Reuters Legal News

SEC proposes a change in disclosure climate

By Lance Dial, Esq., Erin Martin, Esq., and Kirstin Gibbs, Esq., Morgan, Lewis & Bockius LLP

APRIL 7, 2022

Asset management is hard, and it can be especially challenging in an era marked by concerns regarding climate change. Investors are increasingly seeking investment products that incorporate analysis for climate-change risk, and asset managers and their clients are making climate-related commitments with respect to their investments and operations. Traditional financial metrics, such as price/earnings ratios or same-store sales, are insufficient to provide asset managers with sufficient insight into an issuer's operations for the asset manager to meaningfully evaluate climate risks.

As a result, asset managers have been clamoring for issuers to provide increased disclosure of information relating to their exposure to and resiliency against climate-change risks, and their demands have been echoed through several new private and quasi-public organizations such as the Task Force on Climate-Related Disclosures, the Net Zero Asset Managers Initiative, and the Climate Action 100+.

On March 21, 2022, the SEC proposed several climate-related disclosure rules that would clear the air with respect to climate-risk disclosures.

While these organizations have achieved some limited success with respect to increasing public company climate-related disclosure, the United States Securities and Exchange Commission (SEC) had not set forth any mandatory rules with respect to these disclosures, and the lack of clear directives resulted in a fog of climate-related disclosures with limited comparability, consistency, and reliability across issuers.

SEC's climate disclosure proposal

On March 21, 2022, the SEC proposed several climate-related disclosure rules that would clear the air with respect to climate-risk disclosures. These proposed rules represent a comprehensive new set of disclosure requirements ranging from discussions of climate-risk evaluation and governance to the impact of specific climate-related events on financial statement line items and related expenditures.

In sum, the proposed rules would require a narrative discussion in the issuer's financial statements regarding:

- Climate-related risks faced by the issuer, including physical risks (e.g., impact from extreme weather events, sea-level rise and drought) and the identification of the physical location and nature of the properties, processes, or operations at risk, and transition risks (i.e., the risks associated with a transition to a less carbon-intensive economy);
- The governance and oversight of climate risks by the issuer's board and management;
- An assessment of climate-related impacts on the issuer's strategy, business model, and outlook;
- The issuer's process for identifying, assessing, and managing climate-related risks; and
- If applicable, any climate-related targets and goals (e.g., net-zero carbon emissions by 2050).

In addition, the proposed rules would require disclosure of greenhouse gas (GHG) emissions in a format consistent with the GHG Protocol, which divides GHG emissions into three categories: Scope 1, Scope 2, and Scope 3. Scope 1 emissions are those from operations owned or controlled by the issuer; Scope 2 emissions are indirect GHG emissions from the generation of purchased power (e.g., electricity); and Scope 3 emissions are indirect GHG emissions from other sources, including those from the issuer's suppliers and consumers.

With respect to GHG emissions, the proposed rules would require quantitative disclosure of:

- Scope 1 and Scope 2 GHG emissions; and
- For some issuers, Scope 3 GHG emissions, if material.

Opportunities for asset managers

The full SEC proposal, at more than 500 pages, provides a detailed explanation of each of the above requirements and generally notes that the elements included are responsive to requests from asset managers generally and the specific requests provided to the SEC in response to the SEC's 2021 request for comment on climate-related risks. As noted above, asset managers have requested this data in order to better manage climate-related investment risks for their clients and to ensure that they meet their own climate-related investment objectives.

Thomson Reuters is a commercial publisher of content that is general and educational in nature, may not reflect all recent legal developments and may not apply to the specific facts and circumstances of individual transactions and cases. Users should consult with qualified legal counsel before acting on any information published by Thomson Reuters online or in print. Thomson Reuters, its affiliates and their editorial staff are not a law firm, do not represent or advise clients in any matter and are not bound by the professional responsibilities and duties of a legal practitioner. Nothing in this publication should be construed as legal advice or creating an attorney-client relationship. The views expressed in this publication by any contributor are not necessarily those of the publisher.

THOMSON REUTERS®

By way of example, the proposed Scope 1 and Scope 2 disclosures would offer an asset manager insight into the carbon intensity of an issuer's business processes and, therefore, the risks to that issuer of potential new carbon taxation or other limitations on carbon production. Similarly, an issuer heavily reliant on water for its operations may be required to disclose its assessment of the potential risk of droughts on its financial prospects.

The proposed disclosures related to an issuer's value chain and Scope 3 emissions, if material, could also offer asset managers insights into the operations of private companies that are not required to make climate-risk disclosures. In order to meet disclosure obligations under these proposed rules, many public issuers will need to require that their suppliers and customers provide key climate-risk and GHG emission information, which would be included as part of the issuer's climate-risk disclosure. This information will provide even deeper insights beyond the public company and into the overall functioning of markets, sectors, and potentially individual market participants.

The SEC is actively considering new rules regarding disclosures to be made by asset managers and investment products (e.g., mutual funds).

In addition to the climate-related risk information, the proposed disclosures would offer unprecedented insights into the operations of the issuers in which they invest. For example, an issuer's GHG emissions as a whole could be compared to other issuers in similar industries, which could provide insight as to the relative overall efficiency of operations.

Further, the more granular physical-location information of properties, processes, and operations subject to physical climate-related risks would not only allow for more accurate evaluation of location-specific climate risks, but it could also allow asset managers insight into supply-chain lengths, local labor-market limitations, and overall complexity of an issuer's operations.

As a more general matter, the required long-term discussions relating to climate risk could also provide valuable insights into the overall long-term and strategic business plans of an issuer beyond what is currently disclosed.

While asset managers stand to receive significant new climate-related information should these rules pass as proposed, there is key climate-related information that the SEC did not specifically propose issuers to develop and disclose. For example, while the proposed rules would require issuers who maintain an internal carbon price to make disclosures regarding their use of that price, issuers are not required to maintain one. Similarly, issuers who perform scenario analysis to stress-test their climate resiliency would be required to make disclosures relating to that analysis, but the rules would not require issuers to perform the analysis.

Impact on asset manager products and disclosures

Similar to these proposed issuer disclosure requirements, considering new rules regarding disclosures to be made by asset managers and investment products (e.g., mutual funds). It is likely that these proposed issuer disclosure requirements will establish the baseline for any new asset manager product disclosures. For example, mutual funds could be required to report the aggregate GHG emissions of their holdings based on the new GHG emissions disclosures from issuers, and asset managers may be required to include new narrative climate-related risks with respect to their own advisory services.

The proposed climate-related information will also facilitate review of sustainability and climate-related claims with respect to investment products. While widely available data regarding GHG emissions and climate risks will facilitate the management of sustainability and climate-related products, the same data will also be used by regulators (and investors) to ensure that investment products are meeting the sustainability of climate-related claims made in offering documents or marketing materials.

What's next?

The proposal is subject to the later of a 30-day comment period measured from the date of its publication in the Federal Register and a 60-day comment period measured from its original release, which would be May 20, 2022.

The proposal suggests that the SEC wants to move quickly to adopt the proposed rules, providing hypothetical compliance dates starting in fiscal year 2023, but the adoption of a final rule could be subject to legal challenge. In fact, SEC Commissioner Hester Peirce, in voting against the proposal, effectively outlined a pathway for litigation, and several politicians have expressed their opposition to the proposed rules. So, it is not clear what to expect after May 20, 2022.

With respect to related rulemaking, asset managers should expect proposals regarding climate-risk disclosures for asset managers and products in the near term, as climate risk is a key priority for the Biden-Harris administration and also appears to be high on SEC Chair Gary Gensler's priority list. With this proposal and the others in the SEC's pipeline, it's clear that there has been a material change in the climate for disclosure.

 ©2022 Thomson Reuters

About the authors

Lance Dial (L) is a partner at **Morgan, Lewis & Bockius LLP**, and focuses his practice on mutual fund law and operation and on regulations applicable to investment managers. He advises clients on the creation of investment products and environmental, social and governance (ESG) and sustainability matters. He is resident in the firm's Boston office and can be reached at lance.dial@morganlewis.com. **Erin Martin** (C), a partner at the firm, focuses on counseling public companies and their boards with respect to securities regulation, capital market transactions, and corporate governance matters. She previously served at the SEC in the Division of Corporation Finance, and she has specialized knowledge relating to complex matters of SEC disclosure and compliance. She is resident in the firm's Washington, D.C., office and can be reached at erin.martin@morganlewis.com. **Kirstin Gibbs** (R), a partner and co-leader of the firm's energy industry team, as well as a leader of the climate change and sustainability working group, represents pipelines, producers, traders, marketers, utilities, and end users. She handles transactional matters related to the development of new oil and gas infrastructure. She also counsels global clients interested in addressing climate change and sustainability initiatives. She is resident in the firm's Washington, D.C., office and can be reached at kirstin.gibbs@morganlewis.com.

This article was first published on Reuters Legal News and Westlaw Today on April 7, 2022.

© 2022 Thomson Reuters. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional. For subscription information, please visit legalsolutions.thomsonreuters.com.