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THE SEC PROPOSED RULES FOR CLIMATE-RELATED INFORMATION DISCLOSURES

PART I: OVERVIEW

The U. S. Securities and Exchange Commission ("SEC" or "Commission") has proposed, as of March, 2022, to require registrants "to provide certain climate-related information in their registration statements and annual reports, including . . . climate-related financial risks . . and financial metrics in their financial statements." The proposed rule is simply entitled "***The Enhancement and Standardization of Climate – Related Disclosures for Investors".*** (Rel. No. 33-11042 and 34-94478, File # 57-10-22.) The Commissions purpose is basically that such disclosures will provide "decision-useful information to investors to enable them to make informed judgments about the impact of climate related risks on current and potential investments." [p. 7] In addition to its core reasons for doing so, the Commission believes that such disclosures "will promote efficiency, competition, and capital formation". The problem the SEC seeks to better solve is that current SEC regulations "do not adequately protect investors, because the mere omission of same creates financial consequences to investors due to incomplete risk analysis. The 2021 Financial Stability Oversight Council ("FSOC") Report on Climate Related Financial risk 2021 concluded that "severe and frequent natural disasters can damage assets, disrupt operations, and increase costs." [2021 FSOC Report, Ch. 1] From a global perspective, "governments around the world have made public commitments to transition to a lower carbon economy, and efforts towards meeting those greenhouse gases ("GHG") reduction goals have financial effects that may materially impact registrants". [p. 12] The type of information that the SEC seeks to be disclosed should be consistent, comparable, and reliable . . . on . . . material related risks... " (p. 130) Looking back, the SEC introduction to these new amendments to their regulations cited the prior history of the SEC 2010 Commission Guidance regarding Disclosures Related to Climate Change [Release No. 339106 dated Feb 2, 2010]. Looking forward, the SEC proposed amendments to its current regulations would include such things as phase-in periods, safe harbors for certain emissions, exemptions for others, and reduced reporting requirements for smaller companies.

So the first question you may ask is how are these proposed amendments to the regulations different from current SEC filings regarding climate-related information? The answer is that the proposed amendments go beyond the 2010 Guidance, so in that sense, they would “augment and supplement the disclosures already required by the SEC filings” and, in doing so, would be based on the registrants specific facts and circumstances (i.e. company specific risks). The SEC requested public input from investors, registrants, and other market participants on climate-disclosures by March 15, 2021. As of mid-2022, extensive responses have been received. As a result of these inputs, the SEC published their proposed regulations in March, 2022.

Substantively speaking, those in support of the amendments to the current SEC regulations argue that current disclosures do not produce “consistent, comparable, or reliable information for investors or their advisors”, or even when it is produced, the information is more boilerplate green-washing. On the flip side of the debate, such organizations as the American Enterprise Institute, the Cato Institute, the Heritage Foundation, and the Texas Public Policy foundation, as expected, remain in their belief of the so-called “social ordering” of climate related issues. [p. 20] Lastly, efficiency-wise, PricewaterhouseCoopers writes that having climate related information on a registrants’ Form 10-K statement would make it easier to find and compare such critical data. The sheer transparency of same will create a better working relationship between companies and their investors. Given all the inputs received, the SEC proposed climate-related rules and metrics would provide multiple benefits to the market, thereby creating more investor confidence.

So the next question is what is a good “framework” for these requisite climate-related disclosures? In the view of the SEC Investment Advisory Committee (“IAC”), third party voluntary frameworks and disparate types of disclosures, are simply too fragmented, so the Trustees of the IFRS stepped forward and established the ISSB in November, 2021. (The ISSB would be operating within the existing governance structure of the IFRS Foundation with offices in Montreal and Frankfurt.) [p. 33] Its purpose is to consolidate the global standards for climate-related information disclosures. On top of the ISSB framework, the SEC noted that the Greenhouse Gas (“GHG”) Protocol has become a leading reporting standard for GHG emissions. So it is expected that the SEC will also coordinate with the ISSB because any registrant doing business in Europe or

Asia will likely have to comply with the sustainability standards in said countries in those regions.

To digress for background purposes, the IFRS is a Foundation that oversees the International Accounting Standards Board ("IASB"). The IASB promulgates international financial reporting standards adopted by most major countries (140) other than the United States. It established a Task Force on Climate-Related Financial Disclosures ("TCFD") to achieve the goal of collecting consistent, comparable, and reliable climate-related information. The IFRS Foundation established the ISSB in 2021. The ISSB will cooperate with the IASB to ensure compatibility between the financial accounting and sustainability disclosures. Both the ISSB and the IASB will be overseen by the IFRS Foundation Trustees. (There will an ISSB chair, two vice chairs, and 11 other members will be appointed from across the world.) In March 2022, the ISSB published its draft General Requirements for Disclosure of sustainability-related Financial information ("General Requirements Standards") and a draft Climate-related Disclosures framework ("Climate Standards"). Together, the IFRS General Requirements Standards and the Climate Standards represent a significant step towards creating cohesive global standards for mandatory climate-related standards. Basically, the ISSB understands that the primary users of the information (viz; investors, lenders, and other creditors) need consistent, complete, comparable and verifiable sustainability-related financial information to help them assess an entity's enterprise value. The "Core" content of the ISSB General Requirements identifies 4 factors that the ISSB bases their framework on. They are as follows:

[a] Governance
[b] Strategy
[c] Risk management
[d] Metrics and Targets

(E.g., regarding Item #1: GOVERNANCE, the ISSB objective is simply to "enable the primary user to understand the governance processes, controls and procedures used by an entity to monitor and manage significant sustainability related risks and opportunities". In order to do so, entities shall be required to disclose information about the governance structure of same (such as the board, committees, etc.) that monitor and govern sustainability-related risks and opportunities, and managements' role in managing the company systems.)

So the SEC 's proposed regulations are modeled in part on the TCFD framework above, which is currently widely accepted by international investors. According to the SEC, as of October 2021 more than 2,600 organizations globally, with a total market capitalization of $25 trillion dollars, support the TCFD recommendations. [p. 36] Furthermore, the GHG Protocol on emissions is considered the most widely used global GHG accounting standard. (It was created by the WRI and the WBC for sustainability development, and is now incorporated into the TCFD framework.) It provides uniform methods to measure and report the seven GHG covered by the Kyoto Protocol on Scope 1, 2 and 3 type emissions. [p. 38 – 39]

Fast forward to today, so where is the SEC as of mid 2022? The SEC proposed amendments include adding a new subpart Reg S-K to require a registrant to disclose climate related information, including information about its risks that are "reasonably likely" to have a material impact on its business or financial statements, and to provide GHG emissions metrics that could help investors assess those risks. The disclosures may also include how climate-related opportunities may also arise as a result of said risks. Secondly, the SEC Proposal will add a new Reg. S-X that would require climate-related statement metrics.

With regard to the **CONTENT** of a registrants disclosures, the SEC disclosures would include information regarding registrants:

- Company governance oversight between its directors and management
- Likely material impact on registrant
- Likely affect on its strategy, business model, and outlook
- Registrant's integrated processes that address such risks
- Impact of climate-related events and transition activities
- Scope 1 and 2 of GHG emission control metrics process
- Scope 3 GHG emissions being addressed
- Targets and Goals and registrants transition plan

With regard to the **PRESENTATION** of the proposed registrants disclosures, the SEC would require registrants:

- Provide the information in their Annual Report

• Provide Reg. S-K information in a separate section of its registration statement or annual report

• Provide Reg. S-X mandated climate – related financial statement metrics as a note in a registrant's audited financial statements

• Electronically tag the information on Inline XBRL

• File [not just furnish] the climate – related disclosures

The attestations requirements for Scope 1 and 2 emissions disclosures would require a minimum attestation report, minimum standards for acceptable attestations, its framework, and minimum qualifications for attestation service providers. Finally, the phase-in proposal would be based on the filers status, there would be safe harbors, and some exceptions for Scope 3 emissions for smaller reporting companies ("SRCs"). Given this overview, the SEC next proceeds to provide a discussion on the highlights above.

PART II: DISCUSSION

In Part II: DISCUSSION of the SEC proposed rules, I will group together into seven [7] key issues, for pragmatic overview purposes, and to explain why these issues matter. They are as follows:

1. SEC Disclosure Framework

As mentioned in Part I, the new SEC climate-related disclosure rules are basically premised on the current TCFD draft framework (referenced above) that many companies and investors are already familiar with. This would both mitigate compliance burdens for issuers, but it would also leverage the TCFD framework, because it is supported by both issuers and investors according to SEC fact-finding and due diligence. Of particular interest from my perspective is that Reg. S-K would require registrant information on its governance of climate-related risks, and the impact on a company's strategy, business model, outlook, risk management, GHG emission metrics, and targets and goals. [p. 49] Reg. S-X would require the disclosure be in a note in registrant's climate-related financial statements regarding certain climate-related metrics in three (3) categories; namely, financial impact metrics, expenditure metrics, and financial estimates and assumptions. The goal is simply to provide transparency and the impact of this information on the company financials. The climate-related information could be found in the company

annual report and in its financial statements for ease of review. The SEC also supports a narrative discussion and analysis of the climate-related metrics as a means to present these disclosures in context. [p. 52]

More specifically, in providing the above information, the SEC will require the discloser to take into consideration the risk of physical harm to an entity and to their assets, as well as the risks associated with the transition to a lower carbon economy. The test is whether either would have a "material" impact on the registrant's business and financial statements, the disclosure would include both actual and potential negative impacts. The SEC considers something "material" when there is a substantial likelihood that a reasonable investor would consider it important in determining whether to buy or sell securities or how to vote on same. Such determination is largely fact specific, and includes both quantitative and qualitative considerations. [p. 64]

2. Governance Disclosures

The SEC proposed rules would require a registrant to disclose certain climate-related risk information and also its management's role in managing same. This would include a company's board of director's oversight, as well as other financial material matters. Many commenters supported "robust disclosure of a board's and management's governance of said risks and opportunities consistent with the TCFD framework." [p. 93] As mentioned above, one key reason the SEC based their proposal on the TCFD recommendations was that only a small percentage of issuers currently provided governance related information aligned with TCFD recommendations, so it has not been useful. Secondly, for efficiency purposes, it was noted by the SEC that the requested information is similar to the SEC's existing rules under Reg. S-K on corporate governance disclosures on a company's directors, managers, and principle committees. [p. 94] Summarizing same, the five [5] categories of disclosures regarding registrant's directors and managers are as follows:

a) *Board Oversight*: The new SEC proposed disclosure requirements are designed to identify five (5) items, namely [i] the directors and/or committee members responsible for such oversight, [ii] whether any director has expertise in climate-related risks and the nature thereof, [iii] the processes and frequency of discussion of such risks, [iv] whether and how the discloser treats said risk as part of its strategy, risk

management, and financial oversight, and [v] the climate-related targets or goals directors set, and how they oversee the progress thereof.

b) *Management Oversight*: The SEC proposed disclosure requirements would require a registrant to disclose five (5) items that managers practice as part of their role in managing climate-related risks. Registrants must identify [i] the management positions or committee members responsible for such oversight, [ii] how managers address climate-related risks, and the nature thereof, [iii] the processes and frequency of discussion of such risks, [iv] the processes by which managers are informed about, and monitor climate-related risks, such as through their staff, plans of action, third party consultants, and [v] how management reports to directors on such risks, and the frequency thereof. Determining how a company is governing and managing its climate-related specific issues will provide significant granular information on how it does business.

3. Risk Management Disclosures

The significance of identifying climate-related risk factors by the SEC goes back many decades to 1982 when it was identified in its integrated disclosure system at that time. So the proposed new rule would simply take it one step further. The new amendments require the registrant to describe its processes in order to identify, assess, and manage climate-related risks in its risk management practices that would be "decision useful" for investors. As such, a registrant would be required to disclose how [i] it determines the relative significance of climate related risks, [ii] likely or possible significance of regulatory requirements (e.g. GHG emissions), [iii] the company shifting as a result of the eco-system changes in its operations, [iv] it determines the "materiality" of such rules, [iv] it decides on its response to a particular risk, [v] it prioritizes climate risk, and [vi] it intends to mitigate a high priority risk. Collectively, the commenter recommendations the SEC will receive will be of sufficient granularity that an investor can make a better-informed investment or voting decision. Furthermore, they may also indicate how a company board of directors and management may respond <u>in the future</u> as well. [p. 102] The current decision-making process of a registrant will help the SEC understand how a company may decide in the future.

With respect to a company's GHG emissions, a transition plan would be needed to execute an effective strategy. So for any physical risks identified, a registrant would need

to identify how it plans to mitigate or adapt to such risks. Such a transition plan may include such matters as restricting GHG emissions or products with high GHG emission footprints, protection of natural assets, imposition of a carbon tax, and changing customer demands or preferences. Conversely, they may also describe such opportunities for its products that support a lower carbon economy, generation of renewable power, less carbon intensive production methods, conservation goals that help reduce GHG emissions, and any goods or services related to a lower carbon economy.

4. Financial Statement Metrics

Regarding Subpart F of the Discussion section, in certain circumstances when a registrant is required to file audited financial statements, a note to its financial statement must contain certain metrics from existing line items. The three (3) categories the SEC listed are as follows:

- Financial Impact Metrics
- Expenditure Metrics
- Financial Estimates and Assumptions

For example, with respect to a company's Financial Impact Metrics, it would require that the registrant disclose "contextual information" so that investors can understand how it derived the metric. Requiring more narrative-backed accounting information promotes the goal of consistency and comparability of information from all disclosers. This would enable investors to analyze trends in climate-related impacts on financial statements, and narrative trends that contextualize same that far exceed summary statements filed today.

5. Targets and Goals Disclosures

Subpart I of the Discussion section of the proposed SEC Rules addresses those registrants who have set climate related targets or goals and would require information on same such as the reduction of GHG emissions, energy usage, water usage, eco-system restoration, etc. The purpose is the same; namely, the investor needs to assess a company's progress, to achieve company goals, and targets, and timelines to achieve them by requiring a description of the scope of its activities, the unit of measurement it

is using, the time horizon, the baseline time period, baseline emissions, interim targets, and how the registrant plans to meet its goals and targets. Going forward, it also requires a registrant to indicate if it is making progress, and how it is progressing. This tends to show investors basically where the company is headed. Of course, the information disclosed should not be considered "promises or guarantees", and various safe harbors would apply, so the SEC believes that this should not be an impediment for registrants to file same.

6. Disclosure Rules & Affected Forms, and Structured Data Requirements

Subpart J and K of the Discussion section include proposed regulations concerning specific types of changes to forms to be filed, and the data in said amended forms. As such, these two sections specify how the SEC plans to roll out its new rules of climate-related disclosures for various companies that will be impacted by same. This section will be more in flux based on comments the SEC receives, so I will only highlight some of the procedural issues. In Subpart J, the proposed disclosures would be in Registration Statement Forms S-1, F-1, S-3, F-3, S-4, F-4 and S-11, as well as Exchange Act Forms 10 and 20-F. It will also require a registrant to file revised annual reports in Forms 10-K and 20-F, and any material changes to climate-related disclosures in its Form 10-Q (and Form 6-K for foreign private issuers). Notwithstanding the above, SRCs and EGCs would have some modified requirements, types, and also different time periods that would apply to same. Of note is Comment #189 to this section. It references the ISSB framework discussed in the Overview section above. The SEC asked commenters, as an alternative to the TCFD standards being used in these proposed regulations, to consider the ISSB draft standards that may be finalized as early as the end of 2022. Such an alternative framework would encompass ISSB standards as a baseline for SEC reporting purposes.

Lastly, with respect to Subpart K: Structured Data Requirements, this section is more procedural in scope. It requires a registrant to tag the new disclosure in the InLine XBRL and the EDGAR Filer manual to improve the quality and usability of XBRL data for investors, by allowing automated extraction and analysis of climate-related information by investors and other market participants.

7. SEC Treatment of Disclosures and Compliance Data

The final section L of the Discussion addresses a major issue of whether the climate-related information will be considered "furnished" or "filed". The crux of the matter is the degree of liability a registrant will be exposed to if the information is determined to be false. There have been some good arguments on both sides of the debate. Those commenters who want the information to be considered "filed" do so to ensure that the information is accurate and complete which a filed document will require compliance with. On the other side, some commenters argue that "furnished" information will perhaps persuade a registrant to provide broader disclosures, or should only be "furnished" simply because the information is based on projections and aspirational statements, so they believe it is not suited to a stricter liability standard. [p. 288] The SEC has sided with the "filed" camp because they believe it would elevate the disclosures to the same degree of liability as other important business or financial information in registration statements, and periodic reports (with the exception of Form 6-K).

So to recap, the SEC proposes that the climate-related information to be disclosed would be subject to both the Exchange Act §18 and the potential liability of §11. The SEC believes that the combination of the fact that the information would be specific to a company risk assessment and strategy (not external sources), and the applicability of safe harbors to certain disclosures, is sufficient enough to provide the level of confidence for a company to require it to "file" the information with the SEC, not merely to "furnish" it.

Lastly, in Subpart M: Compliance Date, of the Discussion section, the SEC proposes a phase-in approach to the deadlines to file under Reg. S-K and S-X. They begin by requiring large accelerated filers to file as early as 2024 for all proposed disclosures (except Scope 3 GHG emission metrics to be filed one year later.) For accelerated and non-accelerated filers, they will be required to file in 2025 (except GHG emission metrics that are to be filed one year later). And finally SRCs will be required to file in 2026 (except that Scope 3 emission are exempt). In all cases, the Financial Statement Metric Audit Compliance date will be the same as the disclosure compliance date. The SEC believes that the transition period set forth above will provide sufficient time for registrants to make the necessary arrangements to begin gathering and assessing such

data, with the shortest timetable being the large accelerated filers, because they already are doing same, and they have the resources and levels of control in place to file same more readily.

PART III: GENERAL REQUEST FOR COMMENTS

This section is a simple one-paragraph request by the SEC for comments to their proposed regulation amendments. The questions they seek to receive comments about are interspersed throughout the proposal and correlated to the subject matter they relate to.

PART IV: ECONOMIC ANALYSIS

The SEC concludes its overview of the proposed climate-related regulation amendments by delving into the economic justification and explanations for its purpose in proposing to expand its current regulations. The SEC intends to focus on climate-related information disclosures from the perspective of a baseline, the major parties affected, current status of other regulatory schemes, the benefits and costs of amended regulations, the anticipated effects on efficiency, competition, and capital formation, other economic effects and reasonable alternatives. Because this section is more background information regarding the justifications and explanations for proposing the amendments to existing SEC regulations, I will not review same. Suffice it to say that the 125 pages of this section provide credible proof that our inaction today by not addressing climate-related issues (i.e. so-called "externalities") is already costly. So the SEC needs to go even further than they have in the past to obtain usable climate-related information for all parties involved. Of particular interest is the SEC's explanation of why this climate-related information will also be an opportunity for registrants to use their data, and that of other filers, to leverage same to be more efficient and effective in their strategic and sustainable plans for the future.

Overall, the SEC has attempted to rectify over 50 years of the simplistic myth that "private ordering" and minimal climate-related regulations are acceptable. Quantitative type financials only tell the whole story of a company. The SEC now seeks more qualitative and narrative type information on climate-related matters, and how it affects a registrants risk profile, its profits, and the stakeholders affected by same long left in

the dark due to the past asymmetric information provided by SEC filings. So more disclosures are long overdue because the true costs of inaction are the real issue today. These SEC regulations will go a long way to creating sustainable solutions by addressing where they started in the first place. Understanding the true costs and benefits of the business sector "internalities" is a major step forward in creating a sustainable future for all parties. After all, climate related matters were never "externalities" in the first place.

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