

ESG Essentials: What You Need To Know Now

Episode 6 – Preparing for the SEC’s Proposed Rule on Climate Risk Disclosures

Colvin: Welcome back to “ESG Essentials: What You Need to Know Now,” a podcast from Fox Rothschild’s Environmental Social and Governance Practice Group. I’m your host, [David Colvin](#), Co-Chair of the firm’s ESG group. Our series of short, bite-sized podcasts cover core ESG concepts and explore important issues for businesses that are concerned with developing and deploying an ESG profile; responding to increased scrutiny from regulators, investors or consumers regarding their environmental and social impact; and minimizing the potential legal, business and reputational risk associated with ESG. In this episode of the podcast, we’ll be discussing the SEC new proposed climate risk disclosure rule.

For that discussion, I’m really pleased to welcome [Karen Davis](#). Karen is a partner and a member of our ESG and Environmental Practice Groups here at Fox. I’m also happy to welcome [Brittney Powell](#). Brittney represents clients in a wide range of complex business, international trade and environmental matters out of the firm’s Washington, D.C. office.

Karen and Brittney, welcome to the podcast.

Davis: Thanks, David. Happy to be here.

Powell: Hi, thank you for having us.

Colvin: Absolutely. As we all know, at the end of March, the SEC came forward with its long-awaited proposal to address climate risk disclosures in an effort to really standardize and make more consistent the disclosures that companies are making in their SEC filings and annual report regarding their climate impact.

I think it goes without saying that as proposed, the rule is pretty broad and could be quite burdensome on companies who need to report. For example, we know that the rule will require companies to make disclosures and report on the material climate-related risks to the company and its business strategy. Those are probably disclosures many companies are making already. But in addition to that, companies will need to disclose, for example, how those climate-related risks impact the companies’ business and its financial statements. Companies will have to disclose the governance and oversight processes that are in place at the board level, and within the senior leadership level of the company, to address climate-related risk. Then the big elephant in the room in terms of what’s required will be the requirements that companies report and disclose their disaggregated greenhouse gas emissions. For larger companies, that could require the disclosure of admissions by its supply chain partners as well. There’s a lot to talk about, and I’m glad you’re both here.

Let me just start with getting your general reaction to the proposed rule. What do you like about it? What don’t you like about it? Where do you see the issues for companies and clients that will be tasked with complying with it? Karen, let me start with you, if I could.

Davis: I expected the proposal to be bold, but I was still surprised by the scope, the granularity and the timeline of the proposed rule. In terms of the scope, all public companies are required to report on their [scope one and two](#) greenhouse gas emissions. The proposal does not phase in the reporting requirements by industry sector. Of course, not all industries have the same impact with respect to climate risk.

We had heard for a while that there was debate within the SEC on whether [scope three emissions](#) would be included. It appears that they struck a compromise, because the proposed rule requires companies to report on scope three emissions if those emissions are material or if the company has publicly disclosed greenhouse gas emission reduction targets that include scope three emissions.

However, the guidance on what constitutes materiality is not very helpful. There is a quantitative component. Scope three emissions would be considered material if they make up a relatively significant portion of a company's overall greenhouse gas emissions. They use a benchmark of 40%. But companies need to go beyond that and look at qualitative factors. They must consider the total mix of information available to investors and the probability and magnitude of unrealized transition risks.

I think that's going to be tough for companies to determine whether scope three emissions are material. Scope three emissions, of course, are the most complicated component of the proposed rule. Then in terms of granularity, very specific information would be required under the proposed rule. If there is an asset that poses material risk from climate change, the company must disclose the ZIP code of where that asset is located. If flooding presents a material physical risk, the company would be required to disclose the percentage of buildings, plants or properties (in terms of square meters and acres) that are located in a flood hazard area. That's a lot of specific detail.

Then the timeline, it looks like the SEC is trying to get this rule finalized in 2022, maybe targeting December of 2022. If that happens, the first companies that are covered – these large, accelerated filers – they would be required to report on their emissions that are generated in January of 2023. That's not a lot of time to prepare. It's a pretty bold proposal, I would say. It'll be interesting to see if the final rule is substantially similar to the proposed rule.

Colvin: Yes. I would say, as proposed – and again, you're right to point out that what may ultimately be approved may not look the same as what's been proposed – just in the magnitude of the amount of data the companies will have to collect from different corners of the company that they haven't been collecting, and then aggregate that data for purposes of disclosures, is just going to be difficult.

Brittney, let me just turn to you briefly to provide your reaction to the proposed rule. From where you sit and based on your experience in environmental matters, what is your take in terms of the proposal? What do you like? What do you find surprising about the rule?

Powell: Well, the proposed rule is perhaps the most significant new public company disclosure and compliance requirement in a generation. It sets forth very specific and detailed disclosure obligations and I would expect many companies would need to hire personnel just to understand what must be reported and manage the tracking of data. I would also expect that compliance costs will be significant, and companies will need a lot of guidance in order to comply with the proposed rule.

Colvin: Absolutely. For example, companies will need to be disclosing who on their board has been tasked with leading their quote unquote, “ESG effort.” Because this rule is specific to climate, my sense is that many directors who sit on the boards of publicly traded companies, not all, but many, probably don't have a whole lot of environmental expertise to bring to bear. Companies will need to engage third-party consultants and attorneys and others to help them fulfill their obligations with respect to all the requirements that the proposed rule is putting on them.

Let's get a little more granular, as Karen said earlier, and just talk a little bit about the biggest issue for companies that they'll face if this rule is implemented as proposed, with respect to the greenhouse gas emission disclosures. Karen, can you just speak a little more specifically to the difference between scope one emissions and scope two emissions? Understanding that some of our listeners may not fully appreciate what that distinction is or what they are. Can you just talk a little bit about that?

Davis: Sure, David. Scope one emissions, or direct emissions, are from sources owned or controlled by the company, such as emissions from company facilities or vehicles. Scope two emissions are indirect emissions that are generated by electricity, steam, heating and cooling that is consumed by the company but not emitted at company facilities.

Colvin: Brittney, in her earlier answer, Karen, touched on scope three emissions, which are a whole other animal altogether. Understanding now what scope one and two are, what are scope three emissions and why do people need to care about what they are?

Powell: Scope three emissions are essentially all other indirect emissions and include emissions consumed in the upstream and the downstream activities of a company's value chain. Upstream emissions are attributable to goods and services that a company acquires, such as purchased goods, capital goods, waste generated in the operation of the goods produced. The emissions that are generated by a company supplier usually accounts for a large proportion of the upstream emissions.

By contrast, downstream emissions are those that are used in the company's products, such as emissions generated in the processing, use and end of life treatment of sold products, as well as the transportation of goods to a company's customers. The key distinction between scope three emissions and scope two indirect emissions are that these are emissions that are not controlled or consumed in the operations owned or controlled by the company. They will rely on the data provided by their suppliers and by their customers and other third parties in order to report scope three emissions.

Colvin: Would scope three emissions disclosures be applicable to all publicly traded companies? Or is it just a subset of those company?

Powell: The reporting of scope three emissions is not required by all public companies. Because scope three emissions fall outside of a company's direct management and ownership, these emissions can be exceptionally difficult to quantify and control. The proposed rule does contemplate the challenges for companies to collect and report scope three emissions. Some accommodations have been proposed.

One such accommodation would be the exemption of smaller reporting companies from disclosing scope three emissions. A smaller reporting company is generally defined as a company that has a public

float of less than \$250 million, or it has less than \$100 million in annual revenues and either no public float or a public float of less than \$700 million.

There's also a proposed safe harbor provision for the disclosure of scope three emissions. The safe harbor is a limitation of liability that would deem the disclosure of scope three emissions not fraudulent unless they are made or reaffirmed without a reasonable basis, or if they're disclosed on a basis other than good faith. This provision is really intended to address the concern that companies must rely on third parties in their value chain for the scope three emissions data.

Colvin: Staying with scope three for a minute. Let me just add, both of you, understanding that scope three emissions relate to emissions over which the reporting company or the publicly held company has no control. What can companies do, or what should they be doing, to put themselves in a position to be able to collect and then report on that data?

I mean, for example, what if one of their suppliers doesn't comply with providing whatever data they're requested to provide by the reporting company? If the reporting company is going to pay a penalty or be sanctioned for not reporting one of its suppliers is doing or not doing when it comes to emissions, how's it going to work in the real world? What should companies be doing to make sure that they can be at least as far as possible in their disclosures with respect to these scope three emissions?

Davis: I think companies need to start including in their supply agreements, if they don't already have these kinds of provisions, they need to include provisions that obligate the supplier to provide the company with data on the suppliers' greenhouse gas emissions and to respond to requests from the company for additional information and supporting information related to those emissions. In addition, the SEC does recognize that companies may need to go to publicly available sources of information to estimate scope three emissions. So that, if a company does not get the information from its supplier, it may be able to go to public sources of information to get estimates. I think what will happen over time is that the process will get more sophisticated, and companies will start generating and providing to both their suppliers and their customers, better information. But I think in the beginning it will be a challenge until those systems get put into place.

Colvin: Understanding that this rule is still in the proposal phase, and companies and trade associations are submitting public comment. I thought one thing that was pretty remarkable about this proposal in particular – and it's not the fact that it was 500 pages, although that was nice – is the fact that the specs included something like 200 questions with respect to which, they were interested in hearing the answers from public company and trade associations regarding the proposal. So, companies right now are likely busy at work preparing their comment, if any.

Beyond commenting, what should companies be doing right now in anticipation of the fact that, in one form or another, the rule is going to be enacted? It may not look exactly like it does in its proposed form. In fact, it may look significantly different, but there will be climate risk disclosures required now for publicly traded companies. What do each of you recommend companies do in the anticipation of that so that they are as prepared as they can be when a rule is enacted and they have to comply with it?

Davis: Well, the proposed rule includes certain specific requirements for management and for the board. I think that's a good place to start, because that sets forth what the SEC expects companies will

be doing. I think companies should review those requirements and then also conduct their materiality assessments to determine what climate risks may be material to the company, assuming they have not already done that.

They should also consider if there are any climate-related opportunities for the company. Then management and the board need to determine if the company will set any climate-related targets and goals, if those will be limited to scope one and scope two, or if those will extend to scope three. And then they need to start putting programs and procedures in place to implement those programs and to collect and verify the data generated as a result of those programs.

It's important that they involve people who have the relevant expertise, and management and the board needs to provide regular and frequent oversight and direction to the individuals who are implementing those programs. They should receive periodic reports on the progress and provide direction on how those programs should be enhanced or modified. I think it'll be an evolving process, but I think that's where companies may want to start.

Colvin: That's good advice. Well, listen, I think we could spend a day talking about this proposed rule, but unfortunately, that's all the time we have for now. I really appreciate, Karen and Brittney, you both being here. The three of us have been working a lot together with respect to this proposed rule. We've published a [number of alerts](#) that our listeners should know that they can find on our website under the ESG practice group, which I think really contain some very helpful and useful guidance for companies as they start to think about how they're going to comply with a climate report disclosure rule in whatever form it takes when it's ultimately enacted.

That will conclude today's episode of "ESG Essentials: What You Need to Know Now." Please do feel free to reach out with any questions. I can always be reached at my email, which is dcolvin@foxrothschild.com. Check back regularly for new episodes. Thank you so much.