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What should the Municipal Securities Market learn from the SEC's proposed corporate climate change rules?

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NP attorneys discuss what the municipal securities market should learn from the SEC's proposed corporate climate change rules.

What's the Impact

- The proposed rules represent the SEC's current thinking about climate change disclosure.
- The proposed rules use a framework that can assist municipal issuers in crafting their own climate change disclosure.
- The proposed rules offer other insights into the potential future of climate change disclosure that can guide municipal issuers and the municipal securities market in crafting their own climate change disclosure.

On March 21, 2022, the United States Securities and Exchange Commission (SEC) proposed sweeping changes to the corporate securities disclosure rules to enhance and standardize climate-related disclosures. The proposed rules would require corporate issuers of debt and equity securities to provide information regarding certain climate change risks, climate change

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financial metrics, and specific information concerning greenhouse gas ("GHG") emissions.[1] Comments are currently due June 17, 2022.

The proposed rules, if adopted, would apply to issuers of corporate securities and not to the municipal securities market. However, the proposed rules and commentary provide the municipal securities market with the most comprehensive and current insight as to what the SEC considers important to investors—specifically the effects of climate-related risks on a company's business and how a company is assessing and addressing such risks in its operations and in its financial planning. The proposed rules can be divided into two categories of regulations. First, the SEC adopts a framework for defining and disclosing climate change risks. These proposed rules and related commentary will likely help municipal issuers to understand the general topic of climate change disclosure and the kinds of facts that the SEC considers to be important to investors. Second, the SEC is proposing to require public companies to produce new raw data (such as new financial statement metrics and GHG metrics) that will, in the SEC's view, aid investors in better understanding climate change risks of public companies and provide standardized data that will enable investors to better compare the climate change risks of companies when making their investment decisions. This category of proposed changes is likely to have little direct impact on municipal issuers but may change the overall trajectory of climate change disclosure in the long term. With respect to both of these areas, as investors look for increased climate-change disclosure from municipal issuers, we believe that the SEC's proposed rules represent a valuable resource to understand the views of the SEC regarding the importance and need for issuer-specific climate-related disclosures that can be taken into consideration in the municipal securities market.

SEC proposed rules for climate change disclosures

What are the proposed rules?

The TCFD Framework. A significant portion of the proposed rules would represent the adoption by the SEC of the climate change disclosure framework developed by the Task Force on Climate-Related Financial Disclosure ("TCFD"). The TCFD published disclosure recommendations in 2017 that provide a framework by which to define and disclose climate-related risks and opportunities, which the SEC noted "has been widely accepted by issuers, investors, and other market participants" and "should help elicit climate-related disclosures that are consistent, comparable, and reliable while also limiting the compliance burden for registrants that are already providing climate-related disclosures based on this framework" as well as the Greenhouse Gas Protocol, which the SEC states has become a leading accounting and reporting standard for greenhouse gas emissions. Based on the TCFD, the SEC defines climate-related risks to involve two broad categories: transition risks and physical risks, and then provides guidance on the disclosure of these risks.

Physical risks. The SEC defines physical risks to include "both acute risks and chronic risks to the registrant's business operations or the operations of those with whom it does business." The SEC

[1] Release Nos. 33-11042; 34-94478.

then defines acute risks as "event-driven and may relate to shorter term extreme weather events, such as hurricanes, floods, and tornadoes, among other events." Chronic risks are defined as "longer term weather patterns and related effects, such as sustained higher temperatures, sea level rise, drought, and increased wildfires, as well as related effects such as decreased arability of farmland, decreased habitability of land, and decreased availability of fresh water."

Transition risks. The SEC defines transition risks to include the actual or potential negative impacts on a registrant's financial statements, business operations, or value chains attributable to regulatory, technological, and market changes to address the mitigation of, or adaptation to, climate-related risks, such as increased costs attributable to changes in law or policy, reduced market demand for carbon-intensive products, the devaluation or abandonment of assets, risk of legal liability and litigation defense costs, competitive pressures associated with the adoption of new technologies, and reputational impacts that might trigger changes to market behavior, consumer preferences or behavior, and registrant behavior.

Disclosure of climate-change risks. Under the proposed rules, disclosure of climate-change risks and climate-change opportunities is established and developed through the physical and transition risk categories. The SEC's intention is that both of these categories receive equal treatment and that public companies develop robust and company specific disclosure to provide investors with a good sense of the short-, medium-, and long-term impacts of physical and transition risks. If the rules are adopted in the form proposed, corporate issuers would be required to include substantially more comprehensive and detailed climate-related reporting than is mandated under current disclosure requirements in (a) registration statements and in periodic reports filed with the SEC, in a separately captioned "Climate-Related Disclosure" section, and (b) in the notes to the audited financial statements that are included or incorporated in those filings.

Disclosure of Governance, Strategy, and Related Matters. In addition to identifying and describing the nature of material climate-related risks, public companies would also need to include "company-specific disclosure" in the following areas:

- **Governance:** Description of how the public company's board of directors provides oversight of climate change risks and opportunities.
- **Strategy, business model, and outlook:** Description of, among other things, (1) any climate-related risks reasonably likely to have a material impact on the public company, which may manifest over the short, medium, and long term and how those impacts are integrated into their business strategy and business model and (2) "any analytical tools, such as scenario analysis, that [the public company] uses to assess the impact of climate-related risks on its business and consolidated financial statements, and to support the resilience of its strategy and business model."
- **Risk management and climate-related goals or targets and transition plans:** Description of their processes for identifying, assessing, and managing climate-related risks.

GHG emission metrics. In the second category of changes, SEC proposes requiring public companies to describe historical GHG emissions data, both direct and indirect, to be expressed in terms of carbon dioxide equivalent or CO2e. The SEC breaks these down into classes of GHG emissions designated as Scopes 1, 2, and 3. Scope 1 emissions are defined as direct emissions from operations owned or controlled by the company. Scope 2 emissions are indirect emissions from generation of purchased acquired electricity, steam, heat, or cooling that is consumed by the company's operations. Scope 3 emissions are indirect emissions in its upstream and downstream activities and all other indirect GHG emissions.

Proposed Required Financial Statement Disclosures. The proposed rules would require public companies to disclose in a note to their financial statements certain disaggregated climate-related financial statement metrics that the SEC indicates are intended to increase consistency and comparability, as well as transparency about how climate-related risk affects a company's financial statements. These required disclosures include, among others:

- Financial impacts of severe weather events and other natural conditions,
- Financial impact related to transition activities,
- Expenditure to mitigate risks of severe weather events and other natural conditions,
- Expenditure related to transition activities, and
- Impacts of climate-related risks and opportunities.

Observations of the SEC's proposed rules

1. Like so many other areas of the SEC's focus, the SEC emphasizes disclosure about what management knows and what management is planning to do.

Much of the SEC's proposed rules and its commentary focuses not on climate-change risk, as such, but instead on how a public company's management is assessing climate-change risks and opportunities and the strategies and action plans that the public company is planning to take. For example, the SEC would require public companies to disclose a host of issues related solely to the question of governance, including: (1) who on the board of directors is responsible for oversight, (2) expertise of board members, and (3) how the board considers climate-related risks as a part of its business strategy, risk management, and financial oversight. Another is the proposed requirement that the public company disclose a scenario analysis if the public company uses that scenario analysis. The point appears to be that investors need to have the ability to understand climate-related risks and opportunities from management's perspective in order to assess how much management appreciates the risks and opportunities facing operations and, importantly, how that may shape management decisions moving forward.

2. The SEC continues its efforts, in uncertain topics like climate change disclosure, to emphasize disclosure that focuses on what the issuer knows as opposed to what the issuer does not know.

We think that there are parallels in how the SEC is approaching climate-change disclosure to how it approached COVID-19 disclosure. In a sense, climate change disclosure is similar to

COVID-19 disclosure in that they both entail forward-looking topics that involve a wide variety of unknown possible outcomes. Some of the concerns and frustrations of issuers when preparing COVID-19 disclosure at the height of the pandemic apply to climate-change disclosure. How is an issuer supposed to know how far climate change will go or the very wide spectrum of how it may impact their finances and operations? The SEC appears to appreciate this uncertainty and developed proposed disclosure rules that focus public companies on what they know with an understanding that much of climate change impact is unknown and really unknowable. The SEC's approach is to focus disclosure on facts the public company does know, strategies it has developed, and analysis it is using. In that sense, the SEC's proposed rules can be helpful guidance for issuers because the SEC's proposed rules provide a framework to think about climate change disclosure in concrete ways.

3. The SEC appears to be trying to develop consistent, comparable, and reliable reporting of climate-change data to enhance related disclosures for investors.

Perhaps the most significant new development of the proposed rules, as compared to existing SEC and industry guidance, is the ways in which the SEC appears to be trying to develop standardized reporting data that can measure climate-related risks and opportunities. Two aspects of the proposed rules show this. First, perhaps the most controversial element of the proposed rules will be the mandated GHG emission data. Second, the SEC requires new financial statement metrics that will require public companies to keep track of climate-related data as that data develops. The SEC's commentary regarding the GHG emission requirement helps explain this. The SEC states that "GHG emissions information is important to investment decisions for various reasons, including because GHG emissions data is quantifiable and comparable across industries and can be particularly useful in conducting a transition risk analysis." For example, investors may want to know GHG emissions data because it allows them to assess how much a company may need to change its operations and the potential impact to earnings. Thus, one of the most significant contributions the SEC appears to be proposing is to provide investors with new data that allows them to reach informed investment decisions concerning potential climate-change risks and opportunities.

What should the municipal securities market consider doing differently as a result of the proposed rules?

If adopted, the SEC's proposed rules would be a significant development in climate-change disclosure and will ultimately impact how the municipal securities market understands, assesses, and discloses climate-related matters. Here are some ways the proposed rules will inform or provide guidance to the municipal securities market:

Impact of new standardized data

First, if adopted, climate-change disclosure for the corporate market will become much more robust and more factual and that is likely to impact investor expectations regarding climate-change disclosures in the municipal securities market. If the proposed rules become final, in a few years from now, public companies will have disclosed a large data set of financial statement

metrics and GHG emissions data that investors and rating agencies will be able to analyze. In addition, public companies will have developed a track record of identifying climate change risks and opportunities, and management's approach to those risks and opportunities. Over time, investors and rating agencies may impose standards and expectations consistent with the proposed rules to issuers of municipal securities and expect comparable data and content in their climate change disclosure.

Learning from the TCFD framework

Second, the municipal securities market can use the framework in the proposed rules, if adopted, to help improve climate change disclosure. The SEC's commentary regarding a climate change disclosure framework would provide a common structure by which municipal issuers can determine what is material in their own climate change risk disclosure. In general, while the framework works in the municipal securities market, some additional elements will need to be considered. In addition to physical risks and transition risks, issuers of municipal securities also must deal with capital improvement program risks and political risks that are unique to the municipal securities market. Municipalities generally prepare long-range capital improvement programs that can provide the best insight on what they are planning to do and that is somewhat different than what public companies do. In addition, while municipalities are in the process of developing climate action plans and taking other actions not for purposes of profit but instead to further political and other objectives of being a part of climate change solutions. Thus, while the SEC's framework is helpful, we think that our market needs to consider how that framework may look different for municipal issuers given the differences between municipalities and public companies, and to develop a consistent definition of climate change risks.

In the municipal securities market, there can be confusion regarding what is required of climate change disclosure. Some may focus on transition risks—that is, climate change risk disclosure is setting forth climate action plans or other actions that the issuer is taking to reduce its carbon footprint. Other disclosure may focus on physical risks. Still other disclosure may focus only in terms of how the proceeds of a bond issue are being spent. The proposed rules succinctly set forth a clear framework to define climate change disclosure. The framework in the SEC's proposed rules assists issuers of municipal securities to consider a broader set of topics concerning how climate change may have a material impact on their finances and operations and ensure that such issuers are thinking through all of the relevant topics.

Importance of management perspective

Third, issuers of municipal securities should consider whether to follow the SEC's lead to assess climate-change risks from the perspective of management. The SEC throughout the proposed rules makes clear that it understands the uncertainty of climate-change risks and therefore places significant emphasis on what management knows and what it plans to do or not do. For example, if management at a public company is making management decisions based on a scenario analysis that projects climate change impacts, then that information is important for investors. In making climate-change disclosure, issuers in the municipal securities market will likely need to learn from and implement this approach. Over time, we can expect investors and

rating agencies to want to know what information management has about climate-change risk, what studies it has conducted, and what actions does management expect to take and what will guide those actions.

Saying focused on known facts instead of worrying about what we don't know

Fourth, if the proposed rules are adopted, issuers and their advisors will need to focus on known facts that can inform investors in their investment decisions. We believe that there is no need or requirement for participants to replicate the kind of new data the SEC proposes to seek from public companies. But the underlying goals of the SEC may still be helpful guidance, and issuers of municipal securities may consider whether they are able to provide meaningful data that can help investors understand the contours of climate change disclosure. For example, some issuers know that their assets are exposed to the physical risks of climate change and that they are likely to make improvements to make them more resilient to those risks. Much of that information can be reduced to facts and data that can help investors understand the magnitude of what the issuer is facing. In other words, effective climate change disclosure results will focus on those things (which may be few) that issuers actually do know and that can be disclosed to investors.

Different municipal issuers will be impacted differently

Fifth, the diversity of credits in the municipal securities market should not prevent issuers from learning from the proposed rules. Climate change disclosure rules just won't be meaningful to the entire municipal securities market. Some issuers will not have much to say on this topic and will never be able to provide investors with information beyond generic risk factors. For many issuers, however, other than the new financial statement metrics and GHG emission data, they have finances and operations that can incorporate these SEC expectations somewhat easily and see considerable improvement in their climate change disclosure. The municipal securities market involves such diverse credits that it is important to distinguish the credits where the proposed rules are the most relevant from those where there is much less that can be known about climate-change risks in order to provide meaningful disclosure.

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