Published on *The National Law Review* https://natlawreview.com

# Scope 3 To Be Or Not To Be? That Is The ESG Question

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Of all the emerging environmental, social and governance (ESG) issues, one of the more consequential – and imminent – is whether the U.S. will adopt the proposal for disclosure of "Scope 3 emissions" set forth in the Security and Exchange Commission's (SEC) proposed climate-related disclosure rule. In its regulatory agenda issued Jan. 4, 2023, the SEC projected final action would be taken on the climate rule in April 2023 – a short two months away.

Scope 3 emissions are indirect greenhouse gas (GHG) emissions by the various components of a company's supply chain. The EPA describes Scope 3 emissions as follows:

"Scope 3 emissions are the result of activities from assets not owned or controlled by the reporting organization, but that the organization indirectly affects in its value chain. Scope 3 emissions include all sources not within an organization's scope 1 and 2 boundary. The scope 3 emissions for one organization are the scope 1 and 2 emissions of another organization. Scope 3 emissions, also referred to as value chain emissions, often represent the majority of an organization's total greenhouse gas (GHG) emissions."

Under the proposed climate rule, the Scope 3 disclosures would be required "if material or if the registrant has set a GHG emissions target or goal that includes Scope 3 emissions." Additionally, "[t]he proposed rules would provide a safe harbor for liability from Scope 3 emissions disclosure and an exemption from the Scope 3 emissions disclosure requirement for smaller reporting companies." Scope 3 disclosures would be phased in after Scopes 1 and 2.

In addition, the proposed Federal Supplier Climate Risks and Resilience Rule would also require major federal contractors to disclose Scope 3 emissions two years after the rule becomes final.

One of the most controversial and contentious issues has been whether or not to include Scope 3 emission disclosure in the final climate rule – it has been addressed in a substantial number of the more than 4,000 public comments on the proposed SEC climate rule. Commenters have argued that Scope 3 will place undue burden, cost, complexity and impracticability related to tracking and calculating. Along with philosophical and political differences, questions have also been raised regarding the SEC's legal authority to impose the climate rule after the U.S. Supreme Court' decision in West Virginia v. The Environmental Protection Agency.

## Congressional and State Battle Lines

Scope 3 emission disclosures have been one of the main targets of ESG critics in Congress. For example, 19 Senate Republicans warned in one comment letter that the SEC had not accounted for “the substantial compliance costs that will be imposed on suppliers and vendors, many of which are small non-public companies, when public companies demand that they provide information on Scope 3 GHG emissions.”

These comments were echoed by 12 House Republicans, who said, “Scope 3 emission information requirements threaten to extend GHG disclosures well beyond the SEC registrants to nearly every privately owned entity in the country, including countless small firms who often do not have the necessary resources to comply with the significant demands of scope 1 and 2 disclosures.”

A group of Republican attorneys general from 12 states objected to Scope 3 emission disclosures, asserting they are not accurate, consistent, or reliable, would be burdensome to collect and of questionable value to investors, and exceed the GHG reporting required by the EPA and the scope of the SEC’s congressionally delegated role.

Counterpoints and support for Scope 3 emission disclosures were provided from the other side of the aisle. A comment letter submitted by more than 140 Democratic House members noted, “These disclosures should be similar to those that many companies already provide based on broadly accepted disclosure frameworks, such as the Task Force on Climate-Related Financial Disclosures (TCFD) and the Greenhouse Gas Protocol. See, e.g., TCFD, Guidance on Metrics, Targets, and Transition Plans (Oct. 2021).”

Democratic Senators similarly supported Scope 3 emission disclosures in their letter saying, “In order to better support investors in assessing climate-related risk, we urge that you to [sic] require all large registrants to assess Scope 3 greenhouse gas emissions throughout their entire value chain with reasonable assurance by Fiscal Year 2025 for large accelerated filers.” Another group of Democratic Senators went further, asking in their comments for greater specificity on required Scope 3 emissions and said, “We feel the Commission should establish a quantitative threshold for mandatory disclosure of Scope 3 emissions,” based on how much of a company’s total GHG emissions are Scope 3.

A group of 20 Democratic state attorneys general strongly supported earlier compliance dates for Scope 3 emission disclosures, stating:

“We support the SEC’s decision to require large accelerated filers to disclose their Scope 3 GHG emissions if those emissions are material or if those emissions are part of a transition plan. Many registrants’ Scope 3 GHG emissions are by far the most significant portion of the GHG emissions associated with their business. The disclosure of Scope 3 GHG emissions will help inform investment decisions by permitting meaningful comparisons and benchmarking among companies, especially those in the same industry. Scope 3 GHG emissions disclosures also will help investors understand registered companies’ progress in achieving their climate risk management strategies and emission reductions plans and targets, including any net-zero goal that encompasses Scope 3 emissions. And Scope 3 GHG emissions disclosures will help avoid gamesmanship and greenwashing by registrants that artificially limit their Scope 1 and 2 GHG emissions by transferring higher-emission activities and their climate-related risks to third parties.”

There is a similar split of comments from various business and interest groups, including investors, lenders, NGOs, businesses, trade associations, academics, consultants, attorneys, accountants and members of the general public.

More recently, both political parties have formed working groups in the House to advance their respective ESG interests, with immediate attention focused on the SEC rule and the Scope 3 emission disclosure issues in advance of final rule promulgation. On Jan. 25, Democratic representatives announced the launch of the Congressional Sustainable Investment Caucus (CSIC), stating, “As our economy continues to grow, we must work together with the SEC to ensure that investors, asset managers, and market advocates receive the disclosures needed to make profitable and ethical decisions in our capital markets.” A week later, House Republicans formed their own working group “to combat the threat to our capital markets” posed by ESG, stating that “The SEC’s climate disclosure rule is a prime example of this overreach.”

## Global Progress Toward Scope 3 Disclosure Requirements

In recent years, on the global stage, there has been consistent support for adoption of Scope 3 emission disclosure requirements. The EU’s Corporate Sustainability Reporting Directive (CSRD), which became effective Jan. 5, 2023, and will be phased in over the next five years, requires in-depth ESG disclosures by covered entities, including material Scope 3 emissions. A technical advisory group, EFRAG, is working on European Sustainability Reporting Standards (ESRS). The first set, ESRS 1, Climate Change Reporting Standards, is to be issued by June 30, 2023, and will include further detail on Scope 1, 2 and 3 emission disclosure requirements.

In 2021, the EU also promulgated the Sustainable Finance Disclosure Regulation (SFDR) that requires increased disclosure from financial service providers on ESG and sustainability claims for investment products. The overall objective of the SFDR is to provide horizontal and vertical transparency so investors can meaningfully assess the performance of products claimed to be sustainable. The SFDR requires financial entities that are marketing their products as sustainable investments or as focusing on carbon emissions reduction to start reporting Scope 3 emissions as of Jan. 1, 2023.

In 2020, the UK was the first country to require broad ESG disclosures consistent with the Task Force on Climate-related Financial Disclosures. Those included voluntary Scope 3 disclosures. Since then, the UK Financial Conduct Authority (FCA), required TCFD disclosures that include Scope 3 emissions from issuers of UK-listed shares or global depositary receipts, unless the emissions are immaterial. The FCA is currently in the process of developing the Sustainable Disclosure Requirement (SDR), further expanding climate and ESG reporting for covered UK companies. Likely to be approved in 2023, the first set of SDR rules is expected to require Scope 3 supplier emission disclosures.

The UK is also coordinating its ESG disclosure regime to be consistent with the ongoing efforts of the International Sustainability Standards Board (ISSB) to establish global non-financial ESG standards and reporting requirements. In October 2022, the ISSB voted unanimously to include reporting of material Scope 3 emission in addition to Scope 1 and 2 emissions. At its December 2022 meeting, in response to comments, the ISSB proposed to include some relief from Scope 3 emission disclosure requirements. The adjustments, which addressed concerns similar to those raised in comments critical of the SEC’s proposed Scope 3 disclosure requirements, include delaying implementation for a year, providing a framework for companies to report on how they measure their Scope 3 emissions that incorporates the use of estimation, and refining proposed requirements for financed emissions.

The ISSB standards, which are to be completed this year, will be voluntary and are expected to be adopted or adapted by a number of nations.

## The U.S. Is at a Crossroads on Scope 3

The transparency afforded by Scope 3 emissions disclosure is increasingly becoming a critical issue for companies and investors. It is readily apparent that the EU and UK have taken a more proactive approach to disclosure of Scope 3 emissions than the U.S. Such ESG considerations are more deeply ingrained in the cultural and regulatory fabric of the EU and UK, and there is a growing recognition of the importance of ESG considerations in investment decisions, which has driven greater attention to and support for ESG and emissions disclosure.

In contrast, ESG considerations have been slower to gain traction in the U.S., where the focus historically has been on economic growth, and there is ongoing political debate that has led to a seemingly intractable divide over the role of ESG considerations in investment decisions.

As the world's largest economy, the U.S. has a unique role to play in driving sustainable business practices and promoting transparency in the financial sector. While political considerations may play a role in the looming decision whether to include Scope 3 emission disclosures in the final climate rule, the U.S. would be well-served by taking a longer view and recognizing that the need for supply chain transparency is gaining momentum worldwide, and Scope 3 disclosure requirements are not going to go away.

A number of U.S.-based international companies are already required to make those Scope 3 disclosures. The EU CSRD applies to U.S. and other foreign entities that have subsidiaries with more than EUR 150 million of annual turnover in the EU. Accordingly, even if Scope 3 emission disclosures are not included in the final climate rule, the CSRD would require U.S. companies with sizeable operations in the EU to report Scope 3 emissions for their value chains.

And if the SEC decides not to include Scope 3 emission disclosures in the final climate rule, states are prepared to fill the gap. On Jan. 30, the California legislature introduced the California Climate Corporate Data Accountability Act that would require all large U.S. companies doing business in California – not just public companies like in the SEC's proposed climate rule – to disclose their emissions, including Scope 3, starting in 2026.

And so, we await the SEC's answer to this crucial question: Scope 3 – to be or not to be?



National Law Review, Volume XIII, Number 39