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SEC's Proposed ESG rule – Key Takeaways for Public and Private Companies

"If finalized, the new SEC rule would become some of the first mandatory ESG reporting requirements for U.S. companies."

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In March, the Securities and Exchange Commission (SEC) released a proposed rule entitled Enhancement and Standardization of Climate-Related Disclosures for Investors. If finalized, this rule would become some of the first mandatory Environmental, Social and Governance (ESG) reporting requirements for U.S. companies, requiring the disclosure of climate-related risk information in registration statements and periodic reports.

This proposed regulation has significant consequences not just for public companies, but private companies as well. Babst Calland Environmental Attorney Gina N. Falaschi explains the implications of the proposed rules, should they take effect.

What requirements could the rules introduce?

Under the SEC proposal, public companies would be required to disclose the oversight and governance of climate-related risk by their board and management; how any climate-related risk has a material effect on business and consolidated financial statements; the process for identifying, assessing and managing climate-related risks and how to integrate those processes into the company's overall risk management; whether the company has adopted a transition plan to deal with climate-related risks and how to measure any physical or transitional risks to its operations; the effect of severe weather events and related natural conditions; and information regarding any publicly set climate-related targets or goals.

The SEC's proposal also requires the disclosure of certain greenhouse gas emissions. These emissions are divided into three categories based on the Greenhouse Gas Protocol definitions. Scope 1 emissions are the direct greenhouse gas emissions that occur from sources that a company owns or controls, such as emissions from manufacturing activities and vehicles. Scope 2 emissions are the indirect greenhouse gas emissions that occur from the generation of energy that a company buys and consumes in its operations. Scope 3 emissions are the result of assets not owned or controlled by a company that the company indirectly impacts in its value chain, both upstream and downstream, from the company's operations, such as the purchased goods and services, waste generation, business travel, downstream transportation, distribution and use of products sold, and the end-of-life treatment of products sold. Scope 3 emissions would have to be disclosed only if considered "material."

What do companies need to do to prepare?

While the regulation has not yet been finalized, many companies could be required to begin compliance in the near future, so it's prudent that both publicly traded and privately held companies consider the implications of this proposed rule.

Publicly traded companies may need to consider how the disclosed information will be used. The assumption is that forced disclosure will make companies change their behavior and reduce emissions. But it could also open companies to significant liability, including shareholder litigation.

Climate disclosures are surrounded by a degree of uncertainty, especially in anticipating climate impact. Scope 3 emissions calculations require many assumptions about human behavior and estimates to derive at a final number. These emissions also may be counted multiple times by different companies in the same value chain for a particular product.

This rule also requires companies to submit extensive amounts of information, which may require them to hire new personnel or outside consultants to analyze and report the required data to the SEC.

How are private companies affected?

Private companies may be asked by their publicly traded customers to estimate or account for their greenhouse gas emissions, which may also require them to hire outside consultants to assist with calculations and data gathering.

Additionally, this new rule will likely become a standard by which all companies are evaluated. Having ESG disclosures may make companies more attractive to customers and put private companies without ESG disclosures at a competitive disadvantage.

Although intended to drive companies to become greener, the new required disclosures may discourage companies from going public. ESG matters also will likely become a meaningful component of M&A transactions, and due diligence efforts will need to take into account the impact that a potential merger or acquisition will have on its climate disclosures.

ESG is a rapidly developing area of law. Business leaders should work with legal counsel and sustainability consultants when developing both voluntary and mandatory climate-related disclosures to mitigate risks related to these disclosures.

To view the full video with Gina Falaschi on this topic and other articles on current business issues and trends, visit www.pittsburghbusinesstimes.com/babstcalland. To learn more about Babst Calland and its environmental practice, go to www.babstcalland.com.