ClientEarth

August 2020

FCA Consultation CP20/3: Proposals to enhance climate-related disclosures

ClientEarth briefing

Top Lines

- Despite clear investor demand, listed issuers in the UK consistently fail to disclose material climate-related information to financial markets – likely breaching the law.
- The FCA's proposals to clarify and enhance climate change-related disclosure obligations are welcome, but inadequate – unless they are improved, the FCA will not meet its own statutory objectives to protect consumers, enhance financial market integrity and promote competition.
- This is a unique opportunity to mandate TCFD and Paris-aligned disclosures, in line with the expectations of investors, government and broader stakeholders – waiting 2-3 years is too late.
- In order to ensure that investors and consumers have the information they need, the FCA must:

  1. make the new 'climate rule' mandatory, and avoid a confusing 'comply or explain' approach;
  2. apply the new 'climate rule' to all issuers, not just those with a premium listing, from 2022;
  3. amend the 'climate rule' to require issuers to disclose a 'Paris-aligned' strategy, with a credible plan for how they can achieve 'net zero' GHG emissions by 2050 (TCFD+);
  4. clarify that relevant materiality tests under existing disclosure laws require issuers to consider and meet investors' reasonable expectations for decision-useful information;
  5. explain how consistency will be maintained with emerging EU disclosure laws, including those imposed under the EU Non-Financial Reporting Directive (**NFRD**); and
  6. confirm what action is being taken to close existing accountability and enforcement gaps.

Background

It is now widely agreed that listed companies (**issuers**) in the UK are consistently failing to disclose material climate-related information to financial markets.[1] This is despite clear and repeated assertions from investors, over many years, that consistent, comparable and high quality climate-related information is highly material to their decision-making.[2] This continued failure by companies to meet investors' disclosure expectations is depriving financial markets of the information necessary for investors to integrate climate-related information into their investment and stewardship decision-making.[3] This undermines investors' ability to meet their fiduciary duties, increases financial stability risks and deprives consumers and beneficiaries of financial products, which meet their investment objectives. Given the clear materiality signals from investors, it also indicates that many issuers are likely breaching the law.[4]

ClientEarth therefore welcomes the FCA's stated intention to clarify and enhance climate-related disclosure obligations for listed issuers. However, in our view, the new 'climate rule' and technical guidance proposed in CP20/3 are inadequate to meet the FCA's stated objectives. In order to provide investors and consumers with the consistent, comparable and high quality climate-related information needed to support well-functioning markets, the proposals must be improved to ensure that clear legal obligations, aligned with investors' evolving expectations (TCFD+), apply consistently to all listed issuers from 2022, at the latest – as per the Government's Green Finance Strategy expectations.

In advance of preparing our more detailed response to the FCA's consultation, this briefing, sets out ClientEarth's six key recommendations for improving the FCA's proposals. We believe that without addressing these concerns, the FCA will not meet its own statutory objectives to make markets function well, protect consumers, enhance financial market integrity and promote competition. We welcome discussion on these matters and strongly encourage other stakeholders to consider and adapt these points in preparing their own responses to the FCA consultation (due date: **1 October 2020**).

ClientEarth's key recommendations

1. Make the new 'climate rule' mandatory

The recommendations of the Taskforce on Climate-related Financial Disclosures (**TCFD**) are now the base-line industry standard for disclosing material climate-related information in a useful and consistent format. The proposal to introduce a new climate-related disclosure rule (**'climate rule'**) to explicitly require firms to align their disclosures with the TCFD recommendations is therefore welcome. However, the proposal to introduce this requirement on a 'comply or explain' basis misunderstands the extent to which this information is already material to investors. It will lead to slow implementation, lower quality disclosures with greater scope for 'greenwash', and increased uncertainty for issuers, investors, and consumers. The new 'climate rule' must be introduced on a clear mandatory basis. This is because:

- investors expect issuers to use the TCFD recommendations to provide material climate-related information to satisfy existing disclosure requirements, and hundreds of companies now do so;[5]

[1] See, eg, FRC Reporting Lab, 'Climate-related crproate reporting: where to next?' (2019), pg 3.
[2] See, eg, IIGCC, 'Institutional investors' expectations of corporate climate risk management' (2012).
[3] See Bank of England, 'Climate change: why it matters to the Bank of England' (2019).
[4] See further, ClientEarth, 'UK financial regulators are missing in action on company disclosure failures' (2019).
[5] See, eg, BlackRock, 'Statement of engagement priorities for 2017-2018'; Bill McNabb, 'An open letter to directors of public companies worldwide'; LGIM, 'Time to act on climate change: engagement with consequences' (2016).

- the TCFD recommendations are a principles-based framework, which provide flexibility for issuers to disclose in a proportionate way, so concerns about any undue burden are unfounded;
- existing laws protect issuers and directors from frivolous or unfounded litigation for making good faith climate-related disclosures – conversely, a confusing ‘comply or explain’ approach may lead to material omissions, increasing legal risk and uncertainty.[6]

2. Apply the new ‘climate rule’ to all issuers for reporting in 2022

Because of the scale and systemic nature of climate change, issuers across every geography and sector will be affected, regardless of size or market capitalisation. The FCA’s proposal to limit the scope of the new ‘climate rule’ to premium listed issuers only would therefore be a mistake and a missed opportunity. It would deprive investors of consistent, high quality and material information for a significant segment of the listed market, increase legal uncertainty and lead to the concentration of climate-related risks in smaller and less resilient issuers and investors exposed to them. The new ‘climate rule’ must apply to all issuers’ reports published in 2022, including those with a ‘standard’ listing on the Main Market of the London Stock Exchange, and issuers listed on the Alternative Investment Market (**AIM**). This is because:

- issuers with a ‘standard listing’ are a significant segment of the Main Market (over 600 issuers and 40% of total market capitalisation) and the AIM includes over 1200 issuers;
- the FCA has provided no explanation about why non-premium listed issuers might be less exposed to climate-related risks and impacts, which might justify lower standards of disclosure;
- the Government said in 2019 that all listed companies would be expected to disclose in line with the TCFD recommendations by 2022,[7] so issuers have had years to prepare – a staged approach with market-wide disclosures delayed until 2023-25, or beyond, is far too late.

3. Require issuers to disclose a ‘Paris-aligned’ strategy (TFCD+)

A mandatory requirement for all listed issuers to align their disclosures with the TCFD recommendations is a necessary starting point to ensuring better quality climate-related disclosures. However, on its own, this will not be sufficient to provide the information that investors are now demanding. In order to adequately meet investors’ current and emerging needs, the FCA must amend the proposed ‘climate rule’ to require issuers to also disclose a ‘Paris-aligned’ strategy, with a credible plan for how they can achieve ‘net zero’ GHG emissions by 2050 (to be referred to as TCFD+). This is because:

- growing awareness of the urgency of the climate emergency and escalating government action mean that investor information needs and issuer disclosure practices now go beyond the TCFD;
- investors are now demanding disclosures about issuers’ strategic alignment with the Paris Agreement objectives, including sector specific short-medium term GHG emission reduction targets (Scopes 1-3), and capital expenditure plans and accounts aligned with these targets; [8]
- as investors increasingly attempt to mitigate systemic climate risks, such disclosures are now widely being used in asset allocation and stewardship decisions and are therefore material.[9]

[6] See CCLI, ‘Concerns misplaced: Will compliance with the TCFD expose directors to liability risk?’ (2017).
[7] HM Government, ‘Green Finance Strategy’ (2019)
[8] See 2Dii, ‘Passing the baton: climate-related shareholder resolutions and their contribution to investor climate pledges’ (2019); UNFCCC, ‘Race to Zero’ (2020); UNEPFI, ‘Net-Zero Asset Owner Alliance’; Sarasin & Partners, ‘Paris-aligned accounting is vital to deliver climate promises’ (2020); Carbon Tracker, ‘When Capex met climate’.
[9] See, eg, Climate Action 100+; S&P Global, ‘BlackRock voted against management at 53 companies over climate concerns’ (2020); Nest, ‘Nest going net-zero to support green recovery’ (2020).

4. Clarify relevance of investor expectations to existing materiality tests

It is widely agreed that issuers are consistently failing to disclose climate-related information material to investors. ClientEarth therefore strongly welcomes the FCA's intention to use a Technical Note to clarify when and how climate change and other ESG matters need to be taken into account to comply with the Listing Rules (**LR**), Disclosure Guidance and Transparency Rules (**DTR**), the Prospectus Regulation (**PR**) and the Market Abuse Regulation (**MAR**). Unfortunately, the draft Technical Note fails to clarify exactly what test issuers must apply to determine what climate-related or ESG information is 'material'. This increases uncertainty and legal risk for both issuers and investors. The FCA must clarify that relevant materiality tests under existing disclosure laws require issuers to consider and meet investors' 'reasonable expectations' for decision useful information, including on climate change. This is because:

- 'materiality' is the basic legal test for many of the disclosure requirements under the LR, DTR, PR and MAR – lack of a clear definition of 'materiality' undermines investor's access to decision-useful information and exposes issuers to increased legal risks;
- for consistency, the FCA should align its definition of 'materiality' with IFRS accounting standards and the Financial Reporting Council (**FRC**), which both broadly define information as 'material' if it could reasonably be expected to influence the decisions of investors;[10]
- if supported by robust accountability and enforcement mechanisms, a clear definition of 'materiality' provides an essential principles-based test for climate-related and ESG disclosures to evolve in line with investors' reasonable expectations.

5. Explain how consistency will be maintained with EU disclosure laws

The EU is currently reviewing and consulting on a wide range of matters regarding climate change and other ESG-related disclosure requirements for issuers and others. In particular, the EU is proposing to make revisions to the NFRD, and to increasingly standardise ESG and climate-related disclosures. Given the significant exposure which UK issuers and investors have to EU markets, it is essential that as much consistency as possible is maintained. Failure to do so could significantly restrict UK issuers access to capital from European investors. The FCA must therefore explain how consistency will be maintained with emerging EU disclosure laws, including those imposed under the NFRD.

6. Confirm actions to close the accountability and enforcement gap

In recent years, ClientEarth has made numerous complaints to the FCA and FRC regarding issuers' failures to adequately disclose material climate-related information under existing disclosure laws.[11] In all cases, the reported issuers were in high-risk sectors but disclosed no meaningful information about climate change-related risks in their annual reports. Despite this evidence, the FRC and the FCA took no public enforcement action. We believe that failure by the FCA to enforce the law severely undermines investor demands for market-wide, decision useful climate change-related information. The FCA must therefore urgently confirm what action it is taking to close existing accountability and enforcement gaps. Enforcement teams must be properly trained and resourced to supervise the scope and adequacy of corporate climate-related disclosures. Where non-compliance is identified, clear and unambiguous enforcement action must be taken. Ultimately, investors must also be given better tools to hold issuers accountable directly, through increased engagement powers, voting rights and access to the courts.

[10] IFRS, 'IAS 1: Presentation of Financial Statements' [7]; FRC, 'Guidance on the Strategic Report' (2018), [5.1].
[11] See, eg, ClientEarth, 'Insurance firms could face fines over climate reporting failure' (2018).

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