DISCLOSURE OF CLIMATE-RELATED INFORMATION BY LISTED COMPANIES

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For financial years starting on or after 1 January 2021, the FCA is proposing that premium listed commercial companies should make climate-related (CR) disclosures in their annual reports based on the framework established by the Task Force on Climate-related Financial Disclosures (TCFD). Disclosures will not be mandatory, but if a company does not include a disclosure then it will need to explain why.

Background

A number of recent developments indicate that investors and shareholders are increasingly focused on the significant and complex impact that climate change is likely to have on their investments. In particular:

- In October 2019 the Financial Reporting Lab published a paper on Climate-Related Corporate Reporting (the *FRC Lab Report*), highlighting investor expectations and providing guidance to companies on how to improve their CR reporting, including examples of good practice.
- The UK Stewardship Code 2020, effective from 1 January 2020, introduced ESG factors for the first time.
- On 14 January 2020, BlackRock announced a market-leading climate strategy overhaul, explaining that "*climate risk is investment risk*".
- Company responses to climate change were listed as one of the Investment Association's Shareholder Priorities for 2020, published on 14 February 2020.
- On 9 March 2020, ISS published a new Climate Voting Policy designed to help investors integrate CR factors into their voting decisions.

It makes sense that investors should want to commit their capital to companies that both (i) support the transition to a low-carbon economy, and (ii) appropriately manage their exposure to climate change risk. However, in order to make the right decisions, investors need access to the right information. For now, there is no harmonised standard for CR disclosures, either in the UK or internationally, so it is difficult for investors to compare the sustainability credentials of different investment opportunities.

The fact that the FCA is now proposing to prescribe CR disclosure standards among premium listed commercial companies should not come as a surprise. The FCA stated in October 2019 (in FS19/6) that it would consult in 2020 on the introduction of a new CR disclosure regime based on the TCFD framework. More generally, CR issues are a national priority for the UK. In June 2019, HM Government committed to reduce the UK's net GHG emissions to zero by 2050, and a central pillar of Boris Johnson's 2019 General Election manifesto was that the UK should "lead the global fight against climate change". The FCA's proposals can therefore be seen as part of wider UK efforts to lead (or be seen to lead) the sustainable investment movement. In light of this, and the widespread support among investors for the TCFD framework, it seems very likely that the rule changes set out in CP 20/3 will be introduced broadly as proposed.

Issuers should also view CP 20/3 in the wider context of other CR disclosure developments. While the proposed rule will improve the quality of reporting on the impact of climate change on issuers, the European Commission's [Guidelines on Reporting Climate-Related Information] (published in June 2019 and relevant to FY 2019 reporting) encourages issuers also to disclose the material impacts of their businesses on the climate. Issuers should expect these enhanced disclosures to also feed into their ESG 'scores' applied by ratings agencies, which are an increasingly important driver of market demand (and, ultimately, share price). Accordingly, there may be good business reasons to adopt the required disclosure standards early, and to implement new systems that will help issuers to provide meaningful CR disclosures.

What is the TCFD's disclosure framework?

The TCFD was established in December 2015 by the Financial Stability Board with the purpose of developing a set of voluntary climate-related disclosure standards for companies across all sectors.

In its Final Report published in June 2017 (the *Final Report*), the TCFD recommended four high-level types of CR disclosure, and 11 more specific 'recommended disclosures' (together referred to below as the *Recommended Disclosures*):

Governance	Strategy	Risk Management	Metrics and Targets
Disclose the organisation's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material.	Disclose how the organisation identifies, assesses, and manages climate-related risks.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material
Recommended disclosures	Recommended disclosures	Recommended disclosures	Recommended disclosures
a) Describe the board's oversight of climate-related risks and opportunities. b) Describe management's role in assessing and managing climate-related risks and opportunities.	a) Describe the climate-related risks and opportunities the organisation has identified over the short, medium, and long term. b) Describe the impact of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning. c) Describe the resilience of the organisation's strategy, taking into consideration different dim ate-related scenarios, including a 2°C or lower scenario.	a) Describe the organisation's processes for identifying and assessing climate-related risks. b) Describe the organisation's processes for managing climate-related risks. c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organisation's overall risk management.	a) Disclose the metrics used by the organisation to assess climate-related risks and opportunities in line with its strategy and risk management process. b) Disclose Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas emissions, and the related risks. c) Describe the targets used by the organisation to manage climate-related risks and opportunities and performance against targets.

The Final Report also includes:

- *Guidance for All Sectors*, which specifies at a more granular level CR disclosures that companies should make, or should consider making (see box below and on the next page).
- *Fundamental Principles for Effective Disclosure*, which sets out general principles for companies to follow in making disclosures – for example, that disclosures should be sufficiently detailed to enable investors to assess the company's response to CR issues, consistent over time, and comparable to other organisations in the sector or industry.

At the same time as the Final Report, the TCFD also published an Annex entitled "Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures" (the *Annex*). In addition to material replicated from the Final Report, the Annex also includes:

- *Supplemental Guidance for the Financial Sector*, which is based on the Guidance for All Sectors but tailored to banks, insurance companies, asset owners and asset managers.
- *Supplemental Guidance for Non-Financial Groups*, which is also based on the Guidance for All Sectors but tailored for non-financial businesses that are particularly exposed to CR risks – namely businesses in the energy, transportation, materials, construction, agriculture, food, and forestry sectors.
- *Appendices*: these include examples of CR risks and opportunities and how they might impact on a company's financial position and prospects.

Guidance for All Sectors

The guidance specifies (i) information that a company "should" disclose; and (ii) information that a company should "consider" disclosing. Examples of information that should be disclosed include:

- How identified CR issues have affected the company's business, strategy, and financial planning.
- What the company considers to be the relevant short, medium, and long-term time horizons (taking into consideration the useful life of the company's assets and infrastructure, and the fact that CR issues often manifest themselves over the medium and longer terms) and what CR issues could potentially arise in each time horizon that could have a material financial impact.
- How resilient the company's strategy is to CR risks and opportunities, taking into consideration a transition to a lower-carbon economy consistent with a 2°C or lower scenario and, where relevant, scenarios consistent with increased physical CR risks.
- The risk management processes used to identify, assess and manage CR risks, including how the relative significance of CR risks is assessed in comparison to other risks.
- The key metrics used to measure and manage CR risks and opportunities including, where relevant, internal carbon prices and CR opportunity metrics such as revenue from products and services that are designed for a lower-carbon economy. Metrics should include Scope 1 and Scope 2 GHG emissions and, if appropriate, Scope 3 GHG emissions and the related risks.
- Key CR targets such as those related to GHG emissions, water usage and energy usage, in line with anticipated regulatory requirements or market constraints or other goals.

Examples of information that a company should consider disclosing include:

- The processes and frequency by which the board and/or board committees are informed about CR issues.
- Whether the board and/or board committees consider CR issues when reviewing and guiding strategy, major plans of action, risk management policies, annual budgets, and business plans.
- How CR issues could impact on the company's products and services, supply chain and/or value chain, investment in research and development, operations, and location of facilities.
- How the company's strategy might change to address potential CR risks and opportunities, and the CR scenarios and associated time horizon(s) considered.
- In relation to CR targets, whether the target is absolute or intensity based, the time frames over which the target applies, the base year from which progress is measured, and KPIs used to assess progress against targets.

Broadly speaking, the TCFD framework requires a company to disclose what it is doing in response to CR risks and opportunities, and how its strategy, business model, planning and financial position and prospects are affected by CR issues. (The Annex contains more details about CR risks and opportunities and their potential financial impact: see for example figure 3 on page 5 and tables A1 and A2 in Appendix 1.) The TCFD framework does not, however, require a company to report on the impact of its business on the climate.

The TCFD disclosure framework is not currently mandatory – companies are free to disclose less, or different, information about CR issues - but it represents a benchmark of best practice CR disclosure from the perspective of investor risk management. As part of its June 2019 status report, the TCFD reviewed the financial filings, annual reports and sustainability reports of over 1,100 companies from 142 countries across a range of industries. The TCFD found that around 25% of companies provided five or more of the *Recommended Disclosures*, with around 4% of companies providing 10 or more of the *Recommended Disclosures*, suggesting that the 'comply or explain' standard being adopted by the FCA in respect of all 11 *Recommended Disclosures* will be world-leading.

TCFD resources

The TCFD has also published a *Technical Supplement on the Use of Scenario Analysis*. Further guidance is likely to be published by the TCFD and other organisations over the next few years.

The Final Report, Annex, Technical Supplement, TCFD status reports, and other TCFD resources can be found on its website.

FCA's choice of the TCFD disclosure framework as a benchmark for listed companies

The FCA believes that the TCFD disclosure framework provides an appropriate benchmark for listed companies. It notes that the TCFD disclosure framework was the subject of extensive consultation, is already widely recognised by the financial industry and more broadly, and a number of companies are already following it. In addition:

- A number of other disclosure frameworks have aligned with the TCFD disclosure framework.
- In its Green Finance Strategy, published in July 2019, the UK Government endorsed the TCFD disclosure framework.

- The FRC Lab Report is based on the TCFD disclosure framework.

Nevertheless, the FCA acknowledges that reporting in line with the TCFD disclosure framework will require most companies to make changes to their existing systems and procedures.

Proposed rule change

The FCA proposes to introduce a new rule (LR 9.8.6(8)) to require a premium listed commercial company to disclose in its annual report for each financial year starting on or after 1 January 2021:

- Whether the annual report includes all the information specified in the TCFD *Recommended Disclosures*.
- If any such information is included instead in another document, a description of where that document can be found and an explanation of why the information was not included in the annual report.
- Details of where in the annual report or other document such information can be found.
- Where the company has not included all such information in the annual report or another document, an explanation of why not. (See "*Comply or explain*" below.)

For the purposes of determining whether the annual report discloses all the information specified by the TCFD *Recommended Disclosures*, a company will need to "have regard" to the *Guidance for All Sectors* and, where relevant, the *Supplemental Guidance for the Financial Sector or the Supplemental Guidance for Non-Financial Groups*. In addition, the other parts of the Final Report and the Annex, and the *Technical Supplement on the Use of Scenario Analysis*, will also be "relevant".

A company's auditors will not be required to check that the disclosures comply with the new Listing Rule.

Comply or explain

Under the proposed new rule, a company must include in its annual report all the information specified in the *Recommended Disclosures*, or explain why not.

As currently drafted, the rule is not clear whether the disclosure obligation would also apply to all of the information specified in the *Guidance for All Sectors* (or, where relevant, the *Supplemental Guidance for the Financial Sector* or the *Supplemental Guidance for Non-Financial Groups*). As noted above, the *Guidance for All Sectors* distinguishes between (i) information that a company "should" disclose (which might be thought of as *prescribed information*), and (ii) information that a company should "consider" disclosing (which might be thought of as *discretionary information*).

In relation to *prescribed information*, it seems clear that a company must either disclose such information or explain why not. However, in relation to *discretionary information*, arguably a company will comply with the new rule if it genuinely considers whether to include it even if, ultimately, it decides not to do so. This point may be clarified when the FCA finalises the new rule and/or as market practice develops.

Because climate change and its impact on companies are complex issues, best practice and investor expectations are evolving rapidly, and companies are at different stages in putting in place systems and procedures to identify, assess and respond to CR issues, we anticipate that in the first few years of reporting under the new rule there will be a number of areas in which companies may prefer not to disclose all the information specified in the TCFD disclosure framework. For example:

- Companies that are still developing the data and capabilities needed to model and report CR information may be reluctant to disclose key metrics for measuring and managing CR risks and opportunities, or CR targets.

- Companies may be reluctant to disclose details of their resilience testing – i.e. how their strategy, profits, revenue, asset values etc. might be affected in different CR scenarios. This is particularly because, as the Final Report acknowledges, scenario analysis is a relatively new tool that presents a number of challenges. In order to conduct meaningful scenario analysis, companies will probably need to develop their own in-house capabilities or procure suitable products or expertise from third parties. Companies may also be concerned about publishing forward-looking information.
- Companies may be concerned about publishing commercially-sensitive information, such as details of new products or services the company plans to develop in order to exploit CR opportunities.

New FCA Technical Note

The FCA also intends to publish a Technical Note highlighting other provisions in the Listing Rules, and provisions of the Disclosure Guidance and Transparency Rules, MAR, prospectus regime and the UK Corporate Governance Code that may require companies to disclose information on CR issues. It notes that UK-incorporated companies are already required to include certain CR information in their annual reports, such as principal risks and uncertainties facing the company and information on GHG emissions, energy use and energy efficiency.

FCA consultation paper

Details of the proposed rule change and the draft Technical Note are set out in the FCA consultation paper, "Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations" (CP 20/3), published on 6 March 2020. The FCA seeks comments on its proposals by 1 October 2020 (having extended the consultation from the originally published deadline of 5 June 2020 in light of Covid-19). The rule change seems likely to be introduced in Q4 of this year, although it may be deferred as a result of Covid-19.

For the time being, the FCA does not propose to apply the new rule to premium segment investment companies or to standard segment companies.

What companies need to do

While climate change affects nearly all economic sectors, the level of exposure and the impact of CR risks differ by sector, industry, geography, and organization. In addition, as the Annex acknowledges:

"The financial impacts of climate-related issues on organisations are not always clear or direct, and, for many organisations, identifying the issues, assessing potential impacts, and ensuring the material issues are reflected in financial filings may be challenging. Key reasons for this are likely because of (1) limited knowledge of climate-related issues within organisations, which may inhibit the identification of such risks; (2) the tendency to focus mainly on near-term risks without paying adequate attention to risks that may arise in the longer term; and (3) the difficulty in quantifying climate-related risks."

Different companies will of course be at different stages in developing their response to CR issues.

For a company with a calendar year end, the first time it will need to disclose the information specified in the TCFD disclosure framework, or explain why it is not doing so, will be in its annual report for the year ended 31 December 2021, which will be published in the first few months of 2022.

Between now and the end of 2021, companies may therefore want to develop their existing processes and resources relating to CR issues. Some areas for possible focus and development are set out in the box on the next two pages.

Areas for focus and development

- ***Roadmaps:*** Create or refine a "roadmap" to engage with CR issues, including what the company wants to achieve.
- ***Embedding CR issues in decision-making:*** Consider how to embed CR issues into board and management decision-making processes. The FCA says that boards and executive management are likely to need to deepen their engagement with CR issues. Determine what kind of reports on CR issues the board, Audit Committee and Executive Committee should receive, and how frequently.
- ***Metrics:*** Identify which metrics should be used to quantify and assess CR risks and opportunities, the methodology that should be used and which should be publicly disclosed. Examples of metrics can be found in table 1 on page 8 of the Annex. The Government has also published detailed guidance on complying with the statutory Streamlined Energy and Carbon Reporting (SECR) requirements which came into force on 1 April 2019, including guidance on determining appropriate KPIs, collecting and verifying data, setting targets and measuring performance against them, and reporting publicly in relation to GHG emissions, water use, waste, materials and resource efficiency, biodiversity/ecosystem services, and emissions to air, land and water.
- ***Targets:*** Identify and set CR targets, agree the assumptions to be made and put in place processes to obtain all the relevant data needed to measure and report against those targets.
- ***Asset impairment:*** Ensure business and finance teams consider whether carbon-related assets need to be written off or impaired in light of changes in government or regulatory policy, changes in customer preferences etc.
- ***Horizons:*** Determine what "short", "medium" and "long" term mean for the company, bearing in mind its business model, the life of the company's assets, the profile of the CR risks it faces and the sectors and geographies in which the business operates.
- ***Suppliers:*** Embed CR considerations into supply chains and procurement processes.
- ***Contingency planning:*** Carry out contingency planning, both for one-off physical events (such as flooding, storms, unexpected material increases in energy costs, and interruptions to supply chains or distribution networks) and longer-term shifts in climate (such as sea level rises or water shortages).
- ***Resilience:*** Carry out scenario analysis and resilience testing and decide how much information on this to disclose. The FRC Lab Report says that although the TCFD disclosure framework recommends a 2°C or lower scenario, investor expectation is beginning to coalesce around an expectation of modelling towards a 1.5°C world (page 19).
- ***Materiality:*** Identify how materiality should be determined for the purposes of disclosing CR information in the annual report. The Annex cautions against prematurely concluding that CR risks and opportunities are immaterial based on perceptions of the longer-term nature of some CR risks.

Areas for focus and development (continued)

- ***Carbon footprint:*** Review internal policies on carbon-intensive activities, such as business travel.
- ***Workforce engagement:*** Encourage staff to adopt sustainable practices and to suggest new initiatives.
- ***Transition to more energy-efficient equipment and processes***: Consider allocating more resources to investing in new energy-efficient technologies and processes.
- ***Executive remuneration***: Consider incorporating CR metrics into remuneration policies.
- ***Reputation and investability***: Ensure that the company is effectively communicating what it is doing in response to CR issues, in order to improve its reputation, competitive position and attractiveness to investors.


Jeffrey Twentyman
T +44 (0)20 7090 3476
E jeffrey.twentyman@slaughterandmay.com


Richard Hilton
T +44 (0)20 7090 3611
E richard.hilton@slaughterandmay.com