FINAL RULES: THE SEC C-R DISCLOSURES FOR INVESTORS DO THE ENDS JUSTIFY THE MEANS?

§II: DISCUSSION

Introduction

A lot has been written in the past month with regards to the Final Rules of the SEC in March 2024, but I have not read very much about the common themes put forth as to why they decided to modify several key parts of the Proposed Rules. Because the Final Rules are extensive, I will limit this paper to Part II §§ C, D, E, F, and G. Why? These sections are at the heart of corporate systems of governance and management. More specifically, these sections deal with climate related ("C-R") risks and opportunities as to strategy, business model, outlook, governance, management, risk management and targets & goals disclosures. Simply put, it's where systems operations, and compliance policies and procedures will operate under the new C–R disclosure rules. It's where the proverbial "rubber meets the road" so to speak. Simply put, I plan to shed light on the SEC's reasons for rethinking the Proposed Rules (i.e. their why).

So, why bother? The point is that the third-party comments received by the SEC helped the SEC rethink the original hypothetical facts and circumstances that the Proposed Rules were based on, so that the Final Rules would better fit same. Once the Final Rules are implemented, their success or not will answer the question of "did they accomplish their purpose?" So, let's see why the SEC did a rethink on the Proposed Rules of 2022. (NB. pages 31 & 32 of the Final Rules set forth what the various types of changes made to the Proposed Rules, but not why the SEC did so.) This article assumes the reader is generally familiar with the Final Rules.

§C: Disclosure of Climate-Related Risks

- The SEC required a separate disclosure provision focused on C–R risk because it will help investors better understand a registrant's assessment of exposure to C–R risk, and thereby enhance investor protection. The information disclosed will be more consistent, comparable, and useful.

- The definition of C–R risk disclosures is now less prescriptive, and it also specifies the time frames to make the disclosures less burdensome.

- The term "business strategy" was revised to align it with the TCFD recommendations so it should be familiar to all parties.

- The elimination of the determination of negative C–R impacts on a registrant's value-chain was to make it less burdensome because it would have involved a C–R assessment of counter parties the registrant does not control. This includes assessments of value-chain impacts in "transition risks".

- The elimination of <u>immaterial</u> C–R risk disclosure as it is too <u>burdensome</u> as <u>overly complex</u> with respect to material risks that a registrant clearly and consistently faces. (e.g. interaction of two related physical risks).

- The elimination of disclosure of registrants' <u>particular business practices</u> to make the information not <u>overly granular</u> which could cause investor confusion.

- C–R <u>opportunitie</u>s descriptions are now more closely <u>aligned</u> with TCFD definitions, but the reporting of the same is optional.

- The definition of short-term inputs (1 year) vs long-term (beyond 1 year) is to make the Final Rules consistent with the Management's Discussion and Analysis of Financial Condition and Results of Operation ("MD&A") standard for <u>alignment</u> purposes. Likewise, the term "reasonably likely" to occur a MD&A standard.

- The <u>materiality</u> qualifier will now be interpreted <u>consistent with</u> Supreme Court precedents and should consider both quantitative and qualitative factors.

§D: <u>Impacts on C-R risks on Strategy, Business Model, and Outlook</u>

D1: Material Impacts:

- In this section, the Final Rules require registrant to describe "<u>potential material impacts</u>" of C-R related risks to its strategy, business model, and outlook and more specifically describe same such as business operations, products or services, value-chain, mitigation activities, expenditures in R&D, and any other significant changes or inputs. The reason is because it is <u>central to evaluating</u> management's response to impacts and resiliency C-R factors with respect to registrant's operations and financial conditions.

- The <u>materiality qualifier</u> was to avoid a registrant providing large amounts of immaterial data, so it thereby <u>eliminates confusion in scope</u>. It would also make the disclosure more "consistent and comparable", and <u>not overly burdensome</u> because it avoids unreasonable searches internally or request for information in registrants' value-chain externally.

- Requires a registrant to discuss how the material impacts been <u>integrated</u> into its business model or strategy, and its targets. The purpose is for investors to better test a registrant's <u>resiliency</u>. <u>The streamlined information</u> provides flexibility to registrants on addressing both current and forward-looking C-R information.

- The term "business model" was left in and is <u>aligned</u> with a TCFD model for consistency purposes. However, if a registrant has not yet articulated a business model, or does not believe it will be impacted, it need not disclose such information.

- The requirement to include a narrative discussion of C-R factors impact on a registrant's financials statements is limited to material impacts only.

- The Final Rules require disclosure of material expenditures made during the fiscal year as a direct result of C-R risk mitigation or adaptation. It will now be under Reg. S-K. (i.e. not S–X) to reduce the compliance burden. It can be in tabular (quantitative) or narrative (qualitative) form to provide more flexibility in reporting and there is an additional phase in time to develop new systems.

D2: Transition Plan Disclosure:

- With respect to transition plans, this section will require a registrant to disclose its transition plan, but only if it has one. The reason is to avoid being prescriptive (i.e. registrants' strategy and implementation to reduce C-R risks).

- The purpose of identifying a registrant's C-R steps is because it will likely have a material impact on its operations and financial condition, so mandatory details need to be disclosed to investors. The disclosure will now be more flexible and will be subject to a safe harbor.

- The progress in a transition plan must be reported on a registrant's annual report to help investors understand the management of inherent risks and then assess it.

- A transition plan shall include quantitive & qualitative disclosure of material expenditures and impacts on estimates and assumptions. This provides flexibility (i.e. not broad "metrics and targets") and will also be phased in.

- A transition plan reference to "physical risks" has been modified to align with TCFD recommendations which are more familiar to registrants.

- The request that any transition plan, regardless of whether the Board of Directors approved of it, must be disclosed because director approval only would exclude senior management adopted plans that are highly relevant.

- C-R opportunities disclosure will be optional due to possible anti-competitive concerns.

D3: Disclosure of Scenario Analysis If Used:

- In describing the resilience of its business strategy, the SEC requires a registrant to describe its analytical tools such as a scenario analysis that it uses to assess C-R risks to its financial statements and business model.

- Such forward looking information derived from analytical tools of scenario analysis is required only if the registrant uses same, and if their C-R risk is likely to have a material impact on the registrant. This makes the disclosure less burdensome, and it will be subject to a safe harbor.

- In a registrant's disclosure of resilience testing strategies, they need to include a description of the resilience of their strategy under various climate scenarios to <u>streamline</u> the reporting process.

- The requirement to disclose "any analytical tool" is eliminated to be only those tools used by the registrant in view of TCFD guidance on same. The disclosure also is limited to a "brief" description of the parameters, assumptions, and analytical choices used. This will make disclosure <u>less burdensome</u> to both the investor (immaterial detail) and to the registrant (no lengthy descriptions).

- Lastly, no specific risk management model is required, so the final rule is <u>less prescriptive</u> and will <u>streamline</u> a scenario analysis by allowing registrants to use qualitative and quantitative disclosures that best fit its particular circumstances.

D4: <u>Disclosure of Maintained Carbon Price</u>

- If a registrant uses internal carbon pricing in its management of C-R risks, then it must disclose same if the information is "material to its business strategy, results of operations, or financial condition" to <u>help investors evaluate</u> how a registrant is managing is its C- risks and the effectiveness of its business strategy to mitigate or adapt to such risks. The disclosure is only for when internal carbon pricing is material to how a registrant evaluates and manages its C-R risk. The disclosure must be the price per metric ton of CO_2 and the total price, and how it is estimated to change.

- If the scope of entities and operations is materially different from the organizational boundaries to calculate the GHG emissions, a registrant must disclose the difference <u>briefly</u>.

- The purpose of those disclosures is to help investors <u>better understand</u> a registrant's internal carbon pricing practice and avoid confusion about the scope of a registrant's entities and operations by streamlining the reporting and reducing redundancy (i.e. by not having the registrant describe how it uses an internal carbon price to evaluate and manage C-R risks in a separate narrative description).

- The Final Rules will <u>help avoid disclosure of confidential or proprietary information</u> by not requiring a separate narrative description.

§E: <u>Governance Disclosures</u>

Part I: Board Oversight Disclosures

In this section of the Final Rules, it requires a description of the Board of Directors oversight of C-R risks; the identification of any board committees (or subcommittees) responsible for oversight of C-R risks, and its processes for keeping informed on same; and if the registrant has a target or goal or transition plan, then a disclosure on how the Board of Directors oversees progress against the target or goal or transition plan. (It does not apply if registrants do not exercise board control of C-R risks).

- The focus is on existing or developing governance practices, not prescriptive. As such, the proposed rules regarding the identity of directors involved with the C-R risks, their expertise, frequency of reporting, and the setting of targets and goals have all been eliminated. The reason put forth by the SEC is because it would overly emphasize a particular type of risk, and the disclosure of possible sensitive information.

- The Final Rules are less prescriptive in order to discourage boilerplate disclosures, and to promote more usable investor information on material information. As such, it balances the registrant's ability to create its own governance systems, but provides disclosures of the "process" of the board to be kept informed, so that investors can assess the conduct of boards in dealing with C-R risks, for the purpose of investor protection.

- There is no materiality qualifier in this section because anything that the Board of Directors' is involved in is per se assumed to be material, according to the SEC.

Part II: Management Oversight Disclosures

In this section, the Final Rules were modified to require the description of managements' role in assessing and managing C-R risks to be only "material" C-R risks. They specify that such information should include details of management positions or committees responsible as necessary; the processes used to manage, and whether they report same to the Board of Directors. The reason is to provide greater flexibility to tailor the information to registrants' particular governance structure.

- The focus is not on influencing how the registrant should govern, but on what it is doing for oversight practices to allow investors to make better informed judgment on registrants' management systems. So, the focus is on streamlining the requirements regarding material C-R risks. So, the disclosure is "process-based" and not, for example, how many times the Board of Directors meets on C-R risk matters.

- Information on C-R opportunities disclosure is now optional to allay anti-competitive concerns. As such, the Final Rules are now more flexible and less prescriptive.

§F: Risk Management Disclosure

In this section of the Final Rules, it adopts a less prescriptive approach that focuses on a description of the processes of registrant uses to identify, assess, and manage material C-R risks. As such, it avoids a "one-size-fits-all" disclosure model according to the SEC.

- The SEC added a materiality qualifier to disclosure items regarding any existing processes for the identification, assessment, and management of material C-R risks. If none, the registrant need not report such risk, so it is not unduly burdensome.

- In reporting material C-R risks the registrant can disclose same using factors are most significant based on its facts and circumstances. Such meaningful description of the processes with enable investors to <u>evaluate registrants C-R management practices</u> as part of their investment decisions by offering a more complete picture of management.

- The registrants must now identify whether it has (or is likely) to incur material, physical, or transition risk. This <u>clarifies and simplifies</u> what a C-R risk means.

- The Final Rules require the registrant to address how it decides to mitigate, accept, or adapt to a particular risk. However, the SEC reviewed the proposed rule on disclosure of how to mitigate any high-priority risks to <u>reduce prescriptiveness</u> and to <u>streamline requirements</u>.

- The SEC eliminated the disclosure of future restructurings, write downs, or impairments related to C-R risk management. This <u>flexibility</u> in reporting avoids possible release of trade secrets or confidential information.

- The SEC is requiring a registrant to disclose how it is integrating C-R risk into its overall risk management systems because it is important to <u>help investors understand</u> the effectiveness of a registrant's C-R risk management processes.

- The proposed rule that requires a registrant to disclose C-R related management opportunities is optional only to <u>allay anti-competitive concerns</u> regarding business opportunities disclosures.

§G: <u>Targets and Goals</u>

In this section of the Final Rules, it requires a registrant to disclose any C-R target or goal provided it has a "material" affect (or likely) on registrant business, results of operations, or financial condition because investors need such detailed information to <u>understand and assess</u> risk strategy and management of same.

- The SEC declined to (a) limit the disclosure to only publicly announced targets and goals, (b) only formally director or CEO approval targets and goals, (c) limited ones related to GHG emissions, (e) impacts on local communities, albeit these disclosures can be voluntarily disclosed.
- If a registrant is disclosing its targets and goals, then the registrant must provide information that has material impact (or likely), including a description of:

  -Scope of target activities

  -Unit of measurement

  -The time horizon for the targets

  -A qualitative & quantitative description

-Baseline for target and goal and means to track progress

The purpose is to provide investors a better understanding of registrant targets and goals and how to achieve same.

- The SEC declined to include emissions disclosures in the list of information (unless it is a target or goal itself) to streamline the disclosures. In addition, to <u>avoid excess detail</u>, discussion of prospective activities need only be qualitative so it reduces specific details. Likewise, no interim targets need be disclosed, but any progress on meeting the targets and goals must be disclosed, and how they achieved it.

- The disclosures are subject to "material impact" to registrants' business, results of operations, and financial conditions and must include qualitative and quantitive discussions of material expenditures on financial estimates and assumptions as a direct result of the target or goal for <u>better investor understanding.</u> The information on a registrants' implementation challenges and progress allows for <u>flexibility</u> in risk management decisions there is also a phase-in period.

- Carbon offset on REC's disclosure requirements will have a "materiality qualifier" and also include (a) the amount of carbon avoidance, etc. (b) project location, (c) costs to help investors understand the registrant's strategy and impact of registrant, and (d) nature of the carbon offsets or REC's to help investors evaluation the role of these investments in a registrant's C-R strategy, and the impacts on its business. So it is also <u>decision useful</u>.

<u>Summary & Conclusion</u>

Again, so what's my point? Practically all the writers on the SEC final rules highlight <u>what</u> these new rules require a registrant needs to do in order to be in compliance with the new rules. For many reasons, including the impossibility of trying to squeeze far too much information in such a short summary, I have instead focused my attention on <u>why</u> the SEC chose to make their Final Rules so when they are enforced it's possible to measure the effectiveness of same based on why they were enacted in the first place.

Ultimately, the SEC made many important smaller decisions that collectively shaped the future of filings of publicly traded companies, and they did so by simply considering the many comments they received from all parties of interest, (i.e. the good, the bad, and the ugly). To do so, the SEC looked at first-order and second-order challenges. Summarizing when looking over the reasons why a rule was left in, taken out, or modified, the pattern seems to fall into these themes:

-Provide investors a better understanding of registrants' C-R risk exposure

-Create a less prescriptive framework that allows for more flexibility in reporting

-Align the terminology with TCFD recommendations so it will be more familiar

-Make compliance less burdensome

-More closely align with the pre-existing MD&A standards

-Avoid submission of large amounts of immaterial data

-Better test a registrant's resilience

-Disclose material information and data to help investors understand the data

-Avoid anti-competitive concerns

-Avoid disclosure of capital or proprietary information

-Learn more about registrants' oversight practices and systems

-Streamline the reporting for clarity purposes

-Provide investors with more decision useful information

These reasons for the Final Rules will now become the future "benchmarks" to determine the effectiveness when measuring their future performance. I have focused on the C-R disclosures that will affect corporations with respect to business strategy and outlook, targets or goals, and risk, Board of Directors oversight and governance, and management implementation. The SEC used tools such as phase-in periods, financial footnote disclosures, safe harbors, independent third-party assurances for GHG emissions, attestation reports, transition planning, aggregation of expenditures, losses, capitalized cost and charges incurred for severe weather events and other "natural conditions". (The types of registrants have been broken out into LAX, AF, SRC's, and EGC's.)

Finally, as we now know, the SEC issued a stay on April 6th to allow them to defend the various litigation that has been filed under the APA Act §1050 and SEC Act 25 (c)(2). It is only pending the completion of judicial review of the consolidated 8th circuit petitions. According to the SEC, the reason is to "facilitate the underlying judicial resolution of these challenges and allow the court of appeals to focus on deciding the merits. Further, a stay avoids potential regulatory uncertainty if registrants were to become subject to the Final Rules requirements during the pendency of the challenges to their validity.

Looking Back & Moving Forward

A. Looking Back

Let's very briefly put these new C-R Risk disclosures into context. In a Statement dated 3/7/24 by Chair Gensler on the Final Rules regarding mandatory C-R disclosures, he puts forth his case for doing so by stating bluntly, "The SEC has an important role overseeing the disclosures at the core of its basic bargain. Our agency, though, was set up to be merit neutral. Thus, the SEC has no role as to climate risk itself."

So, the question is; whether there is precedent in the SEC's addressing investor risk in general? Chair Gensler lists 5 key disclosure requirement regulations in the past 90 years. The SEC created regulations are briefly as follows:

- *1960s – SEC offered guidance on disclosures related to risk factors.*

- *1970s – SEC offered guidance on environmental risks.*
- *1980s – SEC offered guidance on management discussion and analysis (MD&A) for 10 – K.*
- *1990s – SEC required disclosure on executive stock compensation.*
- *2010s – SEC issued climate guidance on C-R risks face by public companies.*

Given the above, the SEC believes current Final Rules are consistent with its mission and congressional mandate. So given the context of the 2024 Final Rules on C-R risks, the SEC further limits its decision in the context of "material" disclosures, not any and all C-R risk disclosures. That is the SEC's role in the newly finalized rules. So the progression has gone from predominantly "guidance", to "rules" that provide better consistency, comparability, and reliability of disclosures that will provide more useful information than what investors see today. By bringing these filings into annual reports and registration filings, it makes them more reliable, unlike mere sustainability reports.

So why is it important for U.S. capital markets to have U.S. C-R compliance requirements? According to Chair Gensler, many U.S. issuers now have foreign operations that must comply with foreign jurisdictional C-R rules. As such, it's important to have "U.S. standards to which U.S. issuers can point." Both issues and investors will benefit, so it is a win-win.

The SEC received 14,000 comment letters to its Proposed Rules two years ago (March 2022). As a result of the same, it streamlined its Final Rules in many ways. The three key areas of C-R disclosures are as follows:

1) C-R risk disclosure focuses on the company governance and processes used to manage same. This includes transition plans, scenario analysis, or internal carbon prices if a company misuses same. The Final Rules also require disclosure of material C-R targets or goals and annual progress. Finally, in regulation S-K, a disclosure of material expenditures directly related thereto.

2) Certain larger registrants (LAFs and AFs) must report direct emissions (Scope 1) and emissions associated with energy purchases (Scope 2) if material. (Scope 3 emissions are not required to be reported at this time.) Attestation reports for Scope 1 & 2 emissions will also need to be filed, but more time is allowed to do so.

3) Financial statement footnotes disclosures on expenditures for severe weather events will now be required. This will give investors insight into the financial impact on companies and better context for regulation S–K forward-looking disclosures.

In order to allow companies to gear up to provide this data, the SEC allows the earliest data for certain filings will be 2025 to be used by registrants when filing in 2026.

B. Looking Forward

So how does the SEC's Final Rules fit into the broader context of what is going on in the regulatory world today? I would categorize it as a "mind the gap" situation today. Here is a quick overview of what I mean by same. The two major pieces of legislation and/or standards in the climate risk area regarding corporations are the following:

1) Regarding the EU, the Task Force on Climate-Related Financial Disclosures (“TCFD”) recommendations have been followed by the Corporate Sustainability Reporting Directive (“CSRD”) and the International Sustainability Standards Board (“ISSB”) disclosure standards, which are now being considered by various countries. (The UK has adopted its own climate-related regulations.) Although these are EU regulations, so it affects many companies based or listed in the EU, it would also cover many public companies in the U.S. doing business there.

2) Regarding California, extensive C-R disclosures have been recently adopted that apply to public and certain private companies. More specifically, California law SB 261 applies to both public and private companies that do business there, with annual revenues over $500 million, must publish biennial reports about material C-R financial risk and concomitant mitigation efforts the company is taking. SB 253, in addition, requires both public and private companies with annual revenues above $1 billion to disclose their GHG emissions. These regulations are in effect regardless of whether the new SEC Final Rules ever go into effect. So, from an overall cost perspective, it makes it efficient because similar data is required for all three systems.

So, how does the SEC Final Rules "mind the gap" so to speak? The answer is that both the California and EU disclosure regulations and standards cover about 3,000 public companies. These 2 regulatory systems will be effective regardless of whether the SEC ever goes into effect. So why create a trinity of regulatory systems? As the SEC has stated as its purpose in creating the Final Rules, the need is for “consistent, comparable, and reliable” C-R information to enable investors to address risks related to same.

All three (3) regulatory systems are based on the TCFD framework, so it is in alignment with same making reporting less burdensome by streamlining the filing process. Both the issuers and the investor win from a business perspective. And the SEC, as a federal regulator, has always played a role alongside state law in addressing corporate governance-related issues that benefits issuers and investors. This is the context of the new SEC C-R Disclosures Final Rules.

So, this is where we are in Q2-2024. Time will tell how effective they will be, but the denial of C-R risks is no longer a legitimate strategy. The sad part about this is that it took an existential crisis to go from mere social responsibility to major corporate compliance requirements. Enforcement of these rules is in the offing for C-R risks, so be prepared.

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