



# **CLIMATE 2023**

**A Preview of the Year Ahead**

## **SEC Disclosure Requirements for Scope 3 Emissions**

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# SEC Disclosure Requirements for Scope 3 Emissions



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## Summary

SEC Scope 3 emissions Disclosure Requirements is one of the dominant themes for the Climate Transformed corporate community. If implemented, it could lead to an explosion of demand for carbon offsets and a fast-tracking of carbon mitigation strategies. However, does the recent Supreme Court ruling against the EPA put mandatory disclosures into question? We debate this complex legal issue. **Watch the full session [here](#).**

## Key takeaways

- We expect the final ruling on SEC Climate Disclosures to be published in the first half of 2023. It centers around the disclosure of Scope 3 emissions, i.e., emissions from corporate supply chains.
- Data collection is enormously complex. The SEC is setting deadlines for compliance for large companies capable of reporting emissions. Smaller companies will have longer to comply.
- The ruling will be challenged in court, most likely under the new precedence of the recent *West Virginia v EPA* case that saw the EPA lose its ability to regulate Greenhouse Gas Emissions. People opposing the Scope 3 emissions proposal argue that if Congress did not give the EPA sufficient guidance and authority to regulate greenhouse gas emissions, they must have given even less to the SEC. The counterargument is that Congress has given the SEC a responsibility for disclosing material risks. The SEC is aware of the potential challenges and believes it can withstand them.
- A Scope 3 emissions court challenge might be kept open for years, and during that period, companies will have to comply with the rule and put out disclosure.
- The final ruling will likely be watered down. Some safe harbors might get built into this rule as there are issues around the collection of Scope 3 data and its integrity. We might see a time extension for providing the data. This rule requires companies to provide their Scope 3 data for the trailing year within months after that year ended. The commenters have expressed that they require around 18 months to 3 years to gather data, depending on their industry.



## Paul's observations

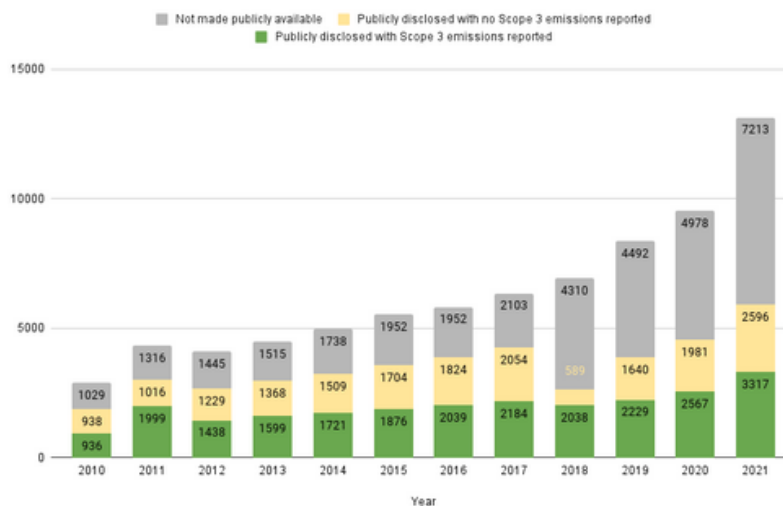
SEC climate disclosure has been embraced as a dominant narrative, a catalyst for a dramatic expansion in businesses as varied as supply chain management software and voluntary carbon markets. Looking back at our recent work, I emphasized this as one of the key drivers of an expansion in demand for voluntary offsets as early as 2023. While Scope 3 disclosures will grow in importance in the years ahead, it is clear that regulators such as the SEC appreciate the complexity of collecting data from global suppliers. As such, corporate disclosures could take many years to implement. While customer and investor pressure for disclosure will grow, regulatory demands won't be fully implemented until later in this decade.

Global Scope 3 disclosure requirements are coming. Multinationals will be required to collate Scope 3 data for EU regulators regardless of whether SEC requirements are watered down. While a court challenge appears inevitable, it will take three to five years to play out, and in the meantime, companies will need to prepare. Despite a slew of venture capital investments, digitizing supply chain traceability is still in its early stages, and complex disclosure will be based on modeling and estimates.

Supply Chain traceability will continue to grow in importance. Private companies' valuations are stratospheric, but it is tough to see how revenue doesn't grow exponentially. Companies like IBM, SAP, Accenture, and McKinsey will spend billions in the years ahead acquiring companies that monitor supply chains as diverse as cobalt and textiles. Despite the elongated trajectory of SEC climate disclosures, the arms race in supply chain traceability will continue.

***" If Congress did not give EPA sufficient guidance and authority to regulate greenhouse gas emissions, they must have given even less to the SEC."***

## Number of companies that publicly disclose Scope 3 emissions



Source: World Research Institute



# Questions & Answers

## The Securities and Exchange Commission's (SEC) disclosure debate

*Michael Littenberg:*

United States is at the rule proposal state of SEC disclosure. SEC solicited comments across a number of different areas regarding making this rule. It was proposed around climate risk disclosure earlier in the year and followed by an initial consultation process. This complex rule covers 30 of the 500 pages of the SEC disclosure. We expect the final ruling to be published in the first half of 2023.

*Todd. O. Maiden:*

Scope 3 emissions are indirect emissions produced outside of the company's operations. We are looking to identify, assess, and quantify all of these upstream and downstream CO2 equivalent emissions of the supply chain of companies regulated by the SEC. We require companies to identify emissions generated by activities such as transportation, product use, disposal, and raw materials. It can be a massive task for the regulated bodies to work with their parties to go through this process, especially if they are not publically traded. Outreach to these parties has an additional cost, and the SEC rule allows them to assess the emissions in their preferred ways. There is an order of measuring Scope 3 emissions for organizations. Larger publicly traded corporations are expected to measure their emissions first, moving down to smaller corporations with some exemptions.

## How reliable is the reporting of Scope 3 emissions of a smaller organization?

*Todd. O. Maiden:*

Even if small companies have a supplier in a foreign jurisdiction such as China, their counterparties still rely upon multiple raw materials suppliers to make their estimates. Some counterparties do not have any way to report their emissions, but at least they can reach out to SEC by doing their best to get estimates.

## The problem of complexity

*Todd. O. Maiden:*

Officials are working to develop international sustainable accounting standards to bring predictability, clarity, and uniformity regarding how companies can accurately estimate their Scope 3 emissions and follow the rule. We are trying to improve this process, and hopefully, in the next few years, companies will have the right measuring tools to measure their emissions.

*Michael Littenberg:*

The system to gather data from the value chain does not exist yet. We can not predict when a standardized system will measure these emissions. One way to generate data is to get an estimate from



the value chain or ask for help from a third-party data provider regarding emission reports. The data providers use various methodologies and assumptions.

According to the SEC's proposed rule, it will be mandatory for companies to explain gaps in data and detail what assumptions and methodologies they used to gather it. Gathering data can increase the costs for companies and the users who have to make investment decisions based on it. Most global supply chains still lack the digitization to measure Scope 3 emissions easily. The Conflict Minerals Rule is the only SEC rule analogous to the Scope 3 proposal that has already been implemented. Ten years later, there are still gaps and a lack of validation in the data. So, providing accurate data on Scope 3 emissions can be challenging for public companies.

### Given the complexity, is there a workable middle ground for Scope 3 disclosures?

*Todd. O. Maiden:*

SEC has tried to set deadlines for compliance for bigger companies with capabilities of reporting their emissions. This is likely to put more burden regarding compliance on the bigger organizations than the smaller ones. Recently, the Federal Government has issued a policy for their contractors to go through a similar disclosure process requiring large organizations to report their Scope 1, Scope 2, and Scope 3 emissions while the smaller organizations are exempted from reporting their Scope 3 emissions. One way to implement this ruling is to limit and specify the factors responsible for Scope 3 emissions. Some emissions can be hard to report, requiring a longer implementation lead time.

## Emissions by Scope

Metric tonnes CO2 per year	2015	2020	2021
Scope 1	3,686	3,032	3,724
Scope 2 (Market-Based)	16,923	7,440	8,161
Scope 2 (Location-Based)	19,278	9,149	9,031
<b>Scope 1 and 2 (Market-Based)</b>	<b>20,609</b>	<b>10,472</b>	<b>11,885</b>
Scope 1 and 2 (Location-Based)	22,964	12,181	12,755
Scope 3		190,118	220,552
<b>Scope 1, 2, and 3 (Market-Based)</b>	<b>20,609</b>	<b>200,590</b>	<b>232,437</b>
Scope 1, 2, and 3 (Location-Based)	22,964	202,299	233,307

*Source: Drill Quip*

### The implications of the Supreme Court's ruling against the Environmental Protection Agency (EPA)

*Michael Littenberg:*

The rule will be challenged in court. Attitudes toward climate disclosure requirements are divided. We have witnessed SEC's other rules being challenged frequently. Most of the Republican SEC Commissioners do not support this rule, and they are bringing a roadmap to challenge this proposal. On



the Democratic side, some statements support this rule while some oppose it. We anticipate a challenge based on the new precedent of *West Virginia v. EPA*, as some senior officials of the SEC and academics have shared why the SEC should have the authority to adopt this rule, and some have shared the opposite. A Scope 3 emissions court challenge might be kept open for years, and during that period, companies will have to comply with the rule and put out disclosure.

*Todd O. Maiden:*

The issue is how a federal court would determine if the SEC has followed the jurisdiction assigned to it by an act of Congress by the legislative branch. We have been following the Chevron Deference Doctrine since 1984, a multi-step process a court goes through not to second guess the proposal of an agency with expertise in a particular area. The court has historically deferred to the expertise of the agency. There is an exception to that rule called the Major Questions Doctrine. According to this, if a proposal has a potential impact on a broad level, such as on the economy, the court takes a clear direction from Congress to empower the agency to rule and regulate in this area. The *West Virginia v. EPA* case dealt with the EPA's authority to regulate greenhouse gas emissions from major power plants. The Supreme Court's ruling came out against the agency, mentioning Congress did not give enough authority to the EPA to regulate greenhouse gas emissions. People opposing the Scope 3 emissions proposal argue that if Congress did not give EPA sufficient guidance and authority to regulate greenhouse gas emissions, they must have given even less to the SEC. The counterargument is that Congress has given the SEC a responsibility for the disclosure of material risks. In the case of *West Virginia v. EPA*, the Supreme Court focused almost exclusively on the Major Questions Doctrine for the first time. If we have a challenge with the SEC Scope 3 rule, it could force the court to address that issue head-on.

*Michael Littenberg:*

One way to look at this is whether there will be any factor that could derail the rule in parts before or during the compliance period, or will the rule stand as it is written? The SEC is aware of the potential challenges and believes it can withstand them.

***"The SEC is aware of the potential challenges and believes it can withstand them." – Michael Littenberg***

### **Given the complexity and likely legal challenges, what does the final rule look like?**

*Michael Littenberg:*

I believe the final rule will become less strict in some aspects. To propose the rule, the SEC needed all three Democratic commissioners to support it, but two Republican commissioners are against this regulation. So, the SEC required a majority of the commissioners to decide to move forward on a rulemaking proposal.

Then interim Commissioner Allison Herren Lee started this rule proposal process when she was the



interim chair of the SEC. She strongly supported Scope 3 to be a part of this rule along with some other aspects, such as financial statement disclosure. Now, her interim period has expired. So, we will observe scaling back regarding the implementation period, specifically for Scope 3 emissions, as companies require more time to report them. We will likely also observe a scaling back in the financial statement footnote requirement. The accounting industry has also raised serious concerns about implementing this rule in its present form. Some safe harbors might get built into this rule as there are issues around the collection of Scope 3 data and its integrity. We might see a time extension for providing the data. This rule requires companies to provide their Scope 3 data for the trailing year within months after that year ended. The commenters have expressed that they require around 18 months to 3 years to gather data, depending on their industry. The SEC received over a thousand comments on the rule, some of which will reflect in its final form.

### **Why can we not keep the emission measurements to Scope 2?**

*Todd. O. Maiden:*

Scope 1 and Scope 2 emissions are easy to measure. Companies can measure this data based on the type of energy they are using in their plants. Scope 3 emissions data can be difficult to collect. Companies need to be responsible for the factors such as the emission produced, such as the carbon produced by recycling their products or at the refinery from where they buy fuel.

### **The outlook for the end of 2023**

*Michael Littenberg:*

By the end of 2023, we will have more clarity regarding this rule than we have now. We will tell our clients that if they are a public company, they must prepare themselves for compliance and understand what the rule entails. Public companies will be required to assess the quality of their data-gathering capabilities and the procedures for acquiring that data. Companies in the value chain will be required to provide a reasonable level of reliable data from a commercial perspective. We have been discussing this with our clients for the past few months.

There is a developing global market for sustainability disclosure. Two developments will likely pull US companies along. One of them is the International Sustainability Standards Board (ISSB); they have mentioned that Scope 3 will be in their standard 2, which is specifically about climate risk. This proposal is still in draft, but we will witness its adoption by various companies in different countries. At the EU level, the Corporate Reporting Directive will be signed. The European Sustainability Reporting standards are under development by Financial Regulation Advisory Group (FRAG), which also takes Scope 3 into account. So, we will get an outcome based on all these efforts.

*Todd. O. Maiden:*

The requirement of reporting Scope 3 emissions by the companies will stay either in the form of an SEC ruling or in some other way. Measuring these emissions is a complex process, so we need to provide companies with clear standards for reporting their Scope 3 to ease their burden.



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