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BEYOND TCFD: THE RISING TIDE OF CLIMATE-RELATED OBLIGATIONS

Governance, Sustainability & Society – Part of the Horizon Scanning series

Set against the backdrop of the Paris Agreement's goal of keeping global temperature increase below 1.5ºc, businesses of all sizes need to engage with the transition to a low carbon future sooner rather than later. Importantly, companies need to look beyond immediate legal requirements and 'tick-box' exercises if they want to be ahead of the curve. In short, they can choose to lead, or may be forced to follow.

Industry-established, investor-led and private-sector climate initiatives are gaining traction today. Aside from best practice, these standards may well become mandatory in law in the near future. This in turn can help inform businesses' corporate purpose in the longer term.[1]

The rising tide

Climate-related disclosures in annual reports became a legal requirement for premium listed commercial companies in January 2021. From October this year, large occupational pensions will need to follow suit. Both of these requirements were brought about, in part, through adoption of the private-sector led framework launched by the **Taskforce on Climate-related Financial Disclosures** (TCFD) in 2017, taking it from being voluntary to mandatory.

This may well point the way of things to come. Governments looking to address issues like climate change will be wary of imposing solutions that align poorly with business needs - so solutions developed and endorsed by the private sector have an obvious appeal. While the less than 1.5ºc of warming target under the Paris Agreement is still almost 30 years away, expectations and obligations on businesses to act will come much sooner, and from a range of sources, not just legislation.

This briefing considers some of the investor-led and other climate change-related initiatives coming to bear on companies in 2021 and beyond, and how corporate boards can be prepared for them.

Investor-led initiatives

Often incorporating and championing the disclosure requirements of TCFD, a wide range of investor and institution-lead initiatives go further and can give clues about what is coming next.

The **Climate Action 100+** (CA100+) is a voluntary initiative that builds on pre-existing investor-led engagement initiatives from across the globe. Investor signatories commit to engaging with the 167 focus companies that represent over 80% of the global corporate industrial greenhouse gas (GHG) emissions. Investors seek from target companies "three asks", namely to:

- implement a strong governance framework which clearly articulates the board's accountability and oversight of the company's climate change risk;
- take action to reduce GHG emissions across the value chain, consistent with the Paris Agreement's 1.5ºc goal;
- provide enhanced corporate disclosure in line with the TCFD framework and sector-specific Global Investor Coalition on Climate Change (GIC) Investor Expectations on Climate Change guidelines (where applicable). This is to enable investors to assess the robustness of the

[1] To hear a discussion concerning corporate purpose, see Podcast: Demonstrating authenticity in sustainable ambitions

company's business plan against a range of climate scenarios, and is likely to require an annual resolution.

Almost 550 investors, representing $52 trillion of assets under management, have signed up since the CA100+ was founded in 2017. Notable new additions are **BlackRock** and **State Street Global Asset Management** – respectively the first and third largest asset managers in the world. The CA100+ has since launched a **Net-Zero Company Benchmark** against which to assess companies' progress. The initiative has seen a number of successes in encouraging change across a range of high-profile businesses.

The **Partnership for Carbon Accounting Financials** (PCAF) is another investor-driven initiative likely to prove consequential. Signatory financial institutions (including investors and asset managers) commit to quantifying, and publically reporting on, the GHG emissions supported or financed by their investing and lending activities. This in turn is likely to drive these activities towards greener investee companies and activities. Since we last wrote about PCAF in August 2020, the number of participating institutions has increased to 103, with recent additions from the UK including Barclays, Federated Hermes, Lloyds, Nationwide, and NatWest.

The UN's **Net Zero Asset Owners Alliance** (the Alliance) offers another example. Launched in September 2019, it encompasses 34 international institutional investors with $5.5 trillion in assets under management. The Alliance aims to transition investment portfolios to net zero by 2050. This is done first by institutions changing themselves, and then by reaching out to change others.

Described as the "gold standard" by the UN Secretary General, the Alliance has started to put in place guidance to ensure that action is taken now, not in 30 years' time. Its 2025 Inaugural Target Setting Protocol, for instance, lays out how all members can achieve substantial emissions reductions by 2025 through transparent five-year targets set according to scientific evidence. The Alliance has said that it will start with the highest emitters in order to meet their sector-specific carbon reduction targets, with a focus on oil and gas, utilities, transport and steel. It further asks members to engage with at least 20 target companies that are not yet aligned with the Paris Agreement 1.5ºc goal.

In December 2020, the **Institutional Investors Group on Climate Change** (IIGCC) launched the similarly named **Net Zero Asset Managers Initiative** which commits signatories to net zero by 2050 and requires them to set interim targets, to be reviewed once every five years. The initiative's 73 signatories account for one third of all assets under management. This was followed in March by the IIGCC's **Net Zero Investment Framework** benchmark launch.

The IIGCC wants its new framework to become the global blueprint for achieving net zero financed emissions, and 35 major investors representing $8.5 trillion in assets, as well as the UN, immediately endorsed it on its launch on 10 March 2021.

Asset managers asserting the need for change

Robust positions can also be seen coming from asset managers directly. In January 2021, **Schroders** wrote to the chairs of the FTSE 350 to explain that:

- Schroders' clients, and by extension the FTSE 350's ultimate shareholders, have demanded greater focus on the sustainability of business;
- this shift is driven by asset flows into sustainable funds materially outstripping other areas, and the need for all business to re-orientate the economy towards net zero carbon emissions by 2050;
- Schroders has therefore asked all FTSE 350 companies to produce and publish detailed, costed, net zero transition plans in 2021 and Schroders will undertake the same process themselves.

BlackRock, the world's largest asset manager, has taken a similar position in its recent commentary on climate risk, making it clear that it expects companies to have clear policies and action plans to manage climate risks and to the realize opportunities presented by the global energy transition.

This means boards will need to develop and disclose how their plan will be compatible with a low-carbon economy and integrated into their strategy. This should include short-, medium-, and long-term targets and goals. Boards will be expected to:

- mitigate climate risk, including from the physical impacts of climate change (sea levels rises, more extreme weather, food disruption etc.) and from the ‘transition risk’ of global regulators aligning on how to achieve a low-carbon transition;
- capitalise on efficiencies that might be borne out of reducing their company’s GHG footprint through decreased energy use, streamlined manufacturing processes, and technology enhancements to reduce waste; and
- embrace innovation and opportunity, on the basis that companies produce viable solutions to address changing market demands are best poised to capture additional market share as consumer preferences, regulation, and global demand shift.

BlackRock has also made clear that they expect directors to have sufficient fluency in climate risk and the energy transition to enable the whole board – rather than a single director who is a ‘climate expert’ – to provide appropriate oversight of the company’s transition plan and targets. The change must be deeply ingrained to be authentic.

In the same vein, **Cevian Capital**, Europe’s largest activist investor, announced in March that it will punish companies that fail to set environmental, social and governance (ESG) targets when deciding executive pay, in a move it believes will deter “ESG box checking”. They would do this through voting at annual meetings, marking one of the toughest stances yet linking executive pay to ESG. The message is clear: “laudable statements” will not be enough.

Amundi, Europe’s largest asset manager by assets under management, provides a slightly different approach aimed at integrating ESG criteria into mainstream investment processes and voting policies by the end of 2021. They have nine ambitions, including 100% ESG integration, acceleration of innovative climate solutions, and enhancing strategic advice and services, which are described as part of their fiduciary duty to their clients. This is on the basis that they consider an ESG-compliant company to be better equipped to outperform others in the long run.

How investors can force change

While not yet mandatory, these initiatives have teeth. The exact method of engagement varies, but a range of traditional and non-traditional investors will look to engage directly with chosen companies beyond just financial topics, court shareholder support for shareholder resolutions, and seek the backing of public opinion. BlackRock, for example, makes clear that they:

- may vote against re-appointing directors that they consider responsible for climate risk oversight, where corporate disclosures are seen to be lacking, or a company has not provided a credible plan to transition its business model to a low-carbon economy;
- may support shareholder proposals to address gaps in a company’s approach to climate risk and the energy transition;
- see intervention as appropriate where there is a lack of urgency and progress in a company’s actions around climate risk; and
- may support shareholder resolutions to accelerate matters even when a company is overall moving in the right direction.

HSBC recently announced it will propose a special resolution on climate change at its AGM in May, following engagement with charity ShareAction, Amundi SA and Man Group Plc. Key commitments in the special resolution include:

- setting short and medium term targets on a sector by sector basis to align HSBC’s provision of finance with Paris Agreement goals, consistent with net zero outcomes by 2050;
- phasing out financing of coal-fired power and thermal coal mining by 2030 in EU/OECD, and by 2040 in other markets;
- expecting to provide between $750 billion and $1 trillion in financing and investment to support its customers to progressively decarbonise and help realise the opportunity for long-term, sustainable growth; and
- the requirement for annual reports on progress, starting with the 2021 Annual Report and Accounts.

Barclays' shareholders recently rejected a resolution proposed by ShareAction and others to

phase out the provision of financial services to fossil fuel companies that are not aligned with the Paris Climate Agreement. Instead, the bank's own strategy to tackle climate change was overwhelmingly approved by shareholders.

Not all investor pressure is successful. The partnership between **BP** and climate activist **Follow This** came unstuck recently over whether BP will be able to increase its emissions to 2030 and still be aligned with the Paris Agreement. It is not clear yet what the impact of the oil major advising shareholders not to support the NGO's proposal for Paris-aligned targets will be. But it may be lose-lose for BP, not least because they could see themselves in the spotlight on climate for another year.

"Transition plans" as a corporate response

The success of the initiatives like those mentioned above can be seen in a spate of recent shareholder resolutions. A number of companies are being asked for example to produce plans to transition to net zero and put those plans to shareholders for an advisory vote.

In October 2020, following pressure from the **Children's Investment Fund Management** (TCIF), the Spanish airport infrastructure operator **AENA SME SA** became the first company in the world to amend its articles to require the board to publish a plan to mitigate the effects of climate change. An annual climate report, drawn up in line with TCFD framework, won the company's progress in meeting the goals set will also be required. Both are intended to be put to shareholders for an advisory vote.

In December last year, **Unilever** became the first FTSE 100 company to commit voluntarily to put its climate transition plan to a shareholder vote. The plan, which has now been published and will be updated on a rolling basis, will similarly be put to a non-binding advisory vote at the company's AGM in May. Shareholders are given an advisory vote every three years on any material changes made or proposed to the plan.

The trend is spreading fast in 2021 and is likely to pick up further in advance of COP26 in Glasgow later this year.

Royal Dutch Shell set out details in early February of how it plans to achieve its target of net zero emissions by 2050, with shareholders to be given the right to an advisory vote on its transition plan each year. It will become the first company in the energy sector to do so.

The Anglo-Swiss miner **Glencore** has also announced that it will offer investors an advisory vote on the topic at its annual meeting in April. So too will **M&G** and **Rio Tinto** in 2022. The services giant **Moody's** will give shareholders a "Say on Climate" vote following engagement by TCI, and other climate-related proposals having been filed at oil and gas giants **Woodside** and **Santos** in Australia and at **Alphabet, Charter Communications** and **S&P Global** in the US.

The recent change in US administration has brought changes in the SEC's stance, as they have refused to allow **ConocoPhillips** and **Occidental Petroleum** to throw out shareholder motions that would force them to lay out detailed plans for cutting their Scope 3 emissions (i.e. those from the burning of their products by customers).

All this builds on momentum that figures like Mark Carney, former Governor of the Bank of England and current finance advisor to the Prime Minister for COP26, are helping to build. At the Green Horizon Summit in November 2020, Carney endorsed moves by investors to force companies to submit their climate change plans to an annual shareholder vote. This was on the basis that such a mechanisms could improve oversight of company commitment to reduce GHG emissions. Given Carney's current role and profile, we should expect to hear more from him in this space, and similar sentiment coming from other climate change voices.

Other changes coming down the track

The TCFD framework continues to spread. The UK government's Green Finance Strategy aims to mandate the framework across the UK economy by 2025. It is already making its way into pensions, charities, and the Climate Financial Risk Forum's guidance for firms on climate risk and opportunities, among others.

However, TCFD and those that embrace it are not the only game in town. They join an array of

existing legislative and fiscal initiatives that continue to expand. For example:

- the **Taskforce on Nature-related Financial Disclosures** (TNFD) is looking to provide a framework for corporates and financial institutions to assess, manage and report on their dependencies and impacts on nature beyond climate change. This will aid appraisal of nature-related risk and highlight biodiversity and 'nature services';
- the **IFRS Foundation**, in light of increasing demands for consistent sustainability information, is looking to develop a global set of internationally recognised sustainability standards to help move away from the 'alphabet soup' of competing standards;
- the UK Government published its net zero **Industrial Decarbonisation Strategy** in March 2021 and has recently agreed a sector deal with the offshore oil and gas industry;
- the **EU** recently had its fifth round of talks on climate law, to discuss in particular the block's 2030 GHG reduction target.

What you need to do

Non-legislative efforts can have a real effect on the world's major carbon emitters, and state and supra-national law is not the only - or even the main - source of change in this area. Where efforts are successful on a voluntary basis, legislation may soon follow to replicate or reinforce those approaches.

Boards need to be alive to both the impact investor-led initiatives might have today, and how they might solidify through legislative and other pressures in the future.

In spite of all of the above, it is just a first step. Real action, not just a plan to act in the future, is needed. Companies looking to lead need to go beyond increased disclosures and articulating their own ambition, towards ensuring they and others take action now to deliver it.

Whilst current momentum is towards companies having transition plans, and over the course of the next 12 month we expect considerable pressure to emerge for annual votes on them, the next phase will be to hold directors to account. Those that are able to get ahead now will avoid next year's less temperate climate for inaction.

In our December 2020 publication we set out some areas of focus and development for companies that will help put them in the best position to publish positive TCFD disclosures next year, but these are also applicable to other climate-related initiatives such as those discussed in this paper.

If you are interested in discussing the matters in this briefing or other related topics, please don't hesitate to contact your usual relationship partner at Slaughter and May.

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