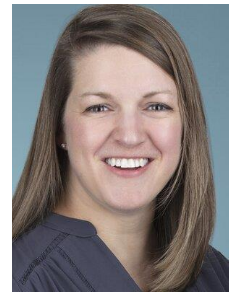
SEC Climate Rules Create Unique Challenges For CRE

By **Laura Truesdale** (April 15, 2024)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On March 6, the U.S. Securities and Exchange Commission adopted long-awaited final rules detailing climate-related disclosures required of public companies in their annual reports and registration statements.

Compared to the proposed rules published in March 2022, the final rules scale back the scope of reportable information and are, generally speaking, more favorable to the commercial real estate industry.

Undoubtedly, however, the new rules will still have a significant impact on public real estate companies and lenders, banks, and other entities investing in their projects.

Real estate businesses that are not publicly traded are also likely to be affected because the new rules will require public companies covered by the rules to obtain information from such nonpublic companies.

In a nod to the controversy that has surrounded the rules since the SEC first began considering them, on April 4 the SEC voluntarily suspended the effective date of the final rules as a result of pending petitions seeking review in various courts of appeals.

However, while the stay creates uncertainty surrounding how and when the final rules will ultimately be implemented, companies may still find it prudent to begin evaluating the requirements in light of the fact that states may impose their own regulations, regardless of the status of the final rules.

Background of the Rules

The SEC published the proposed rules in the Federal Register in March 2022. In the preamble, the agency stated that many public companies already undertake analyses regarding climate-related risks and report their findings to the public or their investors.

Therefore, the SEC explained that the proposed rules were intended to streamline and make more uniform climate-related disclosures so that investors and stakeholders have consistent, comparable and reliable information upon which to base investment decisions.

According to the SEC, over 4,500 unique comment letters and 18,000 form letters were submitted by stakeholders during the public comment process. The final rules reflect the feedback the agency received.

Examples include revisions to the requirements for greenhouse gas reporting, inclusion of materiality qualifiers in several portions of the rules and the scope of financial statement disclosures.

Even with those changes, however, the final rules will have significant impacts on public companies as they are implemented in the coming years. While those impacts may seem obvious with respect to certain types of companies, the commercial real estate industry is likely to face a unique set of challenges in determining how to implement strategies for evaluating, quantifying and reporting the information required by the final rules.

The final rules are complex and include a wide range of documentation and disclosure obligations. Some of the requirements most likely to affect the commercial real estate industry in particular may include the following.

Climate-Related Risks Reasonably Likely to Have a Material Impact on the Company

The final rules require companies to disclose any climate-related risks reasonably likely to have a material impact on the company.

As the SEC noted in the final rules, many companies may already be evaluating the potential for future material impacts from climate-related risks and estimating the effects those risks could have on strategic planning, financial reserves, and market or asset-based initiatives.

Even if the company currently considers climate-related risks, it may be difficult to quantify or explain exactly how likely those risks — such as a hurricane or tornado — are to actually occur and in turn, what the resulting impacts will be on the company's strategy, results of operations, or financial conditions in both the short- and long-term.

For example, a real estate company may understand that the risk of rising sea levels could affect its existing or future investment in properties in coastal markets.

But the likelihood of rising sea levels and the timing of when the effects may actually affect the company's assets are much more technical — and scientific — endeavors. Therefore, some companies may ultimately need a qualified individual on staff to evaluate such data or rely on consultants and other experts to attempt to conduct such analyses.

In addition to considering what climate-related risks the company may face, the final rules also require reporting on the company's strategy for evaluating and managing those risks, and disclosure of how those strategies fit into the company's overall risk management program.

Climate-Related Risks That Have Materially Affected the Company

In addition to opining on climate-related risks that may have a material impact on the company in the future, the final rules also require companies to disclose material impacts that have occurred as a result of past climate-related events.

These impacts may include capital costs and expenditures or losses resulting from severe weather events such as hurricanes, tornadoes, flooding, drought, wildfires, extreme temperatures and sea level rise.

In some ways, disclosure of retrospective costs should be fairly straightforward to evaluate and report because they are often finite or known expenses.

One-time costs such as demolition of damaged assets, increased energy prices associated with extreme temperatures, or replacement costs for assets affected by flooding may be easily measurable.

While these asset-specific financial impacts may be somewhat simple to identify, marketwide financial impacts caused by severe weather events or climate-related risks may be more difficult to measure.

Similarly, companies may face challenges capturing certain types of indirect or abstract losses associated with past severe weather events. This is especially likely to be true if the company has not traditionally kept records of these types of information in anticipation of reporting obligations or otherwise.

For example, a company may have lost productivity when their employees' time and resources were redirected toward addressing unanticipated severe weather events and their impacts. The resulting financial loss associated with that redirection of manpower, however, may prove difficult to calculate.

Targets or Goals That Have Material or Likely Material Effects

Another requirement in the final rules is the disclosure "of any targets or goals that have materially affected or are reasonably likely to materially affect the registrant's business, results of operations, or financial condition."

While the final rules do not mandate the establishment of such targets or their scope and size, the addition of the materiality qualifier in this and other areas of the final rules helps narrow what is reportable.

If the company discloses this information, it must also report on how it intends to meet the goals, what progress has been made as of the reporting date, and what associated material expenditures might result in a significant impact on the company's financial statement.

Notably, the final rules also include specific requirements for reporting on carbon offsets or renewable energy credits or certificates if those elements are a material component of the company's strategy.

As noted above, the final rules do not require companies to establish climate-related goals or targets. However, if real estate companies choose to do so, they could elect to set them on a market-specific or asset-specific level, or both.

For example, on the marketwide level, a company may endeavor to add solar panels to all of its existing industrial assets or locate all future development projects on existing developed sites rather than greenfields.

Similar targets could be set on an asset-specific basis, such as the pursuit of Leadership in Energy and Environmental Design certification for a particular new project or upfit of heating, ventilation and air conditioning systems and windows on an older asset to improve energy efficiency.

Regardless, the analysis of whether any of these strategies are likely to have a material impact on the company's business, results of operations or financial condition will ultimately determine whether and how it needs to be reported.

Greenhouse Gas Emission Reporting

In addition to reporting on past impacts and forward-thinking strategies related to climate risk, some public companies will also be required to disclose greenhouse gas emissions.

In the proposed rules, greenhouse gas reporting was divided into three scopes.

Scope 1 emissions are categorized as direct greenhouse gas emissions occurring from sources owned or controlled by the company, while Scope 2 emissions are indirect greenhouse gas emissions from the company's purchased electricity and other forms of energy.

Significantly, the final rules omitted a third category of greenhouse gas reporting — Scope 3 emissions reporting — that would have required companies to disclose indirect emissions from upstream and downstream activities in a company's value chain, as well.

Not surprisingly, Scope 3 emissions reporting was the subject of many of the comments the agency received during the rulemaking process. The requirement would have forced companies to obtain emissions data from other companies that could include their sellers, suppliers, or clients and customers.

In the commercial real estate context, Scope 3 emissions reporting may have subjected landlords and tenants to reporting requirements for one another's greenhouse gas emissions, even if the landlord or tenant itself was not a public company.

As commenters noted during the rulemaking process, such a requirement could create a distinction between more and less desirable tenants.

In other words, tenants with traditionally low greenhouse gas emissions may become more desirable and have more options on the rental market, while other tenants — such as certain manufacturing or industrial tenants — with higher greenhouse gas emissions might find themselves with fewer or no options in the rental market because their landlords do not want those greenhouse gas emissions included in their own Scope 3 emissions reporting.

For many reasons, the elimination of Scope 3 emissions from the final rule is arguably a welcome change for public companies, from both a policy and administrative perspective. However, those companies still required to report Scope 1 and 2 emissions under the final rule will need to begin tracking that data, if they do not already, in preparation for required reporting.

What Happens Next

Although adoption of the final rules arguably signals a step toward their actual implementation, there is still uncertainty as to how and when we will begin to see required reporting from public companies.

The final rules state that implementation is planned to occur in phases, with the first tranche of companies required to demonstrate compliance for fiscal year 2025 annual reports filed in 2026.

Not surprisingly, however, legal challenges have already been filed in opposition to the final rules. The U.S. Court of Appeals for the Fifth Circuit granted a temporary stay of the rules on March 15, and several lawsuits have been filed in other federal courts since then. The cases were consolidated into the U.S. Court of Appeals for the Eighth Circuit.

As a result of the numerous petitions filed, on April 4 the SEC voluntarily stayed the effective date of the final rules. On the legislative front, Congress is considering measures to repeal the final rules, as well. Therefore, it is unclear when they will officially be implemented and in what form.

Though there is some uncertainty surrounding whether the final rules will ultimately be struck down or revised, especially in light of the SEC's recent stay, companies will still want to begin evaluating how best to move toward compliance, especially because states may ultimately impose their own regulations, regardless of the status of the final rules.

As noted above, the implementation of the final rules is likely to affect companies not directly subject to them, as well. Smaller or private real estate firms may be required to provide information on their own practices to landlords or tenants that are required to report under the final rules.

Moreover, banks, lenders and investors are increasingly asking questions about sustainable practices, climate resiliency and greenhouse gas emissions, and some are even requiring satisfactory responses to do business.

Therefore, it may be prudent for companies that are not currently subject to the final rules to consider implementing practices and preparing documentation to comply with concepts discussed in the final rules in order to make themselves more attractive to investors.

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