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Invoking Investor Demand, SEC Chair Makes the Case for Mandatory Climate Risk Disclosures: 'Companies and Investors Alike Would Benefit from Clear Rules of the Road'

Insights
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Rulemaking proposal – the most significant SEC action on climate in years – expected by October

New rules will apply to public companies and have important implications also for private companies as they move toward maturity

Since the start of the Biden administration, the U.S. Securities and Exchange Commission (SEC) has signaled that climate and broader environmental, social and governance (ESG) disclosure will be an area of heightened focus, subject to more proactive and aggressive regulatory oversight and enforcement.

Last week, SEC Chair Gary Gensler delivered prepared remarks at the U.N. Principles for Responsible Investment "Climate and Global Financial Markets" webinar event, where he previewed the SEC's planned mandatory climate risk disclosure rule proposal—anticipated in or before October—and offered valuable insight into what we can expect. The climate change rulemaking will represent the most significant SEC action on climate matters since the agency's 2010 guidance (discussed below), and mark a departure from the SEC's existing approach to climate risk disclosure. "When it comes to climate risk disclosures," Gensler said, "investors are raising their hands and asking regulators for more…. I believe the SEC should step in when there's this level of demand for information relevant to investors' decisions."

Gensler prefaced his remarks by noting that the SEC has received more than 550 unique comment letters in response to the agency's March request for public input on climate change disclosures. Three out of every four of those responses, he highlighted, support mandatory climate risk disclosures for public companies. Leading technology companies, notably, were among the many respondents that firmly backed such disclosures. Nearly 6,000 additional form letter submissions supportive of the SEC's initiative were also filed.

Emphasizing that both companies and investors would benefit from clear rules of the road to help navigate this area of intense interest and importance, Gensler outlined the following key considerations that climate risk disclosures should address to meet investors' need for "consistent, comparable and decision-useful" information. His remarks portend a potential shift from the SEC's current principles-based, materiality-focused approach toward a more standardized, detailed and prescriptive climate risk disclosure regime.

While the new rules will be applicable to SEC registrants, they will have important implications for private-market actors as well. Early-stage and growing companies, for instance, will want to keep them top of mind when integrating and maintaining climate and other ESG policies as they scale. And firms seeking to go public—whether via a traditional IPO, direct listing or SPAC merger—will need to ensure they are prepared to meet the new regulatory requirements well in advance of their public debuts.

A note on timing. After proposed rules are published later this year, the SEC will open a public comment period (typically 60 days) designed to solicit feedback from companies, investors and other interested parties, whose responses the SEC will analyze and consider before adopting final rules. New rules are thus unlikely to be effective before 2022. Until then, Gensler and other senior SEC officials have underscored that the agency intends to enforce vigorously existing rules and guidance.

- ***Consistency and comparability***. Gensler noted that although the SEC provided guidance on climate change disclosure in 2010, much has changed since then, and investors currently do not have the ability to compare company disclosures to the degree that they need. The consistency with which issuers report information leads to comparability between companies, today and over time, Gensler maintained:

  > "Investors today are asking for that ability to compare companies with each other. Generally, I believe it's with mandatory disclosures that investors can

benefit from that consistency and comparability. When disclosures remain voluntary, it can lead to a wide range of inconsistent disclosures."

- ***Decision-usefulness***. Gensler explained that decision-useful disclosure is not simply generic language or boilerplate text but has sufficient detail so investors can gain meaningful insight.

- ***Potential Form 10-K inclusion***. Gensler said he has directed SEC staff to consider whether climate risk disclosures should be included in companies' annual reports on Form 10-K filed with the SEC—which would carry a higher standard of liability—as opposed to being "furnished" in separate climate reporting outside of annual and quarterly SEC filings (such as furnished on a Form 8-K, in a separate public report or on a company website), which would limit which securities law liability provisions would apply to the disclosures.

  In their comments to the SEC, technology companies have generally opposed mandating climate risk disclosures in SEC filings. They have recommended instead that, because such disclosures rely on estimates and assumptions that involve inherent uncertainty, the SEC should permit them to be provided outside of annual, quarterly and other filings, to avoid subjecting companies to undue liability exposure, including from private parties. Many have also called for a safe harbor or other liability protection for certain climate change metrics and forward-looking information provided by companies in good faith (see, for example, this joint letter from Alphabet, Amazon, Facebook and four other leading technology companies and this letter from Dell Technologies).

- ***Both qualitative and quantitative information***. Gensler suggested that **qualitative disclosures** could answer key questions such as how the company's leadership manages climate-related risks and opportunities and how these factors feed into the company's strategy. **Quantitative disclosures** could include metrics related to greenhouse gas (GHG) emissions, financial impacts of climate change and progress towards climate-related goals.

  Regarding metrics, Gensler observed that although some companies currently provide voluntary disclosures related to Scope 1 GHG emissions (from their own operations) and Scope 2 GHG emissions (from the energy resources they use), many investors are looking for information beyond such disclosures, to Scope 3 GHG emissions (all indirect emissions, not included in Scope 2, that occur in their value chains, e.g., purchased goods and services, business travel, employee commuting, use of sold products including end-of-life treatment, investments). Scope 3 emissions represent the overwhelming majority of most companies' carbon footprint and can be the most challenging to quantify.

Gensler said he has asked staff to make recommendations about how companies might disclose their Scope 1 and 2 emissions, along with whether to disclose Scope 3 emissions and, if so, how and under what circumstances.

- ***Industry-specific requirements***. Gensler indicated he has directed staff to consider whether there should be different climate-related metrics for different industries, in order to provide a further level of specificity and help focus effort and attention on those risks most salient to each industry.

- ***Scenario analyses***. Gensler queried whether companies should be required to provide scenario analyses on how a business might adapt to the range of possible physical, legal, market and economic changes it might contend with in the future. He suggested this could encompass both **physical risks** associated with climate change and **transition risks** associated with companies' stated commitments or compliance requirements from certain jurisdictions in which they operate.

  Gensler hinted at more rigorous and robust disclosure requirements for companies that make forward-looking climate commitments or other public climate pledges. "Today," he said, "companies could announce plans to be 'net zero' but not provide any information that stands behind that claim. For example, do they mean net zero with respect to Scope 1, Scope 2 or Scope 3 emissions?"

  Moreover, the commitments made by jurisdictions in which companies operate, such as to the Paris Agreement or similar goals, could lead to regulatory or economic changes within those locations, he added. Accordingly, he has asked staff to consider which data or metrics those companies might use to inform investors about how they are meeting those requirements.

- ***Interface with existing voluntary reporting frameworks and standards***. Gensler noted that many respondents to the SEC's climate disclosures request for public input (including almost all of the technology firms that weighed in) identified the Task Force on Climate-related Financial Disclosures (TCFD) framework recently endorsed by the G-7 advanced economies, among other globally recognized voluntary reporting frameworks and standards, as a foundation on which new SEC disclosure rules could be based. Gensler stated that while he has asked staff to "be informed and inspired by" these external standard-setters and the international community's work overall, the SEC "should move forward to write rules and establish the appropriate climate risk disclosure regime for our markets, as we have in prior generations for other disclosure regimes," suggesting the SEC may instead take a more independent approach.

If you have questions regarding this client alert, or any related matter, please contact Alexa Belonick, Michele Luburich or another member of Gunderson Dettmer's public companies team.

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