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The SEC Proposed Rule on Climate-Related Disclosures and Its Implications for Commercial Leasing

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In March of 2022, the Securities and Exchange Commission (the "SEC") proposed a new rule regarding mandatory disclosure of climate-related information. This proposed rule, if finalized in its current form, will require public companies to provide certain climate-related data to investors through their registration statements and annual reports. It may have a significant impact on companies that operate with commercial leases, especially with regard to the reporting of emissions stemming from shared spaces and the identification of accurate emissions data in buildings where the owner or tenants are public companies.

Why did the SEC propose this new rule?

In short, the SEC believes this information is important to investors. The SEC's view is that climate-related events may play a role in a company's economic outlook and its ability to do business, and a company's commitment to climate-focused initiatives may be an important factor to investors looking to buy or sell securities issued by that company. While many companies have identified this trend and already provide some climate-related information to investors, that information has not previously been subject to any oversight. The SEC indicated that, as a result, the information that investors receive can be disjointed and confusing. To address this issue, the SEC's proposed rule is, in large part, intended to be a standardization of the specific metrics and processes that public companies must disclose. The SEC believes that a standard reporting process and consistent metrics will allow investors to efficiently compare companies and opportunities.

Additionally, the SEC seeks to codify a standard so that it may have a basis for enforcement and accountability. In the interest of investor safety, the SEC is concerned with ensuring that disclosures by public companies are accurate and transparent. The SEC anticipates that the potential liability that will attach to registrants' official filings will prompt companies to be more careful, and therefore more accurate, in the information they disclose.

What does the proposed rule require?

Specifically, the proposed rule requires public companies to disclose information regarding:

- Oversight of climate-related risks by their board and management;
- The likely material impact of any climate-related risks on their specific business over time;
- The likely material impact of any climate-related risks on their strategy or outlook;
- Any processes they use to identify, assess, and manage climate-related risks;

- Any impacts that specific climate-related events might have on their business;
- Data showing their Scope 1 and Scope 2 Greenhouse Gas emissions (explained further below);
- Data showing Scope 3 Greenhouse Gas emissions, if they are material or if the registrant has published a Scope 3 target/goal; and
- Future plans for climate-related targets and goals.

This advisory deals primarily with the proposed requirements related to greenhouse gas emission data. These proposed requirements depend most on physical location and activity and are therefore the most pertinent to commercial leases.

What methods does the SEC's proposed rule use?

The SEC proposed the disclosure of greenhouse gas emissions data as one of its requirements because it found that such data would help investors quantify a company's impact on environmental risks. The proposed rule also seeks to objectively track the company's commitment to decreasing that impact over time. In determining the proposed disclosure requirements and standards, the SEC relied on the most prominent existing greenhouse gas standard, with which many companies are already familiar. Known as the GHG Protocol[1], this framework lays out a uniform system of measurement for some of the most common types of greenhouse gasses. It also created a concept of "scopes" of emissions, which assign different levels of accountability based on the degree of control that a company has over the emission's creation. The SEC's proposed rule uses that as a basis in defining the scopes, as follows:

- Scope 1 includes "direct GHG emissions from operations that are owned or controlled by a registrant;"
- Scope 2 includes "indirect GHG emissions from the generation of purchased or acquired electricity, steam, heat, or cooling that is consumed by operations owned or controlled by a registrant;"
- Scope 3 includes "all indirect GHG emissions not otherwise included in a registrant's Scope 2 emissions, which occur in the upstream or downstream activities of a registrant's value chain."

An example of Scope 1 emissions would be a process that occurs at a site that a company owns and controls, like burning fuel for a furnace or processing chemicals at a lab. The foremost example of Scope 2 emissions, in contrast, are those that stem from purchased electricity. While these emissions are indirect because they stem from an off-site, independently owned power plant, the reporting company retains some control over the amount of electricity it chooses to purchase or use. Finally, Scope 3 emissions stem from processes that, while the company does not control them, are nonetheless a part of its overall impact. Often, these include emissions stemming from the activities of other companies within the supply chain, either before the reporting company becomes involved (upstream emissions), or after the reporting company relinquishes control (downstream emissions). They may also include emissions associated with employees commuting to work, waste disposal, and some leased assets or outsourced functions.

How will this impact companies involved in commercial leasing?

How should a company report the emissions of its offices if it leases, rather than owns, those spaces? Should the lessee or the lessor report emissions from heating, electricity, and waste disposal? What about common areas in a building with multiple tenants? The SEC's proposed rule does not specifically answer these questions. Rather, it instructs companies to set and report their own organizational and operational boundaries, terms that are taken from the GHG Protocol framework. Unlike the GHG Protocol, which allows a company to determine control based on either financial or operational terms, the SEC has proposed that a company must use the same scope of entities and assets as those it includes in its consolidated financial statements (which are required to be determined in accordance with GAAP). Generally, whichever entity actually controls the space in question should characterize the emissions stemming from that space as Scope 1 or Scope 2, and the entity that does not have control over the space should characterize the emissions as Scope 3.

If a company leases but does not control energy use in a space, and it will therefore classify emissions stemming from that space as Scope 3, it faces additional challenges. What if, for example, it leases office space, but the owner of that space is a private company that is hesitant (or refuses) to disclose its emissions data (and will not be bound to follow an SEC rule)? Again, the SEC does not provide clear guidance on this question, but it seems to see it as a feature of the proposed rule. Under such a scenario, a public company looking to lease space may actively seek out lessors who disclose that information. Thus, the need for public company emissions disclosure may lead to a similar trend in private real estate owners looking for a competitive advantage.

When it comes to Scope 3 emissions, what are the reporting exceptions?

Understanding that gathering Scope 3 emissions data will be a complicated task, the SEC's proposed rule provides multiple exceptions for emissions falling within that scope. To begin with, the SEC proposes to postpone compliance with Scope 3 emissions disclosures until after the date by when compliance with Scopes 1 and 2 is required, and to exclude Smaller Reporting Companies ("SRCs"). An SRC is defined as "an issuer that is not an investment company, an asset-backed issuer, or a majority-owned subsidiary of a parent that is not a smaller reporting company and that: (1) had a public float of less than $250 million; or (2) had annual revenues of less than $100 million and either: (i) no public float; or (ii) a public float of less than $700 million."

For the companies that are not SRCs, the SEC's proposed rule only requires companies to disclose Scope 3 emissions if they are material or if they are associated with a company's published reduction goal. A material disclosure, according to the SEC, is one that a reasonable investor is substantially likely to consider important when making an investment or voting decision. The proposed rule also requires disclosures in the case where a company has set a target for decreasing its Scope 3 emissions. An impending target deadline may create pressure on the company, which is a factor that the SEC believes may be important to investors.

Finally, the SEC proposes a safe harbor accommodation that attaches to Scope 3 disclosures, acknowledging that it may be difficult to obtain information from lessors and suppliers, and it may be almost impossible to verify that information. It is possible that some companies will have to estimate their Scope 3 emissions data because specific statistics are unavailable. To mitigate these concerns, the proposed safe harbor would eliminate certain forms of liability under Federal securities laws. Specifically, Scope 3 disclosures could not be classified as fraudulent statements unless the government could show that they were made without a reasonable basis or without good faith.

What's next?

While the proposed rule has not yet been finalized, it has the potential to have a significant impact on public companies when it does. The publication date for the final rule is unclear. Based on an SEC publication in June, it appears that the SEC is targeting the fall of 2023. However, it is anticipated that the final rule will also be subject to court challenges, which may further delay its implementation.

Ultimately, it is likely that commercial tenants will need to disclose emissions stemming from the spaces in which they operate, and the proper classification of those emissions will depend on the degree of control the company exerts over the spaces in question. In preparation for the finalization of this proposed rule, therefore, public companies that lease space or own leased space should begin to consider their organizational boundaries and compile the emissions data from those footprints.

[1]*See* The Greenhouse Gas Protocol, *A Corporate Accounting and Reporting Standard*, 27, https://ghgprotocol.org/sites/default/files/standards/ghg-protocol-revised.pdf