Written Statement of Elad L. Roisman

before the U.S. House Financial Services Committee

hearing entitled

Beyond Scope: How the SEC's Climate Rule Threatens American Markets

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Chairman McHenry, Ranking Member Waters, and Members of the Committee, thank you for inviting me to testify today.

My name is Elad Roisman. I am a partner at the law firm of Cravath, Swaine & Moore LLP ("Cravath"). Today, I am presenting my own views and not those of my firm or any client of the firm.

Background and Perspective

My testimony and the views I will express today are informed by nearly 20 years of experience in both the public and private sectors working on securities, regulatory, and compliance matters affecting public companies and other securities market participants. In my practice at Cravath, I advise public companies on disclosure, governance, and compliance matters. Prior to joining Cravath, I had the distinct honor and privilege of serving as a Commissioner and Acting Chairman of the U.S. Securities and Exchange Commission (the "SEC" or "Commission"). I was appointed to the SEC after serving as Chief Counsel for the U.S. Senate Committee on Banking, Housing, and Urban Affairs and before that I served as Counsel to then-SEC Commissioner Daniel M. Gallagher, as a Chief Counsel at NYSE Euronext, and as a corporate lawyer in private practice in New York.

My statement below focuses on certain implementation challenges with respect to the SEC's newly adopted rules requiring companies to disclose certain climate-related information in registration statements and annual reports (the "Final Rules").[1] I believe that the Final Rules represent some of the most significant expansions of public company disclosure requirements in decades. Compliance with the new requirements will be a major undertaking for public companies and will be costly and difficult to operationalize for many, particularly (with respect to certain requirements) on the schedule mandated by the Final Rules. Additionally, even if some companies make the determination that the Final Rules ultimately do not require them to disclose certain climate-related information (*e.g.*, certain financial statement disclosure requirements that are subject to *de minimis* thresholds), companies will still need to undertake the work as if they were required to provide such disclosures, as such determinations cannot be made until the work has been completed. I hope that this testimony is helpful to members of the Committee in highlighting some of the concerns and issues that public companies and their advisors will grapple with in order to comply with the Final Rules as well as some of the practical difficulties in their application.

Discussion of Final Rules

On March 6, 2024, almost two years after they were originally proposed, the SEC adopted the Final Rules. As commenters, including some SEC Commissioners, have

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[1] *See* SEC Adopting Release, "The Enhancement and Standardization of Climate-Related Disclosures for Investors" (March 6, 2024), available at https://www.sec.gov/files/rules/final/2024/33-11275.pdf (the "Adopting Release").

noted, the Final Rules differ substantially from the proposed rules in a number of important respects.[2] As a result of these differences, companies, investors, and the public more generally lost the usual and expected opportunity for more meaningful engagement on many of the practical considerations, costs, and definitional issues that will arise as public companies operationalize and begin complying with the Final Rules.

Although the Final Rules are less prescriptive than proposed, they will nonetheless create onerous compliance burdens associated with tracking certain information and are likely to result in a significant amount of climate-related disclosures in response to a number of new requirements, including in public companies' audited financial statements. More specifically, the Final Rules create a new subpart 1500 of Regulation S-K and Article 14 of Regulation S-X. The new disclosures required by the Final Rules can generally be grouped into the following categories, as I will discuss more fully below: (i) Scope 1 and Scope 2 greenhouse gas ("GHG") emissions metrics and related attestation requirements; (ii) climate-related targets and goals; (iii) audited financial statement requirements; and (iv) governance, strategy, and risk management disclosures. These new disclosure requirements and their interplay with state and international climate disclosure regimes will demand much attention from companies, their executives, and their boards of directors. However, before proceeding to such a discussion, it is important to note that many of the new disclosure requirements are qualified by a "materiality" standard and it is worth reviewing the widespread use of this concept throughout the Final Rules.

Materiality

At a basic level, under the federal securities laws, "materiality" refers to the importance of information to investment and voting decisions with respect to a particular company. New subpart 1500 of Regulation S-K contains nearly 40 references to materiality and the Adopting Release contains more than 1,000 such references.[3] While many of the new disclosures are only required if they pertain to *material* risks and information, this does not limit the information that most companies will need to (1) track, (2) document, and (3) analyze in order to make the required materiality and disclosure assessments in the first place. Simply put, for certain requirements, it will be

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[2] *See* Commissioner Hester M. Peirce, "Green Regs and Spam: Statement on the Enhancement and Standardization of Climate-Related Disclosure for Investors" (March 6, 2024), available at: https://www.sec.gov/news/statement/peirce-statement-mandatory-climate-risk-disclosures-030624#_ftnref1 ("Peirce Statement"); Commissioner Mark T. Uyeda, "A Climate Regulation under the Commission's Seal: Dissenting Statement on The Enhancement and Standardization of Climate-Related Disclosures for Investors" (March 6, 2024), available at: https://www.sec.gov/news/statement/uyeda-statement-mandatory-climate-risk-disclosures-030624?utm_medium=email&utm_source=govdelivery.

[3] In the Adopting Release, the Commission made clear that the applicable definition of materiality is the traditional one adopted by the Supreme Court and embedded in other SEC rules. *See* Adopting Release at 105 ("As defined by the Commission and consistent with Supreme Court precedent, a matter is material if there is a substantial likelihood that a reasonable investor would consider it important when determining whether to buy or sell securities or how to vote or such a reasonable investor would view omission of the disclosure as having significantly altered the total mix of information made available.").

difficult for companies to make an informed decision about the materiality of a particular item without tracking, documenting, and analyzing it.[4]

Accordingly, to comply with the Final Rules, companies will need to monitor and collect an enormous amount of information and develop frameworks to assess the materiality of many different climate-related matters (for initial disclosures and on an ongoing basis), as well as establish appropriate disclosure controls and procedures ("DCP") around the collection and analysis of such information in accordance with the Sarbanes-Oxley Act of 2002 ("SOX"). This will be an expensive undertaking and require significant management attention and resources and, most likely, assistance from outside advisors.[5]

Although some companies may have been tracking and disclosing certain climate-related information for purposes of making disclosures outside of their SEC filings, the breadth of information companies will be required to track, document, and analyze under the Final Rules will require significant changes for most, if not all, public companies. This is especially true given the legal liability associated with required disclosures in SEC filings and SOX requirements, which do not generally apply to voluntary disclosures outside of SEC filings.

In summary, while adding "materiality" qualifiers to the new disclosure requirements was helpful in reducing the scope of required disclosures, in many cases doing so will not substantially lessen the resources and costs needed to track and analyze information in order to make the required materiality and disclosure determinations.

<u>Scope 1 and Scope 2 GHG Emissions Metrics</u>

First and foremost, the Final Rules do not explicitly require quantified disclosure of a company's Scope 3 emissions (but as discussed below, companies may still need to track and disclose related information). The Final Rules (Item 1505 of Regulation S-K) do, however, require public companies that are large accelerated filers ("LAFs") and accelerated filers ("AFs")[6] to disclose Scope 1 and Scope 2 emissions to the extent such emissions are *material* (as discussed above). Companies required to provide this disclosure must disclose Scope 1 and Scope 2 GHG emissions data separately, and

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[4] It is also worth noting that companies' materiality determinations may be challenged by the SEC in enforcement actions or through the filing review process, and scrutinized by investors, proxy advisory firms, and other groups.

[5] The SEC acknowledged the potential costs of tracking GHG emissions in the Adopting Release, noting that "[w]e acknowledge . . . that registrants could incur costs to assess and monitor the materiality of their emissions, even in situations in which they ultimately determine that they do not need to provide disclosure, and that for some registrants these costs could be significant, especially if firms are not already tracking this information for internal purposes." Adopting Release at 247. Furthermore, as Commissioner Peirce noted in her dissent to the Final Rules, "[t]he Commission still must concede that this rule will increase the typical external costs of being a public company by around 21%." Peirce Statement.

[6] LAFs and AFs are, generally speaking, companies that have a public float of more than $75 million.

disclose any methodology, significant inputs, and assumptions used to calculate those emissions, as well as the organizational boundaries utilized in calculating the emissions. The Final Rules also contain attestation requirements with respect to GHG emissions disclosure starting at a limited assurance level and stepping up to reasonable assurance for LAFs in subsequent years.

The Commission stated in the Adopting Release that the materiality qualifier means that although GHG emissions disclosure may not ultimately be required, many (if not most) LAFs and AFs will track and measure their Scope 1 and Scope 2 GHG emissions in order to make the required materiality determinations.[7] All companies subject to these disclosure requirements must establish appropriate DCP around the collection and analysis of such information in accordance with SOX. Moreover, applying the traditional materiality determination to Scope 1 and Scope 2 emissions will likely be a complex task for many companies and will likely require the assistance of outside legal counsel and other experts.

Foreign or State Law

Unlike many other areas of the Final Rules, the Adopting Release provides specific examples of considerations that companies will need to assess when analyzing whether their Scope 1 and Scope 2 emissions are material. For example, the Adopting Release notes that "where a registrant faces a material transition risk that has manifested as a result of a requirement to report its GHG emissions metrics *under foreign or state law*," such as the Corporate Sustainability Reporting Directive (the "CSRD") in the EU or California's Climate Corporate Data Accountability Act and Climate Related Financial Risk Act (the "California Acts"), "because such emissions are currently or are reasonably likely to be subject to additional regulatory burdens through increased taxes or financial penalties, the registrant should consider whether such emissions metrics are material."[8] This means that required compliance with non-SEC GHG emissions disclosure regimes (in Europe, California, and likely other jurisdictions), which are unlikely to remain static, may result in a determination that a company's Scope 1 and/or Scope 2 emissions are material under the Final Rules if a company's compliance with such regimes involves increased taxes or financial penalties. The variable nature of regulatory requirements relating to GHG emissions disclosure across the globe could therefore result in evolving materiality assessments and sporadic disclosure of GHG emissions under Item 1505 of Regulation S-K, which may be of limited utility to investors, but still impose significant costs upon companies and ultimately their shareholders.

[7] *See* Adopting Release at 684 ("Although the final rules limit disclosures to circumstances in which emissions are material for registrants, *we expect most, if not all, LAFs and AFs that are not EGCs or SRCs will need to assess or estimate their Scope 1 and 2 emissions to reach a materiality determination*. As a result, we expect these registrants will, to some extent, need to adopt controls and procedures to assess the materiality of their Scope 1 and 2 emissions and determine whether disclosure is required if they do not already have them in place. Registrants that determine that their Scope 1 and 2 emissions are material may likewise need to adopt further controls and procedures, including measurement technologies and other tools to track and report the information to the extent they do not already do so.") (emphasis added).

[8] Adopting Release at 246.

In summary, determining whether a company must disclose its Scope 1 and/or Scope 2 emissions information will be complicated for many. In some cases, it will require companies to take into account foreign or state regulatory regimes. Furthermore, by the SEC's own admission, the Final Rules may require companies to adopt controls and procedures over their Scope 1 and Scope 2 emissions to reach a materiality determination regardless of whether they ultimately disclose that information.[9]

Targets and Goals

The Final Rules place a lot of focus on a company's climate-related targets or goals. New Item 1504 of Regulation S-K requires companies to disclose any climate-related target or goal, *whether or not already publicly disclosed*, that has materially affected or is reasonably likely to materially affect the company's business, results of operations, or financial condition, as well as any additional information necessary to understand the material impact or reasonably likely material impact of the target or goal, and provide annual disclosure of progress towards any such target or goal.

As discussed above, while the Final Rules do not require disclosure of Scope 3 emissions directly, some companies may nonetheless be required to report (in their SEC filings) information regarding their Scope 3 emissions. If a company has a climate-related target or goal that it has to disclose pursuant to Item 1504 (discussed directly above), and that target or goal includes Scope 3 emissions (*e.g.*, net zero or Scope 3-specific), then the company will have to annually update and potentially disclose (under Item 1504) information regarding its Scope 3 emissions in order to explain the progress the company has made towards that target or goal.[10] It is possible this could require a company to build Scope 3 emissions into its DCP to be able to report on such progress. The difficulty inherent in tracking Scope 3 emissions and concerns about the availability and reliability of the underlying data for Scope 3 emissions noted by the SEC in the Adopting Release—which was thoroughly documented in the comment process and likely drove the decision not to ultimately include a specific disclosure requirement for quantified Scope 3 emissions in some cases—would make this a significant and costly undertaking for the companies who may need to disclose Scope 3 emissions information in response to the requirements of Item 1504.

The significant disclosure requirements tied to targets and goals, particularly as they relate to *unannounced* targets or goals, may discourage companies and boards from setting targets or goals if they have not yet done so. For companies that have, many may find it prudent to revisit, revise, or even eliminate already-set targets or goals due to concerns about the costs and potential liability associated with complying with the related

[9] Adopting Release at 683.

[10] There is an ongoing debate about what, if any, Scope 3 emissions information may need to be provided under the Final Rules and the Adopting Release, and clarity and consensus may only be obtained if the SEC addresses this issue directly going forward.

disclosure requirements (updated annually) as well as the related scrutiny that will likely result from public disclosure of previously unannounced targets or goals.

Financial Statement Requirements

The Final Rules also create new Article 14 of Regulation S-X, which contains financial statement disclosure requirements for public companies. The Final Rules will require disclosure of additional climate-related information in the footnotes to the audited financial statements, including, subject to certain *de minimis* thresholds, specified financial statement effects of "severe weather events and other natural conditions," such as hurricanes, tornadoes, flooding, drought, wildfires, extreme temperatures, and sea level rise. More specifically, Rules 14-02(c) and (d) of Regulation S-X will require companies to disclose the aggregate amount of expenditures expensed as incurred, losses, capitalized costs, and charges incurred during the fiscal year as a result of severe weather events and other natural conditions, *regardless of whether they were caused by climate change*.

The annual audited financial statement requirements will be time-consuming and costly to comply with in a number of respects. As a threshold matter, the terms "severe weather events" and "other natural conditions," which are central to the new financial statement disclosure requirements, are not defined in the Final Rules. Companies will need to develop an accounting policy for determining what qualifies as a severe weather event or other natural condition, likely working with their auditors and external counsel. Because the severe weather events and other natural conditions that will trigger disclosure under Article 14 do not need to be related to climate change, a wide range of events will need to be monitored on an ongoing basis to determine whether disclosure will be required and to track related expenditures, losses, capitalized costs, and charges.

As some have noted, the term "natural conditions" is ambiguous and could be interpreted to mean a variety of occurrences with some "natural" aspect, such as a pandemic.[11] In developing an accounting policy to determine what constitutes a severe weather event or other natural condition, companies will need to grapple with difficult questions, including whether the determination as to what constitutes a severe weather event or other natural condition should differ based on geography, season, and other considerations. For example, a multinational manufacturer and distributor will need to consider whether its accounting policy should cover differences in weather patterns and natural conditions in different jurisdictions across the globe.

Companies will also be required to attribute a capitalized cost, expenditure, charge, loss, or recovery to a severe weather event or other natural condition if the severe weather or other event is a "significant contributing factor" to recognition of the capitalized cost, expenditure, charge, loss, or recovery. There is no definition of "significant contributing factor" or "significance" specific to this provision of Regulation S-X. In practice, companies and their auditors may have difficulty applying existing significance concepts to the disclosure required by Article 14. Companies and their

[11] *See* Peirce Statement.

auditors again will need to devote time and resources to determining whether a capitalized cost, expenditure, charge, loss, or recovery relates to a severe weather event or other natural condition or to normal wear and tear, particularly for specific building elements more prone to damage as they age.

Moreover, to comply with the new Article 14 requirements, companies will need to expend significant time and resources to establish internal controls and procedures to record and properly categorize the financial statement impacts, which will be subject to internal control over financial reporting ("ICFR") because they will be included in the company's audited financial statements. This means that management's assessment of ICFR and the auditors' attestation report on the effectiveness of a company's ICFR (for companies that are required to provide such attestation) will also need to cover the internal controls relating to the new financial statement requirements in the Final Rules.

If the current compliance dates remain in effect,[12] the new audited financial statement requirements will be particularly challenging for LAFs, which will have to set up controls prior to, and track information starting, January 1, 2025. Many companies are, and will be, focusing on scoping, tracking, and defining what constitutes "severe weather events" and "other natural conditions" as well as establishing new policies and procedures and setting up internal controls to capture costs and expenditures incurred when such events occur. This is a very significant undertaking and one that is not only complicated, but costly.

Governance, Strategy, and Risk Management

The Final Rules require extensive qualitative disclosure about companies' governance of climate-related risks and related matters. For example, they require a description of climate-related governance at both the board and management levels. For the board, this includes identifying any committees tasked with overseeing climate-related risks, the processes by which the board is informed of such risks, and any board oversight of climate-related targets and goals. The Final Rules contemplate similar disclosure of management's role in assessing and managing material climate-related risks (including as to climate-related expertise), with disclosures generally aligning with the analogous disclosures from the recently finalized cybersecurity rules.

The Final Rules also require disclosure of how climate-related risks have materially impacted or are reasonably likely to materially impact the company in both the short term and in the longer term. Risks will need to be identified as physical or transition risks, each as defined in the Final Rules. Certain disclosures will also be required for any transition plan (if one has been adopted by the company to manage a material transition risk), as well as the company's use of scenario analysis and an internal carbon price (if material to how it evaluates and manages climate-related risks).

[12] As noted below, the SEC has voluntarily stayed the Final Rules pending the outcome of litigation and the effect of such stay on current compliance deadlines is unclear.

In terms of risk management, the Final Rules require a description of the company's process for identifying, assessing, and managing material climate-related risks, including how it identifies whether it has incurred or is reasonably likely to incur a material physical or transition risk and how it decides whether to mitigate, accept, or adapt to such risk. Companies will also need to describe their integration of these risks into their overall risk management system.

While these disclosures are in some respects less burdensome than those in the proposed rules, they still represent a substantial and novel area of disclosure that will require significant time and effort to prepare, on top of the practical challenges of managing the underlying climate-related risks as part of companies' ongoing operations. Additionally, this may result in greater disclosure of climate-related governance processes, strategies, and risks than other processes, strategies, and risks that are of equal or greater concern to management, but are not subject to such prescriptive disclosure requirements. This could give investors the potentially misleading impression that climate-related issues are of outsized importance to certain companies as compared to other risks.

<u>Interplay with State and International Requirements</u>

Finally, companies that operate in a number of global jurisdictions will be subject to different reporting regimes that overlap in some respects but remain distinct and differ in important ways, including with respect to the applicable definition of materiality and the types of GHG emissions required to be disclosed. For example, a global company operating in the U.S. and the EU that has total annual revenues exceeding $500 million and that meets or exceeds certain financial thresholds in the EU will be subject to the Final Rules, the CSRD and likely one or both of the California Acts. Both the CSRD and the California Acts generally require covered entities to disclose Scope 3 GHG emissions whereas the Final Rules do not, and the CSRD uses a "double materiality" standard that is substantially different from the traditional U.S. concept of materiality. Each of these regimes contains its own complexities, and simply determining how to navigate such overlapping regimes will require significant time and resources, including in many cases engaging outside advisors and consultants in different jurisdictions and at significant cost.

Moreover, substituted compliance is not permitted under the Final Rules, meaning companies cannot meet their obligations under the Final Rules by complying with other international disclosure standards, such as those of the International Sustainability Standards Board. Therefore, many companies will have overlapping, potentially inconsistent, and changing requirements that they will have to monitor and take into account when complying with the Final Rules.

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The Final Rules have been challenged in a number of jurisdictions and on March 21, 2024, the Judicial Panel on Multidistrict Litigation issued an order consolidating the federal petitions for review in the U.S. Court of Appeals for the Eighth Circuit. On April

4, 2024, the SEC voluntarily stayed the Final Rules pending the completion of judicial review of the consolidated petitions in the Eighth Circuit.[13] At this time, it is uncertain whether or how the stay will affect the compliance deadlines in the Adopting Release, introducing additional uncertainty into the compliance preparation process for companies.

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In conclusion, companies will need to spend significant time and money in order to analyze, prepare for, and ultimately comply with the Final Rules. The Final Rules introduce a prescriptive climate-related disclosure regime that is likely to result in extensive and granular disclosure on a topic that many companies previously determined was not material to investors under existing SEC guidance and disclosure requirements. It will not be inexpensive or simple to comply with the many new prescriptive requirements in the Final Rules and many companies will need to rely on and hire various outside experts to achieve compliance in a timely manner.

Thank you again for the opportunity to participate today. I look forward to addressing any questions you may have.

[13] *See* In the Matter of the Enhancement and Standardization of Climate-Related Disclosures for Investors, Order Issuing Stay, SEC Release No. 33-11280 (April 4, 2024), available at: https://www.sec.gov/files/rules/other/2024/33-11280.pdf.