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June 16, 2022

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Via rule-comments@sec.gov
File Number S7-10-22

Re: Preventing A Decade of Delay in Consistent and Comparable Scope 3 Disclosures

Dear Ms. Countryman,
I am writing regarding the proposed climate disclosure rule, The Enhancement and Standardization of Climate-Related Disclosures for Investors. *Although I frequently advocate before the Commission on behalf of clients, including ESG , SRI and public pension fund fiduciaries, investors and organizations, these comments are submitted on my own behalf.*

Scope 3 materiality: The Commission should not relegate assessment of materiality to registrants but should provide clarity as to sectors and circumstances in which Scope 3 reporting is required

I am writing to comment on one particular element, the proposal of the Commission that instead of requiring universal reporting of Scope 3 emissions, requiring disclosures of Scope 3 emissions under section 229.1504 (c) based on the registrant's determination as to whether Scope 3 emissions are material.[1] The legal analysis below demonstrates that in the absence of clear Commission guidance, the proposed rule would set back consistent and comparable disclosure to investors of Scope 3 emissions for as much as a decade.

I agree with Americans for Financial Reform and others who recommend that the Commission eliminate the materiality determinations as a basis for Scope 3 disclosures. In particular, I recommend that the Commission either require Scope 3 disclosures for all registrants, or identify sectors and circumstances (e.g. 20% of GHG footprint) where Scope 3 disclosure is required, leaving materiality assessments for other sectors.

[1] The rulemaking proposal requires broad-based disclosure of Scope 1 and Scope 2 GHG emissions, but conditions disclosure of Scope 3 emissions on either an assessment by the company that finds such emissions to be "material", or where the company has set Scope 3 targets. (Question 98 in the rulemaking proposal asks whether this approach is appropriate, and whether the Commission should use a quantitative or targeted approach to trigger Scope 3 disclosures).

Impact of requiring disclosure of Scope 3 emissions *where material*

The focus of this comment is on how the Scope 3 rule is likely to (mal)function *if it is put into effect as written*. To summarize, a review of recent judicial rulings and legal scholarship on materiality supports the conclusion that the Commission does not need to condition required disclosures on such materiality determinations, and that doing so will create expenses, uncertainty and inconsistent disclosures as the company-by-company materiality of Scope 3 emissions is contested in the courts for years to come. This is not because these issues are irrelevant or immaterial to investors, but rather due to doctrinal stagnation in judicial decision-making under which materiality determinations may not consistently reflect the demands of the market for this information. The proposed rule would offer issuers a risky (and I believe inappropriate) loophole through which many registrants could, in essence, buy their way out of disclosure through legal opinions asserting the narrowest interpretations of materiality. Therefore, for many companies, Scope 3 disclosures will essentially be voluntary.

Given the rapid decarbonization that global consensus indicates must happen over the next decade, and the predominant footprint of Scope 3 emissions for many companies, such an approach poses substantial risks to investors. Deferring consistent and reliable Scope 3 disclosures is contrary to the Commission's mission of fostering orderly and efficient capital markets.

The Commission's authority and responsibilities for promoting orderly and efficient capital markets necessitates clarity on Scope 3 emissions disclosure

Fortunately, the Securities and Exchange Commission is not limited to making decisions on disclosure rules that are grounded in the narrowest construction of materiality in judicial determinations. As a group of law professors wrote in a June 6, 2022 letter on the comment record:

> Debates about ESG disclosure rules often reference the Supreme Court's classic articulation of materiality in *TSC Industries v. Northway* and *Basic v. Levinson*. A crucial first step in understanding these cases is that they deal with whether or not an issuer, at some specified point in the past, had a legal duty to disclose particular information, under a particular set of circumstances and in light of the applicable regulatory framework. In other words, the Supreme Court's materiality test applies to an *ex post liability determination* by a court or another adjudicatory body, not to an *ex ante policy choice* by a regulator. In stark contrast, when it engages in disclosure rulemaking, the Commission is making ex ante policy choices. Unsurprisingly, then, neither *TSC Industries*, nor *Basic*, nor any other Supreme Court case touches on or limits the types of information the Commission is empowered to require when it promulgates disclosure rules.

While I strongly disagree with the approach of conditioning Scope 3 disclosures on company determinations of materiality, if the Commission chooses to do so it must provide guidance as to the sectors and circumstances it views as material. As the law professors wrote, even where the SEC integrates a materiality assessment for determining disclosure, the Commission:

> "has not left firms to struggle with the Supreme Court's elegant-yet-economical articulation of materiality; instead, the SEC has supplied extensive guidance on how firms are to go about making the often-difficult materiality judgments. Over the years, some of this guidance has been general in character, and some of it has been more topic-specific. Notably, a subset of existing disclosure items are not qualified by materiality, reflecting a policy judgment—and, we emphasize, a judgment the Commission has always been free to make—that particularized materiality testing at the disclosure stage is unwarranted because, for example, it may be impractical or costly for registrants, because it may be susceptible to abuse, or because the underlying information is basic in nature.

All of the factors described, including the susceptibility to abuse and the impracticality and expense of materiality assessments, is applicable to the need for clarity rather than ambiguity in Scope 3 emissions disclosure requirements.

While the Release follows the customary practice of quoting from the Supreme Court materiality definition, and echoes the Supreme Court's principle that any doubts be resolved in favor of investors, the rulemaking proposal also moves in the direction of providing guidance on what Scope 3 emissions are likely to be material:

> Given their relative magnitude, we agree that, for many registrants, Scope 3 emissions may be material to help investors assess the registrants' exposure to climate-related risks, particularly transition risks, and whether they have developed a strategy to reduce their carbon footprint in the face of regulatory, policy, and market constraints.

The background section of the rulemaking proposal notes at pages 172-173 that the materiality of Scope 3 emissions appears clear in some sectors, such as the automotive sector under pressure to convert to electric vehicles, the financial sector, in asserting GHG goals, and the oil and gas sector where Scope 3 emissions are "likely to be material and thus necessary to understanding a registrant's climate -related risks." The rulemaking proposal also notes that Scope 3 emissions could portend higher sourcing costs for key inputs, changing consumer preferences that cause a significant incline in demand for high carbon products, and other forms of risk to enterprise value. The Commission also noted the potentially deceptive scenario in which a registrant could contract out certain high emission production activities so that its own Scope 1 and Scope 2 emissions might appear lower than a competitor, even though it is just a matter of outsourcing.

I view these observations as pointing in the right direction of providing needed guidance, but stopping short of providing clarity about what sectors and circumstances should trigger Scope 3 disclosure obligations. The Commission avoided any bright line rule for materiality in the rulemaking proposal, mentioning, but not adopting, a 40% of GHG footprint criterion, and also noting that quantitative analysis alone might not suffice to determine whether Scope 3 emissions are material, given the potential that in some instances those Scope 3 emissions might represent a significant risk. If the rule were adopted as proposed, the lack of bright lines and the invitation to materiality assessment will still leave far too much leeway for many registrants to opt out of disclosure.

Judicial interpretation of materiality in climate cases lags market demand and understanding

Instead of requiring consistent disclosure of Scope 3 emissions, the rulemaking proposal largely relegates the determination of materiality of Scope 3 emissions to companies, their lawyers and the courts. In the absence of additional guidance, this encourages companies to turn to the current judicial interpretive frameworks for assessing the materiality of the emissions. Unfortunately, judicial interpretations of materiality in the US courts often diverge significantly from actual market conditions and investor needs and demands.

At issue is the manner in which the materiality doctrines handed down from the Supreme Court focus on a tort-like criterion, assessing what a "reasonable investor" might make of the relevant information, rather than foregrounding the needs and demands of a company's actual investors. Across the investment market there is massive demand for Scope 3 emissions information, as the comment record for the rulemaking proposal will no doubt demonstrate; yet surprisingly, the decision framework deployed by the courts may not reliably treat such information as material. This disconnect is attributable to the slow process of evolution of the materiality doctrine.

As the rulemaking proposal notes, determinations of materiality are grounded in the U.S. Supreme Court, in the landmark case *TSC Industries, Inc. v. Northway, Inc.*, which held that a disclosure or omission is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by *the reasonable investor* as having significantly altered the 'total mix' of information made available."[2]

Thus, the extent to which climate change related disclosures are recognized as material by the courts turns on interpretation of what an individual "reasonable investor" would find important in the total mix of information. While this rationale has a ring of common sense, *as applied* the meaning of *reasonable investor* frequently ignores real-world conditions, demands and decision-making of the market. As noted by legal scholar Thomas Lin, the judicially applied definition of "reasonable investor" relies upon a distinct archetype. When considering what a reasonable investor would find to be relevant to decisions to buy or sell stock, the investor is pictured as an individual who is a rational *human being* of average wealth and ordinary financial sophistication that invests passively for the long-term.[3] " **Most importantly, this "reasonable investor" is a private human being, not a public institution or private business entity like a hedge fund, mutual fund, or investment bank. In the current marketplace, such human beings actually represent a small portion of current investors.**

The cognitive dissonance between this framework for liability determinations and real-world demands for information critical to investment institution decision-making is breathtaking. Examination of current market dynamics demonstrates a disjuncture of individualized investor decision-making from the more predominant, broadly diversified institutional investors. As the scale and diversification of investing institutions has grown, so has the necessity as a matter of fiduciary responsibility to reflect long-term investment concerns and to respond, even in the face

[2] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (defining materiality in the context of a proxy fraud action under Rule 14a-9).
[3] Thomas Lin, Reasonable Investor(s), Boston University Law Review, Vol. 95:46, 2015.

of uncertainty, especially in the face of existential risks that are of a "whole economy" nature. The courts have not yet caught up with this change, which necessitates a fundamental change in the law to embrace systemic portfolio management strategies.

While the Commission might presume that materiality involves essentially an assessment of what kind of information investors are reasonably demanding in the marketplace, as a practical matter the judicial process instead involves imagining the proclivities and decision-making process of HYPOTHETICAL individual rational investor. In practice this may allow the company to second-guess its own ACTUAL investors.

Given the massive demand of institutional investors and their beneficiaries for GHG information and analysis, the disconnect from this individual investor archetype is glaring. As legal scholarship by Thomas Lin and others has made clear, the "reasonable investor" rule is based on a precept that is out of step with current markets, and especially the relative information needs of individuals versus institutional investor decision-making.[4]

A recent decision in the New York State Supreme Court, in which the state of New York brought suit against Exxon Mobil over allegedly misleading climate related communications, applied the reasonable investor archetype as described above, to find a lack of materiality of certain information relevant to long-term climate related financial risks. The court went through the "reasonable investor" analysis to conclude that "**No reasonable investor…would make investment decisions based on speculative assumptions of costs that may be incurred 20+ or 30+ years in the future with respect to unidentified future projects."**[5] The court discussed the proxy cost of GHG emissions at ExxonMobil, and that the speculative nature of the costs made it so that no reasonable investor would consider them material. The court stated that "no reasonable investor would have viewed speculative assumptions about hypothetical regulatory costs projected decades into the future as "significantly alter[ing] the total mix of information made available."[6] In its brief, ExxonMobil stated that "ExxonMobil's independent auditor observed, GHG costs represent … a speculative cost, rather than a known or likely cost."[7] ExxonMobil also noted that "its disclosures repeatedly emphasized the uncertain nature of climate regulations…These statements, "framed by acknowledgements of the complexity and numerosity of applicable regulations," strongly suggest "caution (rather than confidence)."[8]

The New York State case is a poster child for the problem with judicial application of a reasonable investor archetype that ignores the real-world decision-making of public and private pension funds and other institutional investors, all of whom are using GHG and climate assumptions on a day-to-day basis, and making risk and asset allocation decisions based on speculation and projections on climate change.

[4] Prof. Lin suggests that the change to materiality considerations in this institutionalized investing environment should be to imagine that the "reasonable investor" should take account of the decisions made by institutional investors' use of algorithms for investing.

[5] *People by James v. Exxon Mobil Corp*., 65 Misc. 3d 1233(A), 119 N.Y.S.3d 829, 20 (N.Y. Sup. Ct. 2019)

[6] *People by James v. Exxon Mobil Corp*., 65 Misc. 3d 1233(A), 119 N.Y.S.3d 829, 21 (N.Y. Sup. Ct. 2019).

[7] NYSCEF Doc. No. 421, Index No. 452044/2018, Exxon Mobil Corporation Pre-Trial Memorandum, 40.

[8] Singh, 918 F.3d at 64." (NYSCEF Doc. No. 421, Index No. 452044/2018, Exxon Mobil Corporation Pre-Trial Memorandum, 30).

There are countervailing principles and emerging legal theories that can be expected to cause climate related information, including Scope 3 emissions, to increasingly be treated as material in the courts. Because the decision-making is fact specific and case by case, materiality determinations can vary "with the nature of the traders involved in the particular market." *United States v. Litvak*, 889 F.3d 56, 64-65 (2d Cir. 2018). Thus, it follows that there is room in judicial doctrine for the perspective of the reasonable investor archetype to evolve over time to include climate risk concerns and data needs of institutional investors, even those who must use long term and uncertain projections to make decisions, and therefore to ultimately view GHG emission and transition plan disclosures as material in the "total mix" of information available.

Other legal avenues for demonstrating materiality of Scope 3 and other climate related disclosures include litigation focused on misleading statements or omissions associated with a proxy vote (Rule 14a-9). In such instances, the omission or distortion of a company's environmental management or mismanagement can be material to the voting outcome. In the context of proxy voting, the courts have certainly found representations about environmental concerns to be materially misleading. *See United Paperworkers Int'l Union v. Int'l Paper Co.*, 985 F.2d 1190 (2d Cir. 1993) (holding that a company's representations that it had a "longstanding commitment" to protecting the environment and was a "leader" in environmental protection were material to investors because they "conveyed an impression that was entirely false," as the company failed to disclose the full extent of its environmental liabilities)."[9]

In addition, it appears likely that Scope 3 and other climate related disclosures will *eventually* be found material in litigation following the doctrine of *In re Caremark International Inc. Derivative Litigation,* 698 A.2d 959 (Del. Ch. 1996), in which a failure of board oversight on issues of vulnerability for a company may lead to board level liability. In addition, investment fiduciaries may well face liability for a breach of duty of impartiality if they fail to track climate risk in their portfolios, since the failure to track these issues represents, in effect, a choice to focus on the interests of short-term beneficiaries at risk to longer-term retirees for whom the financial impacts of climate change 10 or 20 years from now may be a very material concern.[10]

It is reasonable to anticipate that it will take the next decade, or longer, for the courts to develop doctrines that are consistently aligned with the investment market's realities of climate change. Adoption of Scope 3 materiality requirements without guidance that aligns disclosure with market demand would simply mean delaying the needed consistent disclosure of Scope 3 emissions for a decade or more. Investors do not have this time to wait for the courts to catch up, and therefore, the Commission should provide adequate guidance to ensure that the realities of

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[9] The shareholder decisions regarding votes cast by shareholders on a shareholder proposal to sign and implement sustainability principles known as the Valdez Principles were, according to the decision, reasonably likely to have been affected by the company's "breezy" misleading statements that it was a "leader" in environmental protection while failing to disclose numerous environmental enforcement actions, consent agreements etc. that did not comport with such a self-portrait.

[10] Johnson, Keith L. and Gary, Susan N. and Reeves, Tiffany, Proposed US Department of Labor Rules on ESG Ignore Duty of Impartiality (January 25, 2022). Available at SSRN: https://ssrn.com/abstract=4023660 or http://dx.doi.org/10.2139/ssrn.4023660

the market are clearly reflected in corporate Scope 3 determinations.

Back to Reality: SEC can recognize and act on information demands of the market

According to Prof. Lin, by better recognizing the diversity of investors, regulators can improve investor protection efforts and "consider superior safeguards for all investors." Lin contrasts the existing reasonable investor paradigm with the many investors predominant in the marketplace - irrational, sophisticated, and active investors, as well as entity or institutional investors.[11] Seeing that the majority of investors are not, in fact, individual investors, but institutional investors, Lin concludes that disclosure policy should take account of this diversity:

> The dissonance between the singular paradigm of reasonable investors and the diverse profiles of real investors has created discontent for regulators and investors alike. For regulators, this dissonance has resulted in mismatched regulations that hinder and obviate the soundness of financial regulation. For investors, this dissonance has resulted in misplaced investment expectations that are harmful and frustrating.
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> The dissonance has created significant unrest and workarounds in financial markets that many believe demands a fundamental reexamination of the workings of investor protection.

There is broad demand in the market for Scope 3 disclosure, including by organizations like the Net Zero Asset Owners Alliance. There is no good policy basis for ignoring the demands of those investors.[12] Relegating Scope 3 materiality determinations to the courts would avoid not

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[11] With regard to institutional investors in particular, he notes:

> Private entity investors can be organized as corporations, limited liability companies, partnerships, limited partnerships, or joint ventures, among other forms of business organizations. They represent hedge funds, mutual funds, family trusts, and a host of other private businesses varying in size and industry. Private institutional investors play an outsized role in the financial markets. Whereas one reasonable investor is unlikely to possess the power to alter global markets, private institutional investors can (and do) singularly wield that type of power …On the other side of the public/private divide, public entity investors can include governments and government-affiliated institutions. They represent cities, states, nations, and entities created by public law and given investment authority… by better recognizing the diversity of investors, one can better diagnose the shortcomings of current investor protection efforts and begin to consider superior safeguards for all investors.

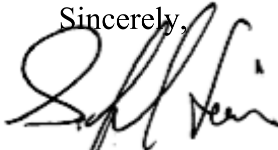
[12] As law professor Madison Condon noted in a recent law review article: [I]nstitutional investors' climate activism is motivated by their desire to mitigate climate change risks and damages to their economy-mirroring portfolios. Unchecked emissions contribute to an increase in global average temperature that is predicted to have a devastating effect on the world economy. One large asset manager predicts that we are headed to a world of 4°C of warming, and that "global economic losses could build to $23 trillion over the next 80 years; equal to permanent damage three to four times the scale of the 2008 Global Financial Crisis, and continuing to escalate." The institutional investors most active on corporate climate engagement have massive portfolios broadly diversified across the entire economy. As "universal owners," it is in their financial self-interest to take action to reduce global emissions, including those generated by the publicly traded fossil fuel companies in which they invest. Condon, Madison, Externalities and the Common Owner (April 26, 2019). 95 Washington Law Review 1 (2020), NYU Law and Economics Research Paper No. 19-07, Available at SSRN: https://ssrn.com/abstract=3378783

yield consistent disclosure and would undercut the Commission's mission of promoting orderly and efficient capital markets.

Recommendation:

To avoid a decade of delay in consistent and comparable Scope 3 emissions disclosures, I recommend that the Commission either establish a universal requirement for such disclosures (preferable) or provide sufficient guidance as to mandatory sectors and circumstances so that the applicability of the rule will not be subject to manipulation and abuse by registrants.

Sincerely,



Sanford Lewis