ALERT MEMORANDUM

The SEC's Climate Proposal – Top Ten Points for Comment

May 20, 2022

Now that the SEC has extended to June 17 the comment deadline on its climate-change disclosure proposal, it's time to review the list of top points for comment.

We think that moderating the proposal in key respects will – far from weakening it – make it more likely to achieve the Commission's long-term purposes of eliciting useful and consistent disclosures. Ideally the SEC's rules would contribute to developing coherent climate disclosure practices around the world – not just for U.S. reporting companies and not just under SEC rules.

With that in mind, a month ago we published a list of points for potential comment. Since then we've had a number of interesting conversations with clients and colleagues, as everyone has had a chance to dig into the proposal and to compare it to existing practices. Today we have ten points we commend to your attention. We are focusing on items where the SEC seems to have ventured beyond what investors and other frameworks have called for, or where the SEC seems to have misjudged the challenges of compliance.

A common element among many of the points below is that the SEC's proposing release states that they were supported by commenters in response to the SEC's March 2021 request for comment. We would urge the Commission to distinguish between types of commenters. The views of advocates and activists – while they are undoubtedly important – are not of the same kind as the view of investors and their representatives, and they do not bear equally on the Commission's statutory mandate for the protection of investors.

1. The Financial Statement Note

The proposal for note disclosure in audited financial statements is seriously flawed – the concepts used in the proposed rule are unclear, the 1% threshold is inexplicably low, the utility of the information is doubtful, and the implications for systems and internal controls are an order of magnitude higher than with the rest of the proposal. It is an unnecessary bolt-on that goes beyond what investors have been seeking. If the SEC maintains this proposal, it should clearly define its terms, replace the 1% threshold with a more sensible materiality threshold, and permit these disclosures to be unaudited.

2. Attestation Requirement

This element of the proposal is premature, as the proposal recognizes by giving it a long phase-in period. There is doubt about the supply, the cost and the quality of climate disclosure attestations; about the half-formed state of professional standards for this work; and about the lack of supervision for attestation providers. We have also heard from clients that the attestation will have a serious impact on their ability to have disclosures ready by the applicable annual report filing deadline under SEC rules.

We are inclined to comment that the SEC should eliminate the final step – the transition from "limited assurance" to "reasonable assurance." That piece seems like the most problematic, and can be severed without impairing the proposal. Many large companies already obtain limited assurance, and it seems likely that more will do so, but few companies are getting reasonable assurance, and the proposing release does not suggest there is strong investor demand for it. We also believe other disclosure frameworks are not yet moving in that direction.

3. Alternative Reporting

The proposal includes a series of questions suggesting that the SEC is considering whether to allow reliance on an alternative reporting framework. The proposal leaves all the variables open, but we believe such a provision would be a major contribution to the development of other valid disclosure frameworks – much as the SEC's acceptance of IFRS financial statements has contributed to the quality and global acceptance of IFRS as a valid alternative to U.S. GAAP. Here is a sketch of a possible approach to the key variables:

- <u>What issuers</u>? The questions in the proposal suggest that alternative reporting might be available to foreign private issuers, and dual-listed FPIs are particularly at risk of being subject to multiple regimes. The SEC should allow FPIs to comply with acceptable alternative regimes, but we would also support allowing alternative reporting for any issuer.
- <u>What alternative regimes</u>? The SEC should establish a process for identifying acceptable alternative regimes. This would permit regimes to be identified both when the rules are adopted and – crucially – in the future as alternative regimes develop. The obvious major candidates are the forthcoming ISSB standard and the European Union's Corporate Sustainability Reporting Directive (CSRD), but the proposing release also cites live proposals in the United Kingdom, Japan and Canada, and there will be national standards in other jurisdictions, too. The SEC should not insist on mutual recognition as a criterion.
- <u>What disclosure mechanics</u>? In our view, disclosures under an alternative regime would have to be filed with the SEC, like disclosures under the SEC's own proposed rules.

- What deadline? The deadlines for filing annual reports under SEC rules – especially for domestic large accelerated filers – are very tight compared to those in other countries and compared to current practices for sustainability disclosures. We suggest that an alternative reporting regime should permit the alternative disclosure to be filed as an amendment to the annual report, so it does not delay the filing of other information. Presumably there would need to be a deadline – 120 days after fiscal year-end would line up with the Form 20-F deadline, but six months would be more consistent with current practices.

4. Liability Safe Harbor

If it works, the proposal will promote climate-related disclosure that reconciles what the reporting-company system can produce with what investors are seeking. The complexities on both sides of that equation are significant, and again, the stakes are high. Nothing about this project requires that the SEC invite plaintiff law firms to the table, to bring claims under the antifraud provisions of the securities laws.

The proposal does contain a safe harbor for Scope 3 disclosure in proposed Rule 1504(f), which shows a path the SEC could follow to shelter more elements of this new disclosure ecosystem from predation. We would suggest that the same safe harbor be extended to other disclosures where either (a) the disclosure is necessarily forward-looking, (b) the registrant will be dependent on third-party information, or (c) methods and standards are subject to change. These would include: impacts of climate-related risks under proposed Rule 1502(b); disclosures about future financial statement impacts under proposed Rule 1502(d); disclosures about scenario analysis under proposed Rule 1502(f); transition plan disclosures under proposed Rule 1503(c); all GHG emissions disclosures under proposed Rule 1504; and "targets and goals" disclosures under proposed Rule 1506.

The proposing release mentions the availability of the existing PSLRA safe harbor, but there are important circumstances (notably for IPOs and "ineligible issuers") where that safe harbor is not available.

5. Scope 3 Disclosure

The Commission should moderate the Scope 3 disclosure requirements to recognize the particular difficulties of calculating and presenting Scope 3 emissions. Disclosure standards, definitions and techniques are still evolving, and the prevalence and quality of Scope 3 disclosures are improving, but that is a complicated process, and there is a risk that absent accepted methodology, the disclosure elicited by the SEC's proposed rules will not further the goals of transparency and comparability. We suggest the following changes in particular, but urge the Commission to consider other changes as well:

- Eliminate for Scope 3 emissions the requirement that emissions data be disaggregated by each of seven constituent greenhouse gases.
- Eliminate disclosure of GHG intensity in terms of metric tons of CO_2e per unit of total revenue.
- Address the challenges that will arise from use of different reporting periods by a registrant and its suppliers and customers.
- Expressly acknowledge that registrants are likely to apply a wide range of methodologies to the calculation of Scope 3 emissions data and to have significant gaps in their ability to collect reliable information.

6. Governance Disclosures in Form 10-K

The proposal would require disclosures about board oversight and management oversight to be presented in the annual report on Form 10-K. Generally, corporate governance information is required in the proxy statement, and can be "forward incorporated" in the 10-K. The SEC took this approach in its proposal on cyber security disclosures, and it should do so with climate-related governance disclosures, too.

7. Annual Disclosure Deadline

We expect the SEC will not be deterred from its proposal that climate disclosures generally be included in the annual report on Form 10-K or Form 20-F. However, the deadlines for annual reports are very tight, especially for domestic large accelerated filers. Other filers – notably FPIs reporting on Form 20-F – have more time, but the climate disclosures will lead them to file later than they otherwise would. A modest proposal would be to permit climate disclosures to be filed by amending the annual report, with a separate deadline such as 120 days after year-end, analogous to the way proxy disclosures are incorporated in an annual report on Form 10-K.

8. Excessively Detailed Requirements

We recognize that the spirit of this proposal is inherently prescriptive: the SEC has opted to give detailed "line-item" requirements. However, that approach seems to have misfired on several significant points, where the SEC would do better to dial back the details.

a. Organizational Boundaries for GHG Emissions – The SEC's proposal requires disclosures about GHG emissions to apply organizational boundaries that are consistent with the consolidated financial statements. As the SEC notes, this differs from the GHG Protocol, which permits the use of organizational boundaries based on either equity share or operational control. We understand from clients that the proposed method presents significant complications (particularly with respect to the distinction between Scope 1 and Scope 3 disclosures) and has no particular advantages. There is no reason the SEC should seek to displace the GHG Protocol (and the other disclosure initiatives that rely on it) in this regard, and we don't believe investors have sought this.

b. Disclosure about Internal Carbon Price – The proposal calls for mandatory disclosures by a registrant that "maintains an internal carbon price." The proposed rule text is vague, and the proposing release is clear that it represents a compromise. Climate activists contend that economic actors should put a price on the carbon they emit and disclose what price they use; but the SEC chose not to propose such a requirement, because there is not at present an adequate market from which to draw a price and many registrants don't use one. The resulting half-measure seems unwarranted. Companies that are trying to think carefully about climate risks will be tagged with extra disclosure, but many will not, and at the margin some could be deterred. It is hard to see how that will advance the cause of consistent, comparable, useful disclosure.

c. Disclosure about Scenario Analysis – Similarly, the proposal compromises on scenario analysis. Climate activists argue that it should be required, but the SEC wisely does not go there, citing a TCFD study to the effect that few companies actually do it. Instead the proposal is to require extensive disclosures only from registrants that "use" scenario analysis. But companies use scenario analysis for a range of reasons, not all of which are relevant to investors, and some of which are meant to be confidential. There is no reason to require them all to be disclosed. At most a registrant should present one or more scenarios it considers most useful to analyze its resilience (rather like the MD&A requirement to tell investors how management views the company's financial performance).

d. Disclosure about Carbon Offsets – The proposal will require a registrant to disclose its reliance on carbon offsets to meet its climate-related targets and goals, and to provide information about how it relies on them. The SEC's motives are understandable, because apparently many carbon targets combine reductions with offsets. But the Commission should carefully evaluate the potential effects of extensive disclosures on the development of the market for carbon offsets. They represent an important but clearly underdeveloped tool, and the SEC should be wary of chilling innovation or other unintended consequences. Mandatory disclosure of details could inflate an already growing demand, affect pricing, and provoke second-guessing of a company's own internal carbon pricing calculation. The SEC should consider replacing this requirement with a more broadly-worded requirement to explain the strategy fully, acknowledging that specific details may appropriately be withheld for a variety of reasons.

e. Zip codes – The proposal requires information about location (for example, location of operations subject to physical risk) and defines "location" to mean zip code "or similar subnational postal zone or geographic location." While this is not the most important point in the proposal, it is a telling example of an overzealous approach supported, apparently, only by a handful of activist commenters.

9. Periods Initially Covered

The proposal generally requires that a company present quantitative climate-related information for three years – the most recently completed fiscal year and the earlier years included in the consolidated financial statements. Many companies will be developing these disclosures for the first time, and even those that have a track record will have to adjust their practices to the new rules. The proposing release refers to existing rules that permit a registrant to omit information that is not reasonably available because it involves "unreasonable effort or expense," but those rules set a high standard. It would be clearer and fairer to revise this proposal so it only requires quantitative climate-related information beginning with the first fiscal year for which the rules are effective.

10. Compliance Timeline

The proposal contains an illustrative timeline for compliance assuming the rule is adopted by the end of 2022. The Commission may not be able to meet that year-end deadline, but whenever it does adopt final rules, it should provide more time than the illustrative timeline contemplated. The amount of work that will be required to collect and report the required data is dramatic. Companies will need to implement governance enhancements, develop their climate-related infrastructure and expertise, and work with their auditors to ensure that the accounting standards are being properly applied to climate-related impacts. Auditors may also want to perform dry runs of their procedures in the quarters prior to implementation of the proposed rules. We have heard from many public-company clients, with experience in reporting climate-related information, that the proposed compliance timeline is simply impossible to meet. The final rule should have a more realistic compliance timeline, with at least one year between adoption of final rules and the beginning of the first reporting period for which the rules apply.

We welcome input on our choices, and we plan to revise this list again before the comment deadline on June 17. You may review our latest SEC thought leadership and ESG-related blog posts here.

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If you have any questions about the SEC's new proposed rules on climate-related disclosures or about any other climate, sustainability or ESG-related questions, please feel free to contact your regular contacts at the firm or any of the Sustainability Working Group members below.

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