SLAUGHTER AND MAY/

CLIENT BRIEFING

JUNE 2021

FCA PROPOSES TO EXTEND CLIMATE-RELATED DISCLOSURE OBLIGATIONS TO STANDARD SEGMENT COMPANIES

For financial years starting on or after 1 January 2022, the FCA proposes to require most commercial companies with standard listed equity shares to 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. The first annual financial reports under the new rule would therefore be published in early 2023.

The proposed rule change, which is expected to be confirmed by the end of this year, will result in in-scope standard listed companies becoming subject to the same rules on climate-related disclosures as premium listed commercial companies. This briefing provides further details of the proposed new rule and what it will mean for in-scope standard listed companies.

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, the "TCFD Recommended Disclosures"):

Governance	Strategy	Risk Management	Metrics and Targets
Disclose the organisation's governance around CR risks and opportunities	Disclose the actual and potential impacts of CR 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 CR risks	Disclose the metrics and targets used to assess and manage relevant CR risks and opportunities where such information is material
Recommended disclosures a) Describe the board's oversight of CR risks and opportunities b) Describe management's role in assessing and managing CR risks and opportunities	**Recommended disclosures** a) Describe the CR risks and opportunities the organisation has identified over the short, medium, and long term b) Describe the impact of CR 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 CR scenarios, including a 2°C or lower scenario	**Recommended disclosures** a) Describe the organisation's processes for identifying and assessing CR risks b) Describe the organisation's processes for managing CR risks c) Describe how processes for identifying, assessing, and managing CR risks are integrated into the organisation's overall risk management	**Recommended disclosures** a) Disclose the metrics used by the organisation to assess CR 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 CR risks and opportunities and performance against targets

TCFD Guidance

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 the box below).
- *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.

The TCFD has also published:

- *Guidance on Scenario Analysis for Non-Financial Companies*.
- *Guidance on Risk Management Integration and Disclosure*.

In June 2021 the TCFD published for consultation:

- proposed *Guidance on Climate-related Metrics, Targets and Transition Plans*: this is intended to help companies establish relevant metrics, targets, and transition plans around their CR risks and opportunities; and at the same time the TCFD proposes to update its *Guidance for All Sectors*, *Supplemental Guidance for the Financial Sector*, *Supplemental Guidance for Non-Financial Groups* and the Annex to reflect recent developments; and
- a draft *Technical Supplement on Measuring Portfolio Alignment*: this is designed to help investors measure how well their investment portfolios align with the goals of the Paris Agreement – in particular, by identifying emerging best practices in portfolio alignment tool construction and promoting the adoption of consistent, robust, and decision-useful metrics.

Further guidance is likely to be published by the TCFD and other organisations over the next few years.

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

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.

Scope of new rule

The FCA proposes that the new rule would apply to issuers of equity shares that are subject to chapter 14 of the Listing Rules (standard listed issuers), wherever they are incorporated or headquartered, but not to standard listed investment companies or shell companies. Around 150 companies - half of which are UK-headquartered - would be in scope.

At this stage the FCA does not propose to extend the new rule to issuers of other securities admitted to the standard segment, which include:

- standard listed issuers of shares that are not equity shares;
- issuers of GDRs that are subject to chapter 18 of the Listing Rules (about 170 companies, most of which are commercial companies with securities also listed on an overseas market);
- issuers of standard listed debt and debt-like securities that are subject to chapter 17 of the Listing Rules (about 1,000 distinct issuers, including UK and overseas public sector issuers (such as local authorities and national governments) and issuers of mortgage-backed securities and other asset-backed instruments).

However, the FCA asks market participants for views on whether and how best to apply TCFD-aligned disclosure rules to such issuers in a way that is effective and proportionate.

Climate-related reporting obligation

Under the proposed new Listing Rule (LR 14.3.27), an in-scope standard listed company would have to include in its annual report for each financial year starting on or after 1 January 2022:

- A statement as to whether the annual report includes CR-related financial disclosures that are consistent with all the TCFD Recommended Disclosures.
- If any such information is included instead in another document - such as a Sustainability Report - details of which information is included in that other document, where it 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, either in the annual report or in another document, information that is consistent with all the TCFD Recommended Disclosures:
  - details of which TCFD Recommended Disclosures it has not provided;
  - an explanation as to why (see "Comply or explain" below); and
  - details of any steps it is taking or plans to take in order to be able to make those disclosures in the future, and the timeframe within which it expects to be able to make those disclosures.

For the purposes of determining whether its CR-related financial disclosures are consistent with the TCFD Recommended Disclosures, a company will have to undertake a detailed assessment of its disclosures taking into account the TCFD's *Guidance for All Sectors* and, where relevant, the *Supplemental Guidance for the Financial Sector* or *Supplemental Guidance for Non-Financial Groups*. The FCA also considers the following TCFD documents to be "relevant":

- the other parts of the Final Report and Annex;
- the *Technical Supplement on the Use of Scenario Analysis in Disclosure of Climate-related Risks and Opportunities*;
- the *Guidance on Risk Management Integration and Disclosure*;
- (where appropriate) the *Guidance on Scenario Analysis for Non-Financial Companies;*
- (assuming the final version is broadly consistent with the consultation version) the *Guidance on Metrics, Targets and Transition Plans*; and
- (assuming the final version is broadly consistent with the consultation version, and where appropriate) the *Technical Supplement on Measuring Portfolio Alignment*.

However, companies will not be required to report on the extent to which they have complied with or applied the guidance in these documents.

For the time being, a company's auditors will not be required to check that the disclosures comply with the new Listing Rule. But this could change in future, particularly if an international non-financial reporting standard emerges.

Comply or explain

As noted above, a company will either have to include in its annual report or another document all the information specified in the TCFD Recommended Disclosures or explain why not. However, the new Rule will say that the FCA would ordinarily expect a company to be able to make CR financial disclosures consistent with all the TCFD Recommended Disclosures "*except where the company faces transitional challenges in obtaining relevant data or embedding relevant modelling or analytical capabilities*". In particular, the FCA expects companies should ordinarily be able to make all the TCFD Recommended Disclosures relating to (i) **governance**; and (ii) **risk management**; and, in relation to **strategy**, at least TCFD Recommended Disclosures (a) and (b), to the extent that the listed company does not face such transitional challenges.

But it will be acceptable for companies to "explain" non-compliance with:

- TCFD Recommended Disclosure c) relating to **risk management**, which broadly requires a company to describe the resilience of its strategy taking into consideration different climate-related scenarios. Here, the FCA recognises that 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 - particularly because, as the Final Report acknowledges, scenario analysis is a relatively new tool that presents a number of challenges, and 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) and/or the risks of publishing forward-looking information.

- The TCFD Recommended Disclosures relating to the **metrics and targets** used by the company to assess and manage CR risks and opportunities. The FCA recognises that in this area companies may still be developing the data and capabilities needed to model and report CR information, and may be reluctant to disclose key metrics for measuring and managing CR risks and opportunities, or CR targets.

SASB Standards

Although the TCFD framework provides a robust framework for CR disclosures, and the new *Guidance on Metrics, Targets and Transition Planning* (referred to above) will provide more specific guidance in those areas, the TCFD framework falls short of a corporate reporting standard. The IFRS Foundation is working towards producing a baseline international reporting standard on sustainability which is designed to improve consistency and comparability of disclosures. In the meantime, companies may want to refer to existing voluntary frameworks that complement the TCFD framework. These include the SASB Standards, which have been developed to help companies disclose financially material sustainability information that is useful to investors.

Towards mandatory disclosure

Although the FCA reiterates that it intends ultimately to amend the Listing Rules to make it mandatory for both premium and standard listed companies to disclose all of the information specified by the TCFD framework, it believes that now is not the right time to introduce this requirement.

Primarily this is because the FCA considers it would be better for any mandatory requirement to be tied to a UK sustainability reporting standard. It expects an Exposure Draft for a common international reporting standard for sustainability - the CR elements of which will be built on the TCFD framework – to be published in the first half of 2022. It is therefore likely to consult on moving to a mandatory compliance basis once the new reporting standard has been introduced in the UK.

More generally, the UK Government is committed to making TCFD-aligned disclosures mandatory across the UK economy by 2025, with most of the changes to be introduced by 2023. In pursuit of this, BEIS has proposed that, for accounting periods beginning on or after 6 April 2022, certain larger UK-incorporated companies and LLPs should have to include in their strategic report disclosures that are intended to align with most of those specified in the TCFD framework: see the box below.

CR disclosures in the strategic report: BEIS proposals

Companies and LLPs in scope would have to make disclosures relating to:

- **Governance**: a description of the governance arrangements in place to identify and manage risks and opportunities arising from climate change, including:
  - who has operational responsibility for climate change, including the experience of that executive or committee; and
  - if the company has an audit committee, whether climate change is a matter considered by the company's audit committee.
- **Strategy**: a brief description of the company's business model and strategy (to the extent that the company is not already required to report such information), and a description of how the business model and strategy may change in response to effects relating to climate change, and the trends and factors that affect this change.
- **Risk Management**: a description of the principal risks and opportunities, including material financial risks and opportunities, relating to transition risk, physical risk and regulatory risk arising from climate change which may affect the business and a description of how the company manages those areas of risk and opportunity, including a description of:

- – its business relationships, products and services that are likely to cause adverse impacts in those areas of risk;
  - – how it manages the principal risks; and
  - – the risk management policies adopted by the company in relation to climate change, any due diligence processes implemented in respect of those policies and a description of the outcome of those policies.
- **Metrics and targets:** a description of the key performance indicators relevant to the entity's exposure to climate change risk and opportunity, and the targets set by the business for those key performance indicators.

The new requirements would apply to (i) UK companies with more than 500 employees and transferable securities admitted to trading on a UK regulated market or AIM; (ii) banking companies and insurance companies; (iii) other UK companies with more than 500 employees and a turnover of more than £500m; and (iv) LLPs with more than 500 employees and a turnover of more than £500m.

Assuming these changes, and the changes to the Listing Rules for standard segment companies, are introduced as proposed, all UK registered premium and standard listed companies with more than 500 employees will, in respect of accounting periods beginning on or after 6 April 2022, have to include in their strategic report all the disclosures mandated by the new legal requirements (and will not be able to explain why they have not done so).

The Department for Work and Pensions (DWP) has also published draft regulations for trustees of occupational pension schemes that will require them to ensure they have in place, and report on, effective governance, strategy and risk management measures for assessing and managing CR risks and opportunities. For more details on this see our February 2021 briefing.

In a consultation paper published at the same time as the one discussed in this briefing, the FCA has also proposed to introduce CR disclosure requirements for asset managers (including some listed investment vehicles), life insurers, and FCA-regulated pension providers. For more details on this see our June 2021 briefing.

Context and implications for companies

At the end of last year, when the FCA introduced the rule requiring premium segment commercial companies to make climate-related disclosures consistent with the TCFD framework, we published a briefing containing further information about the TCFD framework and the wider ESG context. The briefing also includes some guidance on what companies need to do in response to climate-related issues and specifically the new disclosure obligation. In-scope standard listed companies may find it helpful to refer to that briefing.

Related ESG issues

In the consultation paper, the FCA also seeks views (but without setting out any proposed rule changes) on other topical ESG issues in capital markets. These include problems around ESG ratings, which are used by some asset managers and investors to help make investment decisions and by some financial product providers to describe the ESG characteristics of investments. For example, a lack of transparency around the methodologies used by firms can make it difficult for investors to understand a rating and how it could affect investment outcomes; and a lack of common definitions and terminology can make it difficult to compare investments. The FCA seeks views on how it should address these problems: for example, by imposing Handbook requirements on regulated firms about the development and use of ratings; encouraging the creation of a Best Practice Code for ESG data and rating providers; or bringing ESG ratings within the regulatory perimeter.

Views are also sought on various issues related to green, social or sustainability-labelled debt instruments: these will be covered in a separate briefing to be published soon.

FCA Consultation Paper

Details of the proposed rule change for standard listed companies, and the initial consultation on related ESG issues, are set out in FCA Consultation Paper CP 21/18 published on 22 June 2021.

If you would like further information about this topic, please speak to your usual Slaughter and May contact.

CONTACT

JEFF TWENTYMAN
PARTNER
T: +44 (0)20 7090 3476
E: jeff.twentyman@slaughterandmay.com

RICHARD HILTON
ASSOCIATE
T: +44 (0)20 7090 3611
E: RICHARD.HILTON@SLAUGHTERANDMAY.COM

PETER BATEMAN
SENIOR PROFESSIONAL SUPPORT LAWYER
T: +44 (0)20 7090 4577
E: peter.bateman@Slaughterandmay.com

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650

www.slaughterandmay.com

572757054