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4 Things To Know About SEC Climate Reporting Compliance

By **Sarah Jarvis**

Law360 (March 11, 2024, 10:28 PM EDT) -- While the U.S. Securities and Exchange Commission scaled back its long-awaited climate disclosure rules last week, the requirements still pose plenty of compliance challenges, not least of which is figuring out how the new rules will mesh with similar — but not identical — regimes out of California and the European Union.

Companies gearing up to comply with the new regulations have to build out their systems for tracking and reporting the information they'll soon be required to disclose to the financial regulator. While smaller and midsize companies that aren't already tracking such data will have the heaviest lift in that regard, larger firms that are also subject to California's and the EU's requirements must navigate regimes that don't necessarily have much overlap.

"For large, multinational corporations, it's still going to be very challenging for them to have to think about how this fits into what is now an incredible multitude of regulations," said Morgan Lewis & Bockius LLP partner and former SEC attorney Erin Martin.

Different Jurisdictions, Different Requirements

California's Senate Bill 253, signed into law by Gov. Gavin Newsom in October, requires companies to report their so-called Scope 1, Scope 2 and Scope 3 greenhouse gas emissions, which cover their direct, operational emissions; their indirect emissions from energy use; and their indirect emissions from up and down their supply chains, respectively.

The EU's Corporate Sustainability Reporting Directive similarly requires companies to publish reports on how their business affects the environment, as well as the social and environmental risks they face. The directive also includes the controversial Scope 3 emissions.

The SEC scrapped Scope 3 emissions between when it initially unveiled its proposal in 2022 and when the commission finalized the rules March 6 in a 3-2 vote along party lines. The SEC rules will instead require many publicly traded companies to disclose both their Scope 1 and Scope 2 emissions, so long as they are material.

In addition to the disclosure of greenhouse gas emissions, the new SEC regulations will require companies to reveal to investors their climate-related risks, including by providing information about the financial harm caused by severe weather events like flooding and wildfires.

Leah Malone, leader of the environmental, social and governance and sustainability practice at Simpson Thacher & Bartlett LLP, said SEC Chair Gary Gensler made it clear during last week's meeting that the U.S. needs its own rules when it comes to corporate climate reporting and the commission wasn't interested in adopting the requirements laid out by other regimes.

She said the agency made "a very concerted effort to not necessarily bring the rules directly in line with what anyone else is requiring." But recognizing the compliance burden of the regulations, the SEC instead focused on extending implementation dates, reducing the regulation's substantive requirements and limiting the scope of companies included, she said; for example, the SEC exempted smaller reporting companies and emerging growth companies from reporting their greenhouse gas emissions.

Jayni Hein, of counsel at Covington & Burling LLP and co-chair of the firm's carbon management and climate mitigation industry group, said California's laws have earlier compliance deadlines than the SEC's rules, so companies subject to California's regulations will have to attend to that first.

But Hein said the California and SEC requirements have some similarities, including that they both use a framework known as the GHG Protocol, which was led by the research nonprofit World Resources Institute, for standardizing how greenhouse gas emissions are reported.

She added that in the forthcoming implementing regulations of its law, California may attempt to align its requirements more closely with the SEC's final rule, noting that the Golden State's law references opportunities to harmonize or avoid duplication with federal requirements. Gensler has also previously said it is possible the SEC would attempt to harmonize its final rules with EU regulations.

Substitution Across Reporting Regimes Is Unlikely

Malone explained that the three reporting regimes currently don't have any substituted compliance, a practice in which compliance with one reporting regime fulfills the requirements of a different regime.

Because the SEC's law only requires the reporting of emissions that companies deem "material," Malone said she believes it's unlikely that either California or the EU would allow a company's Scope 1 and 2 reporting under the SEC rules to substitute for their own requirements.

"I have a hard time imagining that type of broad substituted compliance," Malone said.

There is a yearslong schedule for phasing in the SEC's many new disclosure requirements, with the largest filers expected to start reporting some information as early as 2025. The finalized rules are expected to go into full effect in 2033.

Malone said there is a degree of uncertainty in how the three reporting regimes will mesh, since other implementing regulations aren't fully in place; the California Air Resources Board is tasked with providing the implementing regulations for the Golden State's laws, and the EU's rulemaking measures for U.S.-based companies subject to the CSRD have been delayed for a couple of years.

"Perhaps the ball is in California's court" if it wants to take steps toward substituted compliance for companies that are reporting to the SEC, assuming California's law is implemented through regulation, Malone said.

Celia Soehner, a former SEC attorney who co-leads Morgan Lewis' practices on capital markets, public companies and ESG, noted that Republican Commissioner Hester Peirce asked during last week's meeting about state law preemption, to which SEC staff responded that they aren't expressly preempting any state law with the new rules.

"But they did acknowledge that whether or not there was an implied preemption would ultimately be a decision that a court of law would need to make based on the specific facts and circumstances of whatever proceeding is in front of it that is alleging implied preemption," Soehner said.

Republican-led states and energy companies have already lodged court challenges to the SEC rule, and more lawsuits are likely, she added.

Howard Sidman, deputy chair of ESG for Jones Day, said in a statement that the relationship among the three sets of rules is "complex and developing." And it isn't yet clear whether a report under one set of rules would satisfy any other set of rules, he said.

The EU has to make an equivalence determination before it would accept California or SEC disclosures in lieu of its CSRD disclosures. Similarly, it's unclear whether the reporting that California requires would be broad enough to address the social responsibility and corporate governance aspects of the CSRD, Sidman noted.

"Even for Scope 1 and Scope 2 emissions, California and SEC reports may not completely align with each other or with the EU," Sidman said. "The result is that a unified and consistent global reporting scheme could continue to be more of a mirage than reality."

'Highest Common Denominator' for Firms Subject to Multiple Regimes

Caroline Swett, a partner with the banking and ESG groups at Debevoise & Plimpton LLP, said the watered-down elements of the SEC's finalized rules won't necessarily offer the same relief for companies that are subject to more stringent reporting requirements elsewhere. And when it comes to cross-compliance with the different regulations, firms will need to look toward the most stringent rules, she said.

Eric Juergens, a Debevoise corporate partner, called it the "highest common denominator" — if companies subject to multiple reporting regimes meet the most stringent requirements of one jurisdiction, "in most cases, they're probably producing information, or thought about most of the other questions that are going to come up in other disclosure regimes," he said.

"If they're subject to California rules and the CSRD or other European rules, they're going to have all the information that those rules require, and then they'll be needing to make a materiality determination for whether they include it within their SEC disclosures," he said. "If you're making it public otherwise, I think there's a real question as to whether you should just be including it in your SEC filings as well."

Juergens added that the financial statement requirements of the new regulations will be among the most difficult to comply with. He said that by the beginning of 2025, firms should have their systems in place to capture the data required by the rules, so they can make disclosures in their financial statements and have that information audited.

"I think that is one area where there's going to be a significant amount of work, because I'm not sure that companies today capture all the information that they're going to need to make the disclosures that are now required," Juergens said.

Noting that the new regulations also come in the context of a polarized political and regulatory landscape, Swett added that companies are "subject to a number of cross-currents in terms of what they should be saying about what they're doing in response to climate exchange, and how they approach and consider climate changes in their activities and operations."

Smaller Companies Face the Heaviest Lift

The SEC's rules are expected to affect about 6,870 domestic filers and 920 foreign filers, and Covington partner Matt Franker said the compliance challenges of the new rules will differ radically from company to company. Apart from the largest firms, most companies will likely face a fairly significant lift in determining what their Scope 1 and 2 emissions are and whether they're material, Franker explained, and the financial reporting element of the SEC's regulation will also pose a challenge for companies and their auditors.

The biggest companies are already taking steps such as making disclosures on climate-related risks, he said, "but once you start getting outside the Fortune 100, or maybe a layer below that, you start to get into really uncharted territory for most public companies."

Franker added that the longer implementation deadlines in the SEC's finalized rules was an acknowledgment of feedback from the record 24,000 comments the commission received on the rulemaking that a large number of companies either aren't tracking this information or aren't prepared to disclose it "with the degree of rigor that normally goes into their SEC filings."

Still, it will be difficult for a lot of companies to get their processes up and running, he said.

"In terms of just data gathering and even pulling together the risk and governance disclosures, that's still going to be a challenge, I think, for companies, even though it does have a little bit of a longer implementation period than what they had proposed," Franker said.

--Additional reporting by Jessica Corso and Keith Goldberg. Editing by Alanna Weissman and Emily Kokoll.
