The SEC Climate Disclosure Rule: Separating Signal from Noise

After many 'head fakes' since March 2022 when the US SEC first released its proposed climate rule, namely "The Enhancement and Standardization of Climate-Related Disclosures for Investors", we finally have some clarity. Per the publicly broadcast US SEC Open Meeting on Wednesday, the Commission adopted a finalized ruling following a vote, which resulted in 2 votes against and 3 in favor of adoption. Per the Factsheet outlining the rule released by the Commission immediately prior to the March 6th Open Meeting and the final rule released immediately following, several substantive changes were made to the proposed requirements released in March 2022, indicating in our view that the Commission feared the rule would inevitably face destructive legal challenges if reporting requirements were not diluted in rigor or were perceived to remain a liability for issuers. Even with these somewhat expected and dilutive changes, challenges to the rule — legal, political and otherwise — are almost certain. We detail these likely challenges later on in this piece.

The final rules will become effective 60 days after publication in the Federal Register, or approximately late in the second quarter. In the interim, below we outline some of the more significant and substantive changes captured in our comparison of the March 2022 proposed and the March 2024 final rulings.

These changes include:

- Removing the requirement to disclose Scope 3 emissions;
- Requiring the disclosure of Scope 1 and Scope 2 emissions only if material;
- Exempting smaller reporting companies, emerging growth companies, and non-accelerated filers from disclosing Scope 1 and Scope 2 emissions;
- Removing the requirement to include line-item disclosures in financial statements for transition expenditures;
- Eliminating the requirement to describe Board members' climate expertise;
- Requiring disclosure of material expenditures directly related to climate-related activities as part of registrants' strategy, transition plan, and/or targets and goals disclosure requirements under the Reg S-K rules, rather than under the Reg S-X rules; and
- Requiring attestation/assurance reports only for large issuers, and with a less prescriptive assurance standard.

For reference, the finalized rule will require compliant disclosure by Large Accelerated Filers based on fiscal year 2025 performance, which – assuming the rule becomes effective — will result in 2026 being the first year many companies need to contend with SEC's climate reporting mandates.

In practice, we do not believe the updated rule meaningfully changes the path forward for corporate issuers, if at all. Given the long-existing competitive, commercial and stakeholder pressures at play, that other regulation stemming from California and the European Union will require similar if not more rigorous disclosure, and that many companies have been proactively preparing for mandated climate reporting by the Commission, efforts required for compliance with the rule have already been actioned by most. Even ignoring competitive and other regulatory reporting pressures at play, despite scaling back the requirements, the practical burden for issuers has not been meaningfully reduced. For example, we fail to understand how in practice one can assess Scope 1 and 2 emissions for materiality without also having a detailed understanding of total indirect emissions and thus accompanying Scope 3 emissions; while the updated rule would not require reporting of Scope 3 figures, we don't see a reality where companies aren't pressed to calculate those figures eventually to the extent they aren't already today. A similar argument can be made regarding the dilutive changes to previous Regulation S-X reporting requirements; despite reducing the quantitative detail required within disclosures, the qualitative disclosures required should entail essentially the same underlying climate scenario analyses and amount of effort to be accurate and credible.

Discussions with clients reveal that while corporate anxiety has certainly ebbed and flowed in tandem with news cycles and rumors related to finalization since March 2022, the requirements posed by the US SEC are no longer an incalculable threat. Rather, they are a fully conceivable and relatively straightforward disclosure exercise as compared to that required by other regulations, such as the EU's Corporate Sustainability Reporting Directive (CSRD).

In this vein, below are the second-order challenges — or those not directly related to enhanced reporting requirements but created as a result — we've learned to be most pressing for clients in 2024.

How to:	The threat of:	Implementing: [1]
— Gain efficiency in global sustainability reporting — Collect, manage and assess data and prepare for assurance requirements — Optimally structure ESG governance — Strengthen internal controls	— Shareholder or NGO activism — An ESG 'controversy' — Greenwashing and litigation — Anti-ESG rhetoric and changing political landscapes — Missing a previously set target or having to recast expectations	— ESG data tracking software — Processes for supply chain due diligence — Change management-centric efforts to prepare for global coordination and compliance efforts — New and deeper layers of management and leadership among ESG teams

We plan to shed more light on these issues and best practice for addressing them in the coming weeks.

In addition to helping clients navigate the above issues, we'll also be watching carefully for how various forces at play — many political in nature – shape the practical future of the finalized ruling.

The 3-2 partisan vote and discussion among the Commissioners at the open meeting reflects the wide range of opinion on the final rule, with Democrats generally supporting the rule as a helpful first step for mandatory climate disclosure and Republicans opposing the rule completely[2].

Now that the rule has been finalized, the SEC will face multiple legal challenges. The lawsuits will span the spectrum of opinion from the ideological left to right, from Republican Attorneys General who believe the SEC does not have legal authority to issue any climate rule, to industry groups that have voiced concerns about specific elements of the rule, to environmental NGOs who are concerned that the rule is not prescriptive enough. While the lawsuits will likely raise several specific issues, fundamentally they will test how much climate information the SEC can require from companies under their existing legal authority.

Republicans in Congress will also continue to push back against the rules while they are being litigated and use their oversight powers to push back on substantial and procedural aspects of the rules. The same day the rule was finalized, Republicans in the House and the Senate announced their intention to attempt to rescind the rule using the Congressional Review Act (CRA)[3]. However, use of the CRA is largely symbolic at this juncture given a Democratic majority in the Senate and a Democratic President who could veto the measure. In addition to

the CRA, House Financial Services Chairman Patrick McHenry (R-NC) announced two hearings examining the final rule. Meanwhile, key Democrats have also expressed dissatisfaction with the rule, claiming it is too watered-down and expressing disappointment that scope 3 requirements were excluded[4].

A similar fight is also playing out at the state level, most notably in California, which has passed its own climate disclosure law that would require most companies operating in the state to report scope 3 emissions. That law is being challenged by the Chamber of Commerce, which contends that the California law usurps the role of federal regulators[5].

As litigation on the SEC and California rule moves forward, state and federal lawmakers on both sides of the aisle will likely continue to leverage any news to make their case for or against the rules. Given strong Republican opposition to the rule, should a Republican win the presidency in 2024, it can be anticipated that the SEC would restart the rulemaking process to significantly roll back or eliminate the rule.

Conclusion

While the finalized rule has been reduced in scope as compared to its 2022 predecessor, we now have more clarity around expectations from issuers, which inevitably helps to drive the market forward. Litigation and politics are certainly expected to pose challenges. Despite this, most of our clients will continue to bolster relevant compliance efforts due to other regulatory pressures such as those stemming out of California and the EU. In this vein, we do not expect a step change increase in effort required by most clients as it relates to assessing underlying climate-related risks and calculating emissions. But we continue to remind clients that disclosure of such information is but one piece of the puzzle — ensuring data availability and proper controls, organizing internal personnel strategically, focusing on performance improvement, achieving stated commitments, and aligning incentives purposely are also essential. Without prioritizing these critical second-order challenges that often require several years to action and even longer to action successfully, clients will struggle to meet the market and regulators' expectations over time when addressing the fundamentals: reporting reliable information and taking meaningful action to mitigate material risks while also demonstrating improvement over time. As the influence of investors and customers should not be underestimated and expectations only continue to rise, we urge clients to assess critically how they will enact change quickly and effectively within their organizations to ensure success in a new normal where focus shifts heavily from disclosure to performance.

Please refer to the SEC's Factsheet on the rule for an in-depth summary of requirements.

Endnotes

[1] https://www.eenews.net/articles/sec-climate-disclosure-rule-faces-legal-gantlet

[2] https://www.sec.gov/news/press-release/2024-31

[3] https://www.politico.com/newsletters/morning-money/2024/03/06/the-sec-climate-rule-whats-next-00145192

[4] https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=409174

[5] https://www.politico.com/news/2024/01/30/business-coalition-sues-california-over-nation-leading-climate-disclosure-laws-00138671#:~:text=The%20U.S.%20Chamber%20of%20Commerce,signed%20into%20law%20by%20Gov

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