that's the type of constraints we're going to be dealing with in terms of the sheer headcount needed to implement these rules.

Stacey Mitchell: So, Ken, taking us from the granular to the global, I'd actually love to have your thoughts on how this proposal compares, or fits into, other disclosure frameworks worldwide.

Ken Markowitz: Stacey, this is maybe a piece that's getting a little lost, that the SEC is now putting the U.S. consistent with our trading partners as part of this global megatrend, I would call it, on climate-related disclosure requirements. And there are a lot of common threads between what the SEC is doing and what the U.K. is doing in their requirements for publicly traded companies, the forthcoming International Sustainability Standards global standard on this, and also the European Union's EFRAG [*European Financial Reporting Advisory Group*] regulation. There's key common threads like alignment and convergence around the Task Force on Climate-Related Financial Disclosures, which forms the foundation of all these reporting standards. As well, a consistent thread among these is a desire to create a standardized disclosure framework to elicit more useful and consistent information for investors across the world.

So, SEC is really furthering that and attempting to put some consistency in the U.S. with some of our key trading partners. And I know you mentioned this in the start of the program, but irrespective of this rule, this is something that has taken a life of its own organically among businesses around the globe and particularly those businesses that have nexuses across borders. And, so, the SEC's action is really very consistent with that, putting together concepts of common vocabulary and noting even the SEC recognizes the role that this is going to play in these global trends.

So, this is formalizing in an enforceable way direct as opposed to making an indirect enforcement through, say, false claims acts or others. This now has direct regulation over it. So, it's a formality in a very big way that's making us consistent with a lot of our leading trading partners, particularly in Europe.

Stacey Mitchell: And sort of playing off of that, Cynthia, actually, and so the enforceability here, I've actually heard commenters remark, and I am familiar with the earlier climate guidance from the SEC, but that arguably the SEC really could require companies to make, I guess, substantially similar disclosures under the existing rules and that guidance to the extent that those disclosures are material to a company's operations or financial statements. Can I ask you to explore that a bit more and get a little bit where you see that to be an accurate statement and where this rule goes beyond?

Cynthia Mabry: Absolutely. So the message from the SEC on these proposed rules and, really, from Chairman Gensler, and, really, from the beginning of the year across all forms of the SEC, we've heard over and over for the last several years, really

since the beginning of the Biden administration, is that investors are calling for consistent, comparable, and decision-useful information. You hear it over and over, and it's mentioned in the rule.

In this case, for the climate change rules, there's a real question of whether the SEC is making the case that climate is important for policy reasons, or is the SEC saying that the climate change data is so important that it's material to investors in making their investment and voting decisions? In our next part, when we talk about the potential litigation associated with any future final rule, it's really the question of whether is the SEC taking a new role in policymaking on weighing in what of the purpose of the corporation, or if this proposed rule is in line with the SEC's mandate and the 2010 climate change guidance?

So in terms of disclosure, many companies, especially large companies, are already doing some of this disclosure. You know, another weakness in the SEC's argument is, really, the SEC providing a lot of statistics, mentioning that, as Ken said, that the rule's framework is in large part based in the TCFD [*Task Force on Climate-Related Financial Disclosures*]. So, the SEC in its proposed rulemaking mentioned many statistics that said that companies were using TCFD; it was widely used among companies. And, so, within those data points, there was a real issue that, while many companies are using TCFD in some form, most companies are not fully implementing all the guidelines of the TCFD, and that includes those that are in the SEC's rulemaking.

So the second item worth noting is the SEC is not qualifying like they have typically done in many of their rulemakings, is not qualifying many of these proposed rules by what is material, applying, and I have air quotes, which you cannot see, what is “material,” applying the Supreme Court's definition of materiality. And that's whether a substantial likelihood that a reasonable investor would consider it important when determining to buy or sell a security or how to vote.

The SEC's final rule could come out with additional requests clarifying that certain rules are related to material disclosure only, which, if that's the case, then if companies are reporting, which they should be, what is material to an investment decision or how to vote, then it should, in theory, the climate change risks and associated disclosures should already be in that company's annual report or registration statement, if it is material.

The SEC's really pushing on that a bit with this rule, suggesting that these prescriptive rules are so important that they need that type of granularity. And that granularity is picked up in GHG reporting. For example, the location of physical risks down to the zip code and requiring updates to existing disclosure, whether or not those updates are material. Really, again, a shift towards prescriptive rulemaking after years of really, you could say, reducing and streamlining disclosure under simplification guidelines.

Stacey Mitchell: And Cynthia, we have not touched on that very much in this podcast yet, but there are a couple scenarios for climate reporting purposes that you only have to report under this proposed rule if you are doing certain things now, then you must disclose them. Wondering if you can give folks sort of a quick overview on that. And, following up on that same question, are those things that you think under the existing rules would be enforceable?

Cynthia Mabry: Thanks, Stacey. So, these are the bucket of proposed rules that I call the "if bucket." If you do something, then you have to disclose. And this is the group of rules that Ken talked about, whether you're really dipping into a corporation's management and how they're evaluating their decisions as a company, or whether you're potentially requiring companies to now divulge things that are commercially sensitive, or requiring a company to report on one of these "if buckets," so transition plan, scenario analysis, and others in this "if" description, which would be so qualified by assumptions or hedged by different risk factors that you're really not providing additional valuable information to the investors.

And there's a real feel or a chilling effect that some institutional investors have publicly commented that they intend to make public comment on these rules related to their concern that requiring companies to disclose these type of activities, which were management tools related to addressing climate change, that if you're requiring companies to do that only "if" they do it, then that would have a chilling effect on the use of those tools that are really there to help companies address climate change. So, there's a real concern there that those rules would have that type of effect.

And, so, when it comes to the final rules, I think that is part of the group of questions or group of proposed rules that's really under the microscope in terms of whether that's going to make it into the final rule or not.

Stacey Mitchell: Alright. So, as we come to the last segment of this podcast, we'd love to talk about some practical steps companies should be considering now in order to comply with either this new final rule or just enhanced climate disclosures being demanded by various stakeholders. So, Cynthia, I'll turn to you in the first instance to give some thoughts.

Cynthia Mabry: So, absolutely. We mentioned attestation reporting. We mentioned need for consultants. So, here is really the time now. Again, keeping in mind that these are the SEC's rules, this is the bare minimum. Assuming the proposed rules are implemented as written, this is still the basic regulatory requirement. This does not take into account what your investors are going to demand that you, individual company, are going to have to disclose. So, it's really still business as usual in terms of stakeholder engagement, which is very important when it comes to ESG reporting, net zero goals and what really your investors are looking for you to do as a company. So, continue that stakeholder engagement.

And then, in terms of the folks that are looking at this rule and have a ways to go, because there is the large companies and the small companies, it's really time

regardless of when this rule is going to be implemented to engage and just have discussions with your internal and external teams. This includes consultants if you need them on carbon accounting. It includes your internal audit teams that we've talked about. It includes your external auditors because there are rules, S-X proposed rules, that would implicate your financial statements, your assessment of internal controls and in financial statements. We mentioned internal controls. There's also the governance aspect, which we have not talked about. Similar to cybersecurity rules, it's really taking a look at your governance structure and how your board and your management is addressing, managing, and assessing climate control risk within your company.

So, those are just a few things. Really doing a gap analysis on where you are now, where you need to be in terms of the regulatory reporting side, but in continuing that stakeholder engagement, continuing on your individual plans for your company, addressing, if you have net zero goals, addressing those goals and making progress. That should not change with this proposed rule.

Stacey Mitchell: And Ken, I'll turn it to you for any last comments before we wrap up.

Ken Markowitz: Thanks, Stacey. And Cynthia, that's really excellent advice. I'm just going to focus, we're in the home stretch right now. The comments are due June 17th here to the SEC on this proposal. And as you all may be working to prepare comments, it's really important to pick and choose what is most important to you in your comments and support those comments with real-life examples of why an issue may be burdensome to you, or how this could affect your business, or how this could affect your business planning and why it may not be appropriate for this rule. Those types of comments are going to resonate the loudest, things that are supported by real-world data and experience as opposed to general voicing complaints that have been aired in the market because there are many, many different aspects of this rule. SEC has called for comment on over 200 issues. So, really focus as you prepare your comments and think through the why and support that why as you present your case to the SEC and consider.

You know, lots to think about here, and certainly looking forward to the next discussion with the two of you and particularly around some of the legal vulnerabilities about this rulemaking that we have not even touched on yet. Thanks, Stacey. Thanks, Cynthia. It's great to be part of it.

Stacey Mitchell: Thank you, guys. And thank you to our listeners for joining us today. If you're interested in learning more about Akin Gump and our climate or ESG know-how, please visit us online at akingump.com, or call any of us that were on the panel today; we are always happy to receive your phone call.

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