



Corporate Governance Considerations Under the SEC's Proposed Climate Disclosure Rules

Update

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As we have noted previously, the U.S. Securities and Exchange Commission's recently proposed rules governing climate-related disclosures, if adopted as proposed, would represent a sea change to the existing public-company disclosure regime. We focus here on the corporate-governance aspects of the proposed rules to help public company boards, executive management and in-house attorneys begin to focus on the governance-related issues they may face and steps they may want or need to take in preparing for the potential adoption of the rule.

Governance-Related Requirements of the Proposed Rules

The proposed rules would add a new Subpart 1500 to Regulation S-K setting forth the new non-financial statement climate-related disclosure requirements, including Item 1501 relating specifically to governance at both the board and management levels.

Proposed Item 1501(a) would require companies to describe the board of directors' oversight of climate-related risks, including the following, as applicable to a particular company:

- the identity of any board members or board committee responsible for the oversight of climate-related risks;
- whether any member of the board has expertise in climate-related risks and a description of the nature of the expertise;
- the processes by which the board or board committee discusses climate-related risks, including how the board is informed about climate-related risks, and the frequency of such discussion;

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- whether and how the board or board committee considers climate-related risks as part of its business strategy, risk management and financial oversight; and
- whether and how the board sets climate-related targets or goals and how it oversees progress against those targets or goals, including the establishment of any interim targets or goals.

Proposed Item 1501(b) would require companies to describe management's role in assessing and managing climate-related risks, including the following, as applicable to a particular company:

- whether certain management positions or committees are responsible for assessing and managing climate-related risks;
- if such positions or committees exist, the identity of the positions or committees and the relevant expertise of the position holders or committee members;
- the processes by which such positions or committees are informed about and monitor climate-related risk; and
- whether and how frequently such positions or committees report to the board or a committee of the board on climate-related risks.

As with other parts of the proposed rules, Item 1501 would permit, but not require, a company to provide disclosures regarding the board's oversight and management's assessment and management of climate-related opportunities, if applicable, in addition to climate-related risk.

An Integrated Approach to Governance and Other Proposed Disclosures

Perhaps obviously, the board-level disclosures that would be required by Item 1501(a) and the management-level disclosures that would be required by Item 1501(b) are related and overlapping. Together, they require disclosure of a company's top-down approach to responsibility for climate-related matters within the organization and cannot be considered separately. Similarly, although Item 1501 is the part of the proposed rules specifically focused on governance, the substantive disclosure requirements of other parts of the proposed rules are directly or indirectly related in many respects to the governance-related disclosure requirements. For example:

- proposed Item 1502 requires, among other matters, disclosures related to impacts of climate-related risk on a company's business strategy, financial planning and capital allocation—all matters squarely within the oversight and management responsibilities of the board and senior management;
- proposed Item 1503 requires specific disclosures regarding risk management with respect to climate-related matters, including disclosure regarding risk-management processes that are inextricably connected to the role of the board and management; and

- proposed Item 1506 requires detailed disclosures regarding a company's climate-related targets or goals, if it has set them, which tie directly to proposed Item 1501(a)'s required disclosures regarding the board's role in setting such targets or goals.

Accordingly, although we are focused here on corporate governance and there is only one item (Item 1501) of the proposed rules that is specifically focused on the topic of governance, because of the interconnectedness of all parts of the proposed rules, we encourage companies to think about governance as part of an integrated approach both to complying with all of the proposed rules and to articulating an appropriate narrative regarding the company's overall strategy to climate-related risks and opportunities.

Approaching the Proposed Disclosure Requirements with Stakeholder Reaction in Mind

As we have noted previously, we expect that adoption of the proposed rules (or merely anticipation of their adoption) will require most public companies to make significant systemic changes just to be able to collect, assess and report the information the proposed rules would require them to disclose. But new disclosure requirements also have a way of driving organizational change because of actual or anticipated reactions of investors or other stakeholders to a company's disclosures. Describing the board's oversight of climate-related risk as "none" or "N/A" may not be a desirable message, even for companies in industries that might be less adversely affected by climate-related risk.

We expect the proposed rules to galvanize shareholder voting and activism, in particular as institutional shareholders and proxy advisory firms focus more intently on the adequacy of board and management oversight. Might voting guidelines be further modified considering the disclosures required by the proposed rules? Will an approach to climate-related risk that fully complies with adopted disclosure rules but that is perceived to be a less-than-fulsome embrace of climate-related risk and disclosure lead to complaints relating to responsiveness and accountability and eventually efforts to have board or committee members replaced? We think the answer to each of these questions is likely to be "yes," and, as companies think about corporate governance through the lens of compliance with the proposed rules, they should keep potential stakeholder reaction to disclosures in mind, in addition to the systemic changes they may need to make to comply with the rules and, of course, governance that is actually appropriate and effective under the company's particular circumstances.

Climate-Related Risk and Enterprise Risk

A premise of the proposed rules is that information regarding climate-related risk is material to investors or potential investors in all public companies, regardless of industry or particular circumstances, which raises the question of whether adoption of the proposed rules effectively would require that a company regard climate-related risk as one of its most significant risks (or

categories of risks), regardless of whether that is consistent with the previous results of the company's enterprise risk assessment. In assessing potential impacts of the proposed rules, companies should pay careful attention to their enterprise risk assessment process, consider how the proposed rules could affect that process and further consider how that process, with any impacts resulting from the proposed rules, could affect the management of their businesses. Regardless of the future of the proposed climate-related disclosure rules, this is a good reminder of the interplay between a company's enterprise risk assessment process, business management and disclosures in SEC filings—*i.e.*, that the disclosures should be consistent with the assessment's conclusions and that the assessment's conclusions should guide business strategy and execution.

Board Composition and Expertise in Climate-Related Risk

The proposed rules could be read effectively to require that public company boards have an additional skillset, lest a company be required to disclose that no member of the board or applicable committee has any expertise in climate-related risks.¹ Companies therefore should be thinking about board composition in view of this disclosure requirement. Questions a company may wish to consider include:

- What does it mean to have expertise in climate-related risk?
- Is there a specific type (or types) of expertise in that general category that is particularly relevant to the company's circumstances?
- Does the board currently have one or more members with relevant expertise?
- How many members with relevant expertise should the board have? (See the related point regarding committee composition below.)
- If, based on the foregoing, the board desires to bring on new members with relevant expertise, should they take the place of existing directors or should the board be expanded, considering the overall mix of board-member experience, qualifications and other characteristics, as well as the appropriate size of the board for the company's circumstances?²

As we have noted previously, individuals with the relevant climate-related experience and expertise likely will be in high demand, perhaps with insufficient supply to meet that demand. Accordingly, companies might benefit from prioritizing the assessment of board expertise and beginning a search for candidates if appropriate.

Board Committee Evolution and Considerations

We expect that adoption (or anticipated adoption) of the proposed rules will lead the boards of many public companies to form a board committee with responsibility for oversight of climate-related risks and related disclosures if they have not already, whether with sole responsibility for climate-related matters or with broader ESG or EHS responsibility. Boards that currently have

such a committee may want to reassess the appropriateness of the committee's responsibilities and composition in light of the proposed rules. Experience relating to the SEC's 2008 overhaul of its oil and gas disclosure requirements might provide insight as to the near-term impact of the proposed climate-related disclosure rules from a board oversight perspective. After adoption of the oil and gas disclosure rules, the boards of some companies in the industry formed board committees with specific responsibility for oversight of oil and gas reserves disclosures (though the practice of forming, and staying power of, committees with sole oversight responsibility relating to reserves disclosure has waned in the last few years).

As companies evaluate the need for a new committee with oversight responsibility for climate-related risks and disclosures or the revamping of their existing committee structure, questions to consider include:

- Should the committee be an entirely new committee; should it replace an existing committee; or should the responsibilities of an existing committee be expanded?
- If the responsibilities of an existing committee are to be expanded, would those existing responsibilities fit naturally with climate-related oversight responsibilities?
- Should the committee consist solely of independent directors, or at least non-employee directors, or would it be appropriate for a current executive serving on the board (e.g., a COO) to serve on the committee?
- Should the committee include a single "climate-related risk expert" or will there be pressure (external or even intra-committee) for there to be more than one, not unlike how many public company audit committees have more than one person who qualifies as an "audit committee financial expert"?
- What is the relationship of the new committee to the audit committee (if the audit committee is not the committee with climate-related oversight responsibility, which it could be for some companies), and are there any overlapping responsibilities, especially relating to disclosures in SEC filings or other public disclosures? In that regard, we note that the proposed rules' requirement to include qualitative and quantitative disclosures regarding the impacts of climate-related matters in the notes to audited financial statements is one area in which there clearly would be some overlap necessitating coordination between committees.
- When will the committee meet and how would that fit into board/committee meeting schedules, and are there committee membership conflicts that would preclude concurrent meetings of different committees?

Considerations Regarding the Role of Management

The proposed climate-related disclosure rules raise two different but related areas for consideration of management's responsibility: (1) the process-related responsibility for climate-related disclosures and (2) the substantive

responsibility for assessing and managing climate-related risk. We are focusing here on the latter, which, as described above, is the subject of proposed Item 1501(b) of Regulation S-K.

As with board oversight, the proposed rules' requirement to include disclosures regarding management's role in assessing and managing climate-related risk should drive companies to consider their current practices and whether any changes should be made with a view to the disclosures that would need to be made if the proposed rules were adopted. Among the questions to consider are the following:

- Should there be a single executive/management position with direct responsibility for assessing and managing climate-related risk, or should there be a team or committee of management with that responsibility (or perhaps a combination)?
- If a single position, should climate-related matters be the sole responsibility of the position, or could climate-related matters fall under an existing position with other responsibilities?
- If a team/committee approach, which parts of the company should be represented in order for it to be effective and how, practically, would it operate?
- What would be the reporting structure for the position or team as it relates to other executives and ultimately the board?
- What expertise is needed for the position or team, and does the company currently have it or need to hire it (being mindful of the likely high demand/short supply of talent in this area)?

The questions and challenges identified above touch just one aspect of the SEC's proposed climate-related rules and are certainly not a comprehensive list of what public companies will need to consider if the rules survive in substantially their current form. Regardless of the proposed rules, stakeholder support for climate-focused strategies and management requires ongoing board and executive leadership attention and execution, which we think should be driving companies to consider the matters discussed above as they may apply during the time prior to implementation of the final rules or in a world in which the final rules are not implemented or are implemented in a substantially scaled back form. Bracewell will continue to provide insights and updates on these matters going forward.

1. PwC's 2021 Annual Corporate Directors Survey reported that, although most directors said that ESG is part of strategy and risk management considerations, just 25% of directors said that their boards have a strong grasp of ESG risks.

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See <https://www.pwc.com/us/en/services/governance-insights-center/assets/pwc-2021-annual-corporate-directors-survey.pdf> (p. 8/31).

2. A 2021 report indicated that the average board size for S&P 500 companies was just under 11 directors. See <https://www.spencerstuart.com/-/media/2021/october/ssbi2021/us-spencer-stuart-board-index-2021.pdf> (p. 12/66).