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Preparing Now for the SEC's New Climate Rules

- Even though the Securities and Exchange Commission's (SEC's) climate-related disclosure rules are on hold while court challenges are heard, companies need to prepare for the possibility that some or all parts of the rules will come into effect.
- A growing number of states and other countries are requiring similar disclosures, which can include quantitative and qualitative measures of the climate impact of operations, projected climate-related risks and progress toward sustainability goals.
- Directors need to consider how oversight responsibility for compliance should be allocated within the board and its committees, and what metrics the company should use to provide the highly detailed disclosures the rules mandate.
- Beyond compliance with government requirements, the growing number of climate disclosure regimes is likely to shape the expectations of investors and other stakeholders.

On March 6, 2024, the SEC adopted new rules mandating climate-related disclosures in public companies' annual reports and registration statements. As anticipated, the rules are facing multiple legal challenges, which have been consolidated in the U.S. Court of Appeals for the Eighth Circuit.

In light of these legal challenges, the SEC voluntarily stayed the effectiveness of the new rules while the rules are under judicial review. Under the compliance schedule as originally adopted, large companies would be required to comply beginning with their 2025 annual reports.

While the stay buys additional time for companies to comply, and the litigation leaves the ultimate status of the rules uncertain, companies nonetheless need to lay the groundwork to comply in case some or all of the rules do come into effect. Below are key considerations for boards.

What should companies do pending the legal challenges and SEC stay?

The challenges and the stay do not necessarily mean pencils down for companies when it comes to enhancing internal controls and making other preparations for climate-related disclosures, although there may not be the same sense of urgency now. Even if the SEC's climate rules are scaled back or overturned, many companies still would be subject to other climate disclosure requirements, such as new mandates in California (which are also subject to pending legal challenges) and/or Europe. Taking all the uncertainties into account, companies will need to balance their own risk tolerance, climate disclosure readiness and competition for compliance resources.

What information will need to be disclosed?

Although the SEC's final climate rules were meaningfully scaled back from the commission's original proposal, they nevertheless add potentially extensive climate-related disclosure requirements. Required information includes:

– Baseline climate disclosures, including material climate-related risks, strategy, targets/goals and governance. The rules also require a new note to the audited financial statements regarding "severe weather events and natural conditions," whether or not related to climate change.

– Material expenditures that are a direct result of (i) climate-related risk mitigation/adaption, (ii) disclosed transition plans and/or (iii) disclosed targets/goals (or actions taken to achieve/progress toward those targets/goals) and their impact on financial estimates and assumptions.

– For larger companies, Scope 1 and/or Scope 2 greenhouse gas (GHG) emissions, if material, with third-party attestation to the disclosures' accuracy.

(Deadlines for compliance vary according to a company's filer status and the type of disclosure.)

These disclosure requirements are based in part on the disclosure frameworks of the Task Force on Climate-related Financial Disclosure (TCFD), which focuses on governance, strategy, risk management, and metrics and targets, and the global GHG Protocol.

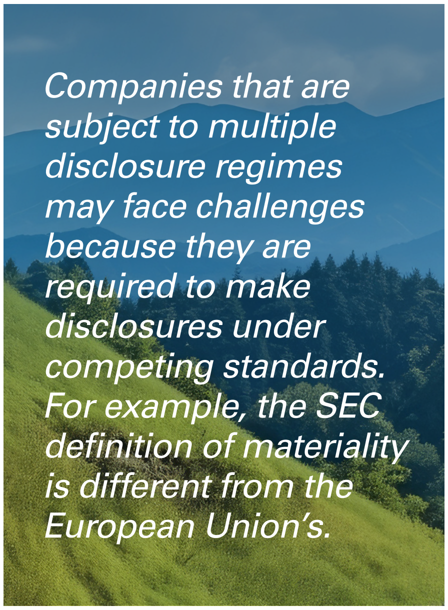
The SEC, however, declined to adopt an existing framework and instead created its own standards in response to feedback on the proposed rules. The SEC also declined to permit companies to use an existing framework as an equivalent standard for SEC purposes.

As a consequence, companies that are subject to multiple disclosure regimes may face challenges because they are required to make disclosures under competing standards. For example, the SEC rules are based on materiality under the traditional reasonable investor standard, whereas the European Union's Corporate Sustainability Reporting Directive is based on so-called "double materiality," taking into account both financial impact and external impact on the environment and society.

What should boards focus on now?

With the prospect of the SEC rules eventually taking effect on the horizon, here are issues that boards should be contemplating in their oversight role.

– **Governance structure.** Climate-related risks can take many forms, and it may not always be clear which board committee(s) should be responsible for overseeing particular types of risks. Boards should ensure that appropriate board and/or committee oversight



is in place for all relevant climate risks. For example, climate-related financial impacts may fall under the audit committee's purview, while broader sustainability strategies may be better addressed by the nominating and corporate governance committee, or the full board. For some companies, a standalone ESG or sustainability committee might be best positioned to oversee climate-related risks. In addition, given that the new SEC rules require both quantitative and qualitative climate-related disclosures in audited financial statements, audit committees should provide appropriate oversight of disclosure controls and procedures, and internal control over financial reporting with respect to climate-related matters.

- **Identifying and assessing climate-related risks.** Under the SEC rules, climate-related disclosures in many cases will be required only if they are determined to be material, and companies will be required to disclose the processes they use to identify, assess and manage any material climate-related risks. The SEC staff in recent years has indicated in the course of reviewing company filings that it may scrutinize companies' materiality determinations for climate-related disclosures. As a result, companies will be expected to have robust processes to identify and assess climate-related risks.

- **Disclosure committee composition.** As part of disclosure controls for climate-related matters, companies should consider whether their disclosure committee (or an equivalent body) has relevant subject matter expertise or, if not, whether experts are able to escalate potentially material climate-related issues for the committee's review.

- **Measuring progress.** Companies that have set climate-related targets/goals, whether publicly disclosed or not, would need to assess on an ongoing basis their progress toward those targets/goals, and that may need to be disclosed in SEC filings. Boards should help ensure that the company's process for measuring progress is appropriate and that the company remains on track to achieve the established targets/goals.

- **Compliance readiness for all jurisdictions.** In addition to the SEC rules, multiple state and foreign jurisdictions either have adopted or proposed climate-related disclosure rules that may become relevant for certain companies, depending on the nature and scope of their operations. As a result, companies may need to navigate a complex mix of climate-related regulatory requirements.

– **Stakeholder expectations.** In addition to regulatory requirements, climate-related disclosures are also driven in part by demands from investors and other stakeholders. Companies should continue to engage shareholders and other stakeholders regarding their expectations and consider whether and how those expectations should be factored into climate-related risk management processes.

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