UPCOMING CLIMATE DISCLOSURE: INCLUDING SCOPE 3 DATA HIGHLIGHTS THE COMPLEXITIES

If all goes according to plan, we are on the cusp of proposed rulemaking by the Securities and Exchange Commission ("SEC") that will mandate climate-related financial disclosures, likely based on the guidelines set out by the Task Force on Climate-related Financial Disclosures ("TCFD"), at least for SEC reporting companies (and possibly for private companies accessing the US capital markets). The details of the rulemaking are yet to be seen, but we can anticipate that the learning curve for many reporting companies will be steep and we can also anticipate, judging from the responses to the SEC's March 2021 request for public input, that the SEC comment process will yield a significant volume of comments – in support and in opposition. One likely area of contention will be the extent to which disclosure will be required to cover the contributions of third parties to a reporting company's greenhouse gas ("GHG") emissions.

Scope 3 Data

According to a recent article in Reuters, the SEC staff is still debating an issue that has been percolating for some time as an increasing number of companies have provided climate-related financial disclosure on a voluntary basis. The issue is whether mandatory disclosure should be limited to Scope 1 and 2 data, or should extend to Scope 3 data. As noted in one of my previous posts, there are three types of GHG emissions as set out in the GHG Protocol:

- Scope 1 GHG emissions are direct emissions that occur from sources that are owned or controlled by a business, which includes on-site fossil fuel combustion and fleet fuel consumption.
- Scope 2 GHG emissions are indirect emissions that occur from the generation of electricity, heat, steam or cooling purchased by, or otherwise brought onto the premises of, a business. These emissions are measured at the source.
- Scope 3 GHG emissions cover all indirect emissions outside Scope 2 that arise in a value chain (both upstream and downstream), such as business travel, purchased goods and services, employee commuting, transportation and distribution of products, solid waste disposal and wastewater treatment. There are 15 categories of Scope 3 emissions listed in the GHG Protocol.[1]

In remarks delivered in July, SEC Chair Gary Gensler noted that he had asked the SEC staff to make recommendations about how companies might disclose Scope 1 and Scope 2 emissions, "along with whether to disclose Scope 3 emissions – and if so, how and under what circumstances." The importance of Scope 3 data is underscored by the question he posed in those same remarks: while companies could announce plans to be net zero without providing the underlying data, do they mean net zero with respect to Scope 1, Scope 2 and

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[1] The 15 categories are: extraction/production of purchased materials and fuels; transportation of purchased materials or goods; transportation of purchased fuels; employee business travel; employee commuting; transportation of sold products; transportation of waste; extraction, production and transportation of fuels consumed in the generation of electricity; purchase of electricity sold to an end user (reported by a utility); generation of electricity (reported by an end user); leased assets; use of sold products and services; disposal of waste generated in operations; disposal of waste generated in the production of purchased materials or fuels; and end-of-life treatment of sold products. See also the EPA's Scope 3 Inventory Guidance.

Scope 3 emissions? Said another way, what is the basis on which an increasing number of companies are making net zero commitments to investors and the markets?

In a December 15 submission to the SEC, Ceres focused on the importance of Scope 3 GHG emissions disclosure. This supplemented a June 10 submission in which Ceres called for tabular disclosure of estimated Scope 1, 2 and 3 GHG emissions, by category, assured at a reasonable level of assurance. In the later submission, Ceres noted that market signals from investors, US financial regulators speaking through the Financial Stability Oversight Council ("FSOC"), the IFRS Foundation and the TCFD suggest that Scope 3 emissions assessments and disclosure are emerging as the "standard expectation for all market participants." Ceres concludes that investors seeking commitments from companies to reduce their GHG emissions across the value chain consistent with the Paris thresholds cannot properly analyze climate-related risks to their portfolios "without a clear, complete accounting and disclosure of emissions in the most relevant key Scope 3 categories." In effect, Scope 3 data is critical to investment, voting and other decisions by financial market participants.[2]

Ceres notes, in particular:

- Among the Ceres Investor Network that submitted responses to a survey, 71.4% called for mandatory Scope 1-3 emissions disclosure, with respondents viewing Scope 3 data as the "highest source of emissions for critical industries to investors and the economy, such as banking (financed emissions) and oil and gas (use of sold products)."
- The October FSOC report (see my prior post) found that financial institutions should conduct emissions inventories, including Scope 3, to assess transition risks. The FSOC report, while recognizing the potentially challenging nature of the undertaking, as Scope 3 covers all indirect emissions associated with the value chain, states, "Scope 3 emissions provide a more complete picture of the transition risks facing an organization, because it includes the risks of increased costs or restrictions throughout its value chain." Financial institutions are likely to have low Scope 1 and 2 emissions, with the bulk concentrated in their portfolios covered by Scope 3; for this reason, transparency around Scope 3 emissions is critical to understanding the systemic risks to the financial system posed by climate change, and facilitating the alignment of capital flows towards sustainability objectives.
- The Climate-related Disclosure Prototype, developed by the Technical Readiness Working Group chaired by the IFRS Foundation to provide recommendations to the International Sustainability Standards Board (see my prior post), indicates that Scope 3 emissions disclosure should be mandatory. The Prototype calls for GHG emissions to be disclosed in terms of absolute gross Scope 1, Scope 2 and Scope 3 in accordance with the GHG Protocol, and emissions intensity. It calls for an explanation of what is included within Scope 3 and provides the following example:

[2] An IHS Markit study (June 2021) estimates that, in 2019, Scope 3 emissions accounted for an average of 75% of total GHG emissions from the electric utility sector and about 88% from the oil and gas sector. These figures do not account for the fact that some double counting may be involved. The study cites the example of aviation fuel combustion, which may be a Scope 1 emission for an airline but a Scope 3 emission for the producer or refiner.

> [A]n online retailer may be exposed to risks or opportunities related to the greenhouse gas emissions arising out of third party transportation and distribution services purchased by the reporting entity for outbound logistics of products sold to customers. The retailer may determine that information about such emissions is material to the users of its general purpose financial reports in their assessment of its enterprise value. Therefore, the retailer will explain how the emissions information provided by entities in its supply chain has been included in the determination of Scope 3 greenhouse gas emissions.

- The initial TCFD guidelines (June 2017) called for Scope 3 data to be disclosed, if appropriate and material. New TCFD guidance on metrics, targets and transition plans (released in October 2021) notes that Scope 3 GHG emissions disclosure "is an essential component of climate-related risk analysis in commercial and financial markets and is increasingly being requested by investors and other market participants." These disclosures are particularly necessary to inform lending, investing and insurance underwriting, and accordingly the TCFD strongly encourages companies to disclose Scope 3 emissions data. See also Implementing the Recommendations of the TCFD (also released in October 2021).

Needless to say views on Scope 3 among respondents to the SEC's call for public input varied:

- A number of respondents were of the same view as Ceres. See, for example, letters from CDP and the NRDC.
- One responded noted, currently there are "challenges with the accuracy" of Scope 3 emissions data, though given the relevance of the data throughout the value chain, a Scope 3 disclosure requirement "will increase transparency at the global level and encourage consistency across multiple jurisdictions." This respondent posited that the quality of Scope 3 data would improve as a result of mandatory disclosure.
- Another respondent, which voluntarily reports Scope 1, 2 and 3 GHG emissions data and encourages all companies to so report, noted that standardization of Scope 2 and Scope 3 emissions reporting is ongoing.
- Another noted that due to cost and complexity, in weighing the burdens of Scope 3 reporting against materiality, the SEC should consider size and type of registrant; "[i]t may be appropriate to prioritize full emissions disclosure requirements for the largest filers, filers in industries with the highest levels of transition risks, and industries for which Scope 3 emissions data is the most useful." This theme was echoed by others.
- Another called for phasing in Scope 3 requirements, but suggested that the SEC issue guidance encouraging reporting companies to continue to produce quantitative information (including comprehensive emissions data) aligned with the TCFD framework, supplemented by sector-specific metrics, even if it goes beyond the initial rulemaking requirements.
- Others called for Scope 3 requirements to apply for industries for which the data are material. See, for example, letter from T.RowePrice.

- Another, citing the current lack of consensus on methodology and data, suggested that before mandating Scope 3 disclosures, various challenges need to be addressed. In the case of financial institutions, these challenges include the need for Scope 1 and 2 data (across the 15 categories in the value chain of portfolio companies) before Scope 3 data can be provided. Data availability, quality and methodology need to evolve. In addition, double counting within and across portfolios needs to be addressed.
- Others called for Scope 1 and Scope 2 data only. See, for example, letters from the BRT and SIFMA, although SIFMA does recognize that some market participants see value in disclosing Scope 3 emissions, but suggests a delay due to existing data limitations, methodology ambiguities and other practical hurdles. Similarly, ICI recommends that the SEC impose Scope 1 and Scope 2 disclosure requirements now, while promoting the development of reporting practices (assumptions, models and methodologies), before mandating Scope 3 disclosures.

Liability Concerns

There is a concern that disclosing Scope 3 data, which, by definition, will only be available from third parties – suppliers and other partners (as the EPA notes, one entity's Scope 3 emissions are another's Scope 1 and/or 2 emissions) – could expose reporting companies to litigation if the information proves to be materially misleading. In fact, this concern is part of a broader set of concerns as to liability for material misstatements or omissions tied to mandatory climate-related disclosure. These concerns include, among others:

- first and foremost, the difficulty of measuring climate risk, with associated high degrees of variability and uncertainty;
- the entire disclosure undertaking for climate-related risks is without precedent, and methodologies have only recently been developed;
- disclosure is likely to change over time as climate scenarios, and the perceptions of risks of climate change, evolve; and
- reporting companies will need to rely on third parties not only for Scope 3 data, but more broadly on an array of third parties that generate climate data, models and methodologies, over which they will have no control.

Ultimately, this is all about data and climate scenarios, and risk reporting systems will have to be developed to adequately capture the risks. Another open question is how new climate reporting will fit within the established framework for financial reporting, including internal control over financial reporting and disclosure controls and procedures, which SEC reporting companies have long had in place.

The SEC has various options for addressing liability concerns, including treating the information as "forward-looking" for purposes of the forward-looking safe harbor available under the Private Securities Litigation Reform Act of 1995 ("PSLRA"), or treating the information as "furnished" rather than "filed. Both approaches were suggested, for example, by then Commissioner Elad Roisman in June 2021, as well as by a number of respondents to the SEC's request for public input. However, neither of these options would protect reporting companies against all forms of liability under the antifraud provisions of the federal securities laws.

The PSLRA safe harbor for forward-looking statements only applies to antifraud claims brought by private plaintiffs, and not the SEC.

Information that is furnished, rather than filed (for example, material furnished under Item 2.02 or 7.01 of Form 8-K or a report on Form 6-K that is not specifically incorporated by reference into a registration statement under the Securities Act of 1933 (the "1933 Act")), among other consequences, is not subject to liability under Section 18 of the Securities Exchange Act of 1934 (the "1934 Act") and is not automatically incorporated by references into registration statements filed under the 1933 Act (thus eliminating exposure under the strict liability provisions of Section 11). That information, however, may be subject to liability under other antifraud provisions of the 1934 Act, namely Section 10(b) and Rule 10b-5.

The SEC ultimately accorded "furnished, not filed" status to Form SD (for conflict minerals and resource extraction disclosures), and has proposed the same treatment for Form SR (for disclosures relating to stock buybacks). The SEC could require specific climate disclosure to be included in a separate report (that is, outside a Form 10-K, 10-Q or 20-F report) along the lines of Form SD and proposed Form SR, although given the pervasive impact on so many companies of the effects of climate change, isolating climate-related disclosure in a separate report may be unwieldy and impractical. However, a separate report could have the advantage of affording reporting companies more time each reporting period to pull together the necessary data for reporting.

Commentators have suggested that the SEC provide explicit guidance, rulemaking or other relief to address liability concerns. Any of these should address not only information generated by a reporting company, but also disclosure based on third-party information, which would address the Scope 3 issues. It will also be important for the SEC to address the implications, from a liability perspective, of requiring companies to provide information that is not financially material (at least not material in the traditional sense of the term that has been the cornerstone of disclosure practice dating back decades), if that is the route the SEC takes. It remains to be seen where the SEC will land on the materiality question, particularly in light of the increased focus in Europe on "double materiality" and "dynamic materiality"

Concluding Thoughts

As I have noted before in the context of climate change, the direction of travel is clear. How straight the path may be, or how wide it may be, or how steep it may be – are for the moment matters of conjecture. What is also clear is that those tasked with collecting the data that will form the basis of climate-related disclosure for any particular reporting company, preparing that disclosure, reviewing that disclosure, and signing off on that disclosure, those who will read and interpret the disclosure from an investor or market perspective across their relevant portfolios, and the regulators who will review the disclosure across the market to assess compliance, will need to familiarize themselves with an entirely new map. This may be the most significant undertaking ever faced by the capital markets. My focus on Scope 3 data is but one example of the complexities presented by the evolving disclosure landscape.

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