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Overview of the SEC Climate Risk Disclosure Proposed Rule

On March 21, 2022, the Securities and Exchange Commission (SEC) voted 3-1 to issue sweeping proposed climate-related disclosure rules for public companies. In issuing the proposed rules, the SEC cited its existing statutory authorities under the federal securities laws—specifically, the Securities Act of 1933 (P.L. 73-22) and the Securities Exchange Act of 1934 (P.L. 73-291). The proposal represents a more prescriptive and detailed approach to climate-related disclosures relative to the existing broad, principles-based climate-related disclosure regime embodied in the SEC's 2010 "Guidance Regarding Disclosure Related to Climate Change." Among other things, it would require all public companies, as a growing number voluntarily do, to report on their direct greenhouse gas (GHG) emissions and under certain circumstances their upstream and downstream GHG emissions.

Public companies would also be required to report on the impacts of climate-related natural events and transitional activities to mitigate such impacts on their consolidated financial statements. According to the SEC, both the current and proposed disclosure regimes are grounded in the federal securities laws' concept of *materiality*—the notion that required disclosures should encompass the types of information that investors consider important when they make investment or corporate voting decisions.

Some SEC officials say that the current voluntary reporting protocol has often resulted in incomplete and inconsistent significant climate-related disclosures due to differences in methodology and in assessing what is material. Various investors and observers have said that these shortcomings have compromised the complete disclosure of the financial risks related to climate change. And according to some SEC officials, the proposed rules are aimed at addressing such perceived drawbacks.

Other SEC officials have, however, argued that the current reporting protocol has generally resulted in firms consistently reporting materially significant climate-related impacts. They also asserted that the proposed rules go beyond the SEC's statutory authority, will not result in consistent and comparable inter-firm reporting due to unreliable data and modeling based on potentially speculative assumptions, and discards the materiality qualifier for some disclosures while employing an overly expansive definition of *materiality* for some others.

At the time of the vote, Chair Gary Gensler remarked, "Today's proposal would help issuers more efficiently and effectively disclose [climate risks] … and meet investor demand, as many issuers already seek to do." Some environmental groups have supported such measures based on similar arguments. For example, the Environmental Defense Fund said that, if finalized, the rules would "help investors price climate risks accurately and allocate capital prudently and efficiently through access to comparable specific, and decision-useful climate risk information."

Echoing a common criticism of the proposal, the U.S. Chamber of Commerce asserted: "[T]he prescriptive approach taken by the SEC will limit companies' ability to provide information that shareholders and stakeholders find meaningful while at the same time requiring that companies provide information in securities filings that are not material to investors."

The proposal earned praise from Senator Sherrod Brown and Representative Maxine Waters, the respective chairs of the Senate Banking and House Financial Services Committees. It was criticized by the ranking Members of those committees—Senator Pat Toomey and Representative Patrick T. McHenry.

If adopted, the disclosure requirements would direct domestic or foreign SEC registrants to include climate-related information in their registration statements, such as Form S-1, and their periodic reports, such as Form 10-K. The proposed disclosures can be divided into four broad types described below: climate-related risks, GHG emissions, targets and goals, and audited financial statement disclosures.

Proposed Disclosures

Climate-Related Risks. The proposal includes a number of provisions that involve non-financial disclosures surrounding corporate climate-related risks. They are modeled in part after the recommendations of the Task Force for Climate-Related Disclosures—a group of financial experts created by the Financial Stability Board. They also draw from the Greenhouse Gas Protocol, a global initiative that provides standards for business and government to monitor GHG emissions. These provisions would require a covered company to disclose:

- A description of its climate-related risks and relevant risk management processes.
- How identified climate-related risks have had or are likely to have a material impact on its business and financial statements during the short, medium, or long term.
- How identified climate-related risks have affected or are likely to affect its strategy, business model, capital allocation, financial planning, and outlook.
- How climate-related events (including severe weather events and other natural conditions) and transition activities (to help mitigate or adapt to climate-related

risks) would impact the line items of its consolidated financial statements, as well as the financial estimates and assumptions used in the statements.

- Its estimated cost of carbon emissions (if it uses an internal carbon price). Information about that estimate and how it is formulated must be disclosed.

- Disclosures that enable investors to understand those aspects of the registrants' climate risk management strategy (if the firm has undertaken scenario analysis, developed transition plans, or publicly issued climate-related targets or goals).

GHGs. Under the proposal, firms would generally be required to disclose their direct GHG emissions from operations that they own or control (Scope 1 emissions) and indirect GHG emissions from purchased electricity and other forms of energy (Scope 2). They would also be required to describe the methodology, significant inputs, and assumptions used for their calculations. For both, the disaggregated constituent GHG emissions would also have to be disclosed.

Firms would also be required to disclose their Scope 3 emissions if they deem them material or have established GHG emissions targets or goals. Scope 3 emissions are a consequence of a firm's activities but derive from its upstream and downstream activities, which may be neither owned nor controlled by it. Examples of Scope 3 emissions include emissions associated with the production and transportation of goods, purchases from third parties, employee commuting or business travel, waste generation, the processing or use of the registrant's products by third parties, the processing of sold products, the use of sold products, franchises, and investments. The required reporting of Scope 3 emissions has been one of the most controversial aspects of the proposal.

The proposal provides for a "safe harbor" that would shield firms from legal liability under the federal securities laws for their Scope 3 reporting if done in good faith. It would also exempt smaller reporting companies from Scope 3 disclosure requirements. (Smaller reporting companies are public companies with (1) a public float of less than $250 million or (2) annual revenues of less than $100 million and either (i) no public float or (ii) a public float of less than $700 million.)

Targets and Goals. If a firm has publicly established climate-related targets or goals, the proposal would require it to disclose a number of related items. Among them are (1) the scope and time horizon for the targeted activities and emissions, (2) how the targets will be met, and (3) data that tracks progress toward the goals. In addition, if carbon offsets or renewable energy certificates (RECs) have been part of a firm's plan to meet its climate-related goals, then the firm must disclose certain information, including the amount of carbon reduction represented by the offsets or the amount of generated renewable energy represented by the RECs. (A carbon offset is a transferrable instrument that represents an emission reduction of a metric ton of carbon dioxide or its equivalent. A REC represents a tradeable amount of energy from renewable energy sources.)

Footnoted Financial Statement Disclosures. Companies would be required to add disclosures about certain climate risks to their audited financial statements as footnotes when the risks are likely to have a material impact on line items and the firms' related expenditures. These footnotes would require disaggregated metrics that explain the impact of climate-related events (e.g., severe weather events, other natural conditions, and identified physical risks) and transition activities (including identified transition risks). Financial estimates and assumptions impacted by these developments must also be noted. As part of a firm's financial statements, the notes would be subject to auditing by an independent registered public accounting firm.

Materiality

A central tenet of the proposed rule is that the information to be disclosed is material to investors. SEC Chair Gensler argued in a statement on the rule that the mandated disclosures follow the materiality principles laid out by the U.S. Supreme Court. He also contended that substantial investor demand for such information is evidence of its materiality. Specifically, Gensler cited requests for such disclosures from investors with $130 trillion in assets under management. He noted that the Supreme Court has explained that information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment or voting decision or if it would have "significantly altered the total mix of information made available" (*Basic v. Levinson* and *TSC Industries, Inc. v. Northway, Inc.*). The SEC stated in the rule that GHG emissions have become a commonly used metric to assess a company's exposure to climate-related risks that are reasonably likely to impact its business, operations results, or financials.

In a dissent, Commissioner Peirce stated the rule lacked "a materiality limitation," "an adequate statutory basis," and a "credible rationale for such a prescriptive framework" when existing disclosure requirements already capture material risks from climate change. Other commenters disagree. For example, Emory School of Law Professor George Georgiev opined that "materiality" should be considered from the lens of a "reasonable investor" and that the SEC should not "second-guess" the validity of investor-driven demands, such as from BlackRock, State Street, Vanguard, CalPERS, and others who requested such disclosures. Then-Harvard Business School Professor Robert Eccles additionally noted (prior to the rule) that SEC Staff Accounting Bulletin No. 99, from 1999, states that "exclusive reliance on certain quantitative benchmarks to assess materiality … is inappropriate" and that both qualitative and quantitative factors must be considered in determining materiality.

Related CRS Products

CRS Report R46766, *Climate Change Risk Disclosures and the Securities and Exchange Commission*, by Rena S. Miller, Gary Shorter, and Nicole Vanatko.

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