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Revisiting the SEC's Proposed Climate Change and GHG Disclosure Regulations

Background:

On March 21, 2022, the Securities and Exchange Commission ("SEC") issued proposed regulations imposing on public reporting companies disclosure obligations concerning climate change impacts and GHG emissions. The proposal, entitled "The Enhancement and Standardization of Climate-Related Disclosures for Investors," reflects the broader societal trend demanding greater transparency regarding environmental, social, and governance ("ESG") issues, and would require domestic and foreign registrants (i.e. public reporting companies) to disclose climate-related risks that are reasonably likely to have a material impact on each registrant's business, results of operations, or financial condition. It would further require public companies to include climate-related financial metrics in their audited financial statements, and disclosure of their greenhouse gas ("GHG") emissions in accordance with uniform protocols. The proposal was published on March 21, 2022 and the public comment period closed on June 17, 2022. No date has yet been set for final adoption of the regulations.

The proposed amendments are intended to provide "consistent, comparable and reliable," and therefore "decision-useful" information regarding a company's climate-related financial risks and metrics, in order to allow investors to make informed investment decisions.[1] The proposal establishes a uniform reporting framework for reporting climate-related impacts based on the

[1] See 87 FR at 21335.

protocol created by the Task Force on Climate-Related Financial Disclosures ("TCFD"). The TCFD was created by the Financial Stability Board, an international, non-governmental body established by the G20 economies that monitors and makes policy recommendations intended to enhance the stability of the global financial system.[2] The proposal's GHG reporting requirements are modeled on the Greenhouse Gas Protocol, a voluntary GHG measurement and accounting standard established through a partnership of World Resources Institute and the World Business Council for Sustainable Development.[3] Both the TFCD framework and the GHG Protocol are widely utilized, although many other voluntary measurement and reporting protocols exist.

The SEC Proposal:

The proposal would amend the SEC's existing reporting requirements set forth in regulation S-K and regulation S-X. For regulation S-K, which addresses the non-financial aspect of disclosures, the proposal would add a new subpart 1500, establishing new requirements for separate disclosure of climate-related impacts in the following areas:

(1) governance of climate-related risks and risk management processes, including procedures for board and management oversight;

(2) the likely material impacts of climate-related risks on the business and financials over the short-, medium-, or long-term;

(3) how climate-related risks have or may affect the registrant's strategy, business model, and outlook; and

(4) the impact of climate-related events (severe weather events and other natural conditions) and transition activities on the financials;

(5) the registrant's GHG emission metrics, and

(6) climate-related targets and goals.

The proposal's reference to "transition activities" refers to activities undertaken to address anticipated climate-related risks, such as increased natural disasters, i.e., flooding, wild fires, or

[2] See the Financial Stability Board website at https://www.fsb.org/about/#mandate.

[3] See the Greenhouse Gas Protocol website at https://ghgprotocol.org/about-us.

drought. The term also includes changes associated with the transition toward a low-carbon economy, such as the transition to electric vehicles and away from internal combustion engines.

Public companies would also need to address these factors in the Management Discussion and Analysis ("MD&A") section of a public filing, to the extent that their impacts might lead to a different outcome than that set out in the company's projections.

GHG Emissions:

For quantification of GHG emissions, the proposal establishes a uniform methodology for measuring and reporting the seven GHGs covered by the Kyoto Protocol: carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons, sulfur hexafluoride, and nitrogen trifluoride. The proposal would require registrants to report their GHG emissions according to the classification system established under the GHG Protocol, which categorizes emissions as Scope 1, Scope 2, or Scope 3. Scope 1 emissions are the registrant's Direct Emissions from its business operations, Scope 2 emissions are emissions from the generation of electricity used by the registrant, and Scope 3 emissions are all other indirect emissions, including emissions up and down the value chain for the registrant's products. Scope 3 emissions also include emissions from employees commuting or business travel. The proposal would require all registrants to report Scope 1 and Scope 2 emissions; Scope 3 emissions would need to be reported if they are determined to be material, or if the registrant has set a GHG emissions target or goal that includes Scope 3 emissions. Smaller reporting companies are exempt from reporting Scope 3 emissions.

For Regulation S-X, which establishes reporting obligations for financial metrics, the proposal would add a new Article 14 requiring registrants to include certain climate-related metrics in a note to the audited financial statements. The required financial metrics would include both aggregated and disaggregated climate-related impacts on existing financial statement line items. In addition, a public company would be required to include relevant data on its progress toward meeting established targets or goals, and how such progress has been achieved. For larger reporting companies, the financial statement metrics fold into the existing requirement of audit by an independent registered public accounting firm, and would need to be included within the company's internal control over financial reporting (ICFR), so as to provide reasonable assurance that the company's financial statement is reliable, and prepared in accordance with GAAP.

Additionally, large accelerated and accelerated filers, including foreign private issuers, will be required to include in the relevant filing, an attestation report covering, at a minimum, the disclosure of its Scope 1 and Scope 2 emissions and to provide certain disclosures related to the service provider. The proposal would initially require a limited assurance and after a

specified transition period a reasonable assurance, for Scopes 1 and 2 disclosures. The proposed rules would provide minimum attestation report requirements, minimum standards for acceptable attestation frameworks, and would require an attestation service provider to meet certain minimum qualifications. The proposed rules would not require an attestation service provider to be a registered public accounting firm.

Estimated Compliance Costs:

According to the SEC's own estimates, the cost of complying with the proposed rules is estimated to be $640,000 for larger reporting companies in the first year, including $180,000 in internal costs and $460,000 for outside consultants, while the first year costs for smaller reporting companies is estimated to be $490,000, including $140,000 in internal costs and $350,000 for outside consultants. In subsequent years, the costs are estimated to be $530,000 for larger companies and $420,000 for smaller reporting companies. While companies that are subject to existing climate frameworks such as the TCFD, CDP, SASB, and GRI may be able to leverage their existing disclosure systems, larger companies will also incur additional costs in obtaining assurance for Scope 1 and Scope 2 emissions disclosures, which are estimated to range up to $235,000 for larger filers. All told, the regulations would impose a multibillion-dollar annual compliance cost on reporting companies.

Author's Take

The SEC's proposal has faced significant pushback from public companies, investors, and lawmakers, raising concerns regarding the significant burdens the regulations would impose. Concerns raised include the high costs of the rule, the complexity of the reporting scheme, and the potential unintended consequences of the rule, such as impacts on non-reporting companies.

The Wall Street Journal has recently reported that, as a result of this unexpectedly strong opposition, the SEC is considering scaling back the proposal to make the regulations less onerous, and more defensible in the face of legal challenges.[4]

Even if the proposal is scaled back, the SEC almost certainly will face multiple legal challenges to any final issued rule. The costs of the regulation are significant, particularly for smaller companies; in fact, it is likely that the indirect costs of the proposal are underestimated.

More broadly, there is a legitimate question whether the SEC has sufficient expertise in the area of climate change to create an appropriate protocol for quantification and reporting of GHG emissions, let alone for evaluation of the potential impact of various climate scenarios on

business results. The multiplicity of available measurement and reporting protocols suggests that a variety of approaches are possible. While the SEC states that the purpose of the regulation is disclosure, disclosure without the ability to evaluate significance may be less impactful. To the extent that climate change or GHG impacts do have a material impact on business results (i.e., have an impact that exceeds the one percent reporting threshold), the impact would arguably be reportable in the absence of the proposed rules. To the extent that climate change or GHG impacts do not have a material impact on business results, there is a legitimate question whether the issue is properly within the SEC's scope of authority.

Finally, it does not appear that there has been a meaningful analysis of the impacts of the proposed rule on non-reporting companies that are suppliers to reporting companies, and the costs of obtaining and supplying the information reporting companies need to satisfy their Scope 3 disclosure obligations. Public companies reporting Scope 3 emissions or setting Scope 3 emissions targets will necessarily look to their suppliers for information on the suppliers' GHG emissions and related metrics. The obligation to quantify and track these emissions are often imposed on a public company's suppliers through a supplier code of conduct, which a supplier must agree to in order to be approved as a vendor. The supplier code of conduct may require suppliers to track their Scope 1, Scope 2, and Scope 3 emissions, and may require the suppliers to set their own GHG reduction targets.

Given the extensive pushback from the public companies and other stakeholders, the SEC may want to consider issuing a revised proposal for public comment prior to issuing a finalized rule. Doing so would allow meaningful evaluation of these issues and others raised in response to the proposed rule.

[4] *"SEC Considers Easing Climate-Disclosure Rules After Investor Pushback," Wall Street Journal,* February 3, 2023.

- **Kevin Desharnais** | Member

Canada - Charging Forward

Automotive manufacturing in Canada has thrived for decades as a result of its skilled manufacturing workforce, investment in technology research and education, and its allegiance with the U.S. Now, as countries across the globe race towards electrification, Canada is discovering that it wields yet another advantage, its mineral resource deposits. With an abundance of lithium, nickel and cobalt, among other minerals, Canada now possesses both the know-how and the raw materials necessary to develop and supply electric batteries.

As previously discussed in Vol.1 No.3 of *Plugged In*, there has been tremendous public and governmental pressure on Chinese sourced goods in the U.S. While this pressure and the polices born from it are undoubtedly disturbing the electric vehicle supply chain in North America, it presents Canada with an opportunity it cannot afford to miss. According to Bloomberg New Energy Finance's 2022 annual battery metal supply chain ranking, China has been and continues to be the race leader in the battery metal supply chain rankings, with Canada following closely behind in second. However, Canada currently lags behind in its ability to process raw materials and manufacture battery cells. This is where OEMs and global auto supply chain manufacturers should look to invest in order to scale electrification initiatives. Last year, the Canadian government secured a $5-billion investment from Stellantis and LG Energy Solutions for Canada's first large scale lithium battery production factory in Windsor, Ontario, which is set to be operational in 2024. This year, Europe's largest automaker, Volkswagen, has chosen St. Thomas, Ontario, for its first overseas battery cell gigafactory. This historic multi-billion dollar investment from Volkswagen is further confirmation that Canada is well positioned to be a global leader in electric supply chain manufacturing.

While Canada possesses many tangible factors that would attract investments in the electrification space, it also has a reputation for being environmentally responsible and committed to sustainability, relative to other countries with manufacturing capabilities. As the demand from consumers for sustainable products continues to drive the electric vehicle market forward, a company's business practices and where it chooses to source or manufacture parts will undoubtedly become part of a consumer's consideration process. Battery and parts manufacturers may be able to leverage Canada's reputation for environmental responsibility and benefit from this goodwill.

In addition to Canada's skilled workforce and environmental goodwill, the availability of Canadian battery minerals will continue to draw major international investments and will inevitably create

significant employment and business opportunities in Canada. As policy makers hustle to increase Canada's manufacturing competitiveness, those looking to capitalize on opportunities in the Canadian automotive and automotive-adjacent industries need to keep abreast of the rapidly changing regulatory environment.

The race to secure electric supply chain manufacturing facilities and the jobs that follow is well underway and Canada has been creeping up the leaderboard; it's now time to push for the checkered flag.

- **Justin Quach** | Attorney

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Issue Authors:

Kevin Desharnais | *Member* | *Chicago, IL*
KDesharnais@dickinsonwright.com
Tel.: 312-782-6660

Justin Quach | *Attorney* | *Toronto, ON*
JQuach@dickinsonwright.com
Tel.: 416-644-2813

Editor: ***Rasika Kulkarni*** | *Associate Attorney* | *Silicon Valley, CA*
RKulkarni@dickinsonwright.com
Tel.: 408-701-6192