New Insights into the SEC’s Climate Change Disclosure Rulemaking

August 6, 2021

As we have underscored in prior publications, considerations related to environmental, social and governance (“ESG”) topics are a top priority for the Securities and Exchange Commission (“SEC”) as a result of increasing investor focus on ESG matters. This prioritization of ESG is particularly strong with respect to climate change-related issues, reflecting significant market demands and the all-of-government approach of the Biden administration to combat climate change. The SEC has announced a number of initiatives related to ESG in general, and in March 2021 then-Acting Chair Allison Herren Lee requested public input on potential rulemaking for climate change disclosures. Chair Gary Gensler’s remarks on July 28, 2021 at the Principles for Responsible Investment “Climate and Global Financial Markets” webinar offer potentially valuable insights into the current direction of travel at the SEC as the agency formulates a climate change disclosure regime.

This memorandum summarizes six key takeaways from Chair Gensler’s speech and the lessons they provide for companies seeking to prepare for a future SEC climate change disclosure regime.

LOCATION OF DISCLOSURE

Chair Gensler’s remarks highlight that one priority of a future climate change disclosure rule should be to respond to investors’ desire for information that is “consistent and comparable”, echoing themes from prior remarks by SEC officials. Notably, in this speech Chair Gensler connects consistency and comparability to the location of mandatory climate change disclosures, reporting that he has instructed the SEC staff to consider whether climate change disclosures “should be filed in the Form 10-K, living alongside other information that investors use to make their investment decisions”. Whether such disclosures would need to appear in traditional Exchange Act reporting or in separate standalone reports has been a topic of significant debate, and Chair Gensler’s remarks seem to indicate that the SEC will require disclosures on Form 10-K in order to ensure consistency across the spectrum of registered reporting companies. Significantly, the speech makes no mention of the challenges presented by assembling the necessary ESG data within the tight timeframes involved in the preparation of Form 10-K filings. This may require some registrants to adjust existing data collection and verification practices to align with a change in the timing of reporting such information.

SCOPE OF QUANTITATIVE DISCLOSURES

Chair Gensler’s remarks also identify a priority that disclosures should be “decision-useful”. This also echoes themes from prior remarks by Chair Gensler and other SEC officials, but the July 28 speech provides insights into Chair Gensler’s view that decision usefulness is hindered by qualitative disclosures that are merely “generic
text”. Rather, decision usefulness requires meaningful qualitative disclosure and, significantly, quantitative disclosures on “greenhouse gas emissions, financial impacts of climate change and progress towards climate-related goals”. It was widely assumed some line-item quantitative disclosures would be a part of an SEC rulemaking regime, but Chair Gensler’s remarks signal the potential scope of those quantitative disclosures.

To that end, Chair Gensler indicates that disclosure requirements for greenhouse gas emissions will cover not just Scope 1 greenhouse gas emissions, but also Scope 2 and possibly even Scope 3 emissions, with Chair Gensler reporting that he has instructed the SEC staff to consider whether, how and in what circumstances Scope 3 greenhouse gas emissions should be required disclosures. While it was widely expected that Scope 1 greenhouse gas emissions would form part of a line-item climate change disclosure reporting regime, the potential requirement to report Scope 2 and possibly even Scope 3 greenhouse gas emissions is a significant development. Many companies report their Scope 1 and Scope 2 greenhouse gas emissions as part of voluntary sustainability reporting or in response to other regulatory requirements (such as the Environmental Protection Agency’s Greenhouse Gas Reporting Program), but they may need to adjust their practices if the data must be filed with the SEC. While some companies report estimates of their Scope 3 greenhouse gas emissions, it can be challenging to establish rigorous and reliable disclosures around Scope 3 greenhouse gas emissions given the wide scope of potential emissions captured by the definition and the difficulty in measuring and/or calculating such emissions. Companies should consider taking active steps now to build an infrastructure for collecting and processing greenhouse gas emissions data for inclusion in a Form 10-K, including appropriate disclosure controls and procedures. These processes may need to cover not just direct emissions from the company’s own operations, but also what will be necessary to report Scope 2 and Scope 3 greenhouse gas emissions if those are required.

Similarly, Chair Gensler’s suggestion of rules specifically requiring disclosure of progress towards climate-related goals is a potentially significant concept for companies. Management should implement rigorous and reliable processes for tracking metrics towards achieving any climate change commitments they make, with appropriate discussions at the board level to ensure the goals and commitments are reasonable. These processes and discussions already frequently occur in the context of voluntary sustainability reporting or managing relationships with investors or other stakeholders that are concerned with climate change commitments, but they take on a further importance if they may be a required element of an SEC disclosure regime. Climate change commitments and the targets set to meet them can no longer be mere marketing puffery and must be thoroughly vetted and monitored by boards and senior management and subject to disclosure committee review.

RELATIONSHIP WITH THIRD PARTY STANDARDS

A key point of discussion in connection with potential SEC climate change rulemaking was the relationship between SEC rules on climate change disclosures and those propounded by private framework providers such as the Task Force on Climate-Related Financial Disclosures (“TCFD”) or the Sustainability Accounting Standards Board (“SASB”). The SEC could have elected to incorporate standards from TCFD or SASB wholesale as the basis of a climate change disclosure regime, following countries such as the United Kingdom that have announced the goal of making TCFD-aligned disclosures mandatory by 2025. Alternatively, the SEC could have chosen to develop a set of high-level, principles-based disclosure rules, then identified compliance with TCFD or SASB standards as an approved method of complying with those rules, similar to the relationship between rules requiring internal control over financial reporting and the standards produced by the Committee of Sponsoring Organizations of the Treadway Commission.

However, Chair Gensler’s speech suggests the SEC will adopt neither of these approaches to incorporating existing third party disclosure regimes into a climate reporting rule. Chair Gensler states he has instructed the SEC staff “to learn from and be inspired by these external standard-setters”, but concludes that “we should move forward to write rules and establish the appropriate climate risk disclosure regime for our markets”. While this approach will make the SEC’s rulemaking efforts potentially more challenging in the short-term and leaves open questions such as how climate change disclosure standards will be efficiently updated over time, it should alleviate many of the governance and funding-related concerns that would arise from the SEC adopting standards from a third-party organization.
Chair Gensler’s remarks illustrate the influence of prominent third party standard-setters in other ways as well. For example, he signals the SEC may require disclosure of scenario analyses regarding the effects of future climate change, such as how companies might be impacted by both physical risks and transition risks associated with climate change. This echoes similar elements of TCFD disclosures. Chair Gensler also states he has asked the SEC staff to consider industry-specific rules, identifying “banking, insurance [and] transportation” specifically. This suggests the SEC contemplates that if there are industry-specific standards they will be narrowly applicable additions to a baseline of industry-agnostic disclosure rules. This represents an approach more aligned with TCFD rather than standards-setters like SASB which produce fully industry-specific standards across a broad range of sectors.

**RULES APPLICABLE TO FUNDS**

Chair Gensler’s remarks also discuss a climate change disclosure rule being coupled with greater requirements applicable to investment funds. He identifies the growing trend of funds branding themselves as ESG friendly, suggesting there will be further rulemaking on required practices by funds to support those claims, as well as how such funds are named. This idea reinforces previously expressed sentiments from the SEC, as well as the motivation for other regulations, such as the Sustainable Finance Disclosure Regulation in the European Union. Rules designed to curb so-called “greenwashing” may be one of the few points of agreement on ESG-related matters between Chair Gensler and Republican Commissioners Peirce and Roisman.5 Rulemaking applicable to funds may have significant consequences for companies. The rise of ESG has put companies under increasing pressure from their investors to make ESG-related disclosures to allow those investors to allocate capital in line with their ESG commitments. As those investors are subject to more rigorous rules and potentially greater SEC enforcement scrutiny on the support required to make claims that funds are “green”, “sustainable” or “low-carbon”, investment funds are likely to increase their pressure on companies for supporting ESG data, even beyond what may be required from companies by SEC disclosure rules.

**SIGNIFICANT OMISSIONS**

Given the relatively abbreviated length of Chair Gensler’s remarks, there may be limited insight that can be derived from topics that were not covered. However, the absence of certain topics in his prepared remarks may potentially be illustrative of the current direction of travel at the SEC on climate change rulemaking.

First and most obviously, the remarks concerned solely climate change rulemaking rather than a potential disclosure regime also encompassing other areas of ESG, such as a reopening of human capital disclosure rules or mandatory rules related to reporting of diversity. A key distinction in the wider ESG space is a “climate-first” approach versus an “all-of-ESG” approach. The speed at which the SEC is moving to propose a climate change disclosure regime suggests it may be operating on a “climate-first” model.

Second, Chair Gensler’s remarks include no discussion of potential liability for companies for their climate change disclosures. This topic has been raised by Commissioners Peirce6 and Roisman7 in their recent speeches sounding notes of caution on ESG rulemaking. By not discussing the point, and by asking the SEC staff to consider “whether these disclosures should be filed in the Form 10-K” (emphasis added), companies should prepare for the possibility there will be no reduced liability regime applicable to climate change disclosures.

Third, Chair Gensler’s speech includes no discussion of possible external assurance over climate change disclosures. While it is a nascent trend for some companies to engage third parties to provide assurance over portions of their sustainability reports, it is unclear whether and how this might be affected by the SEC climate change disclosure regime. For example, Chair Gensler does not indicate whether external assurance will be required for registrants in the same way reviewed or audited financial statements are required; whether responsibility for supervision of climate change assurance processes will fall within the jurisdiction of the PCAOB or another body; or whether a private ordering of climate change data assurance will be left to develop.

Last, Chair Gensler’s remarks include no discussion of scaled disclosures based on company size, maturity or other similar concepts. Generally, larger and more established companies have been able to invest greater resources in
establishing the necessary infrastructure for sustainability reporting in response to investor demands, meaning a mandatory climate change disclosure regime may present unique compliance challenges for smaller companies. This consideration is not reflected in Chair Gensler’s speech, suggesting companies of all sizes should expect to be subject to a new climate change disclosure regime, or should at least to start preparing for that possibility.

**TIMING FOR RULEMAKING**

The SEC had previously signaled its readiness to move promptly to formulate an ESG disclosure regime following the closing of the public input window. Chair Gensler’s remarks underscore this commitment within the limits of the SEC’s rulemaking process, noting “I have asked SEC staff to develop a mandatory climate risk disclosure rule proposal for the Commission’s consideration by the end of the year.” While we have previously encouraged companies to begin preparations in the short term for the climate change disclosure regime being contemplated by the SEC, Chair Gensler’s remarks provide valuable context for the timing of regulatory developments. Even after completing the significant amount of work that will lead to a proposal being presented to the Commission by year-end, there will be a number of steps required for the SEC to collect feedback, prepare and adopt a final rule and establish an effective date. Nonetheless, the steps for companies to formalize ESG data monitoring and collection processes can be time intensive and require significant internal coordination between operational, accounting, internal audit and legal functions. To be ready for a proposed rule that makes its way to the Commission by the end of 2021 and that could potentially apply to Form 10-Ks as soon as those covering the 2022 fiscal year, companies should consider serious preparations in the short term. These steps will also position them to more effectively respond to the increasing importance of ESG reporting to private investors as well.

* * * * *

Chair Gensler’s remarks provide potentially valuable insights into the SEC’s early conclusions in response to the comment letters received on climate change disclosures, and should encourage companies to continue their preparations for a climate change disclosure regime. Companies would also be well-served to continue to monitor speeches and public statements from SEC officials for further insights into the progress of the SEC rulemaking process.

* This publication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It should not be relied upon as legal advice as facts and circumstances may vary. The sharing of this information will not establish a client relationship with the recipient unless Cravath is or has been formally engaged to provide legal services.

---

4 Scope 1 greenhouse gas emissions are direct emissions from sources owned or controlled by the registrant. Scope 2 greenhouse gas emissions are emissions associated with the registrant’s purchase of electricity, heat or cooling. Scope 3 greenhouse gas emissions are all emissions the registrant impacts in its supply and value chain, including from third party assets not owned or controlled by the registrant such as suppliers and customers.