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FCA Consultation CP21/18: Enhancing climate-related disclosures by standard listed companies and seeking views on ESG topics in capital markets

ClientEarth Response

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- ClientEarth welcomes the FCA's consultation on expanding climate-related disclosure requirements to issuers of standard listed equity shares, and to invite views on environmental, social, and governance ("**ESG**") topics in capital markets (consultation "**CP21/18**"). We strongly support the introduction of requirements for climate-related disclosures for standard listed issuers. However, the disclosure requirements and scope of companies proposed are insufficient to ensure the granularity of detail that consumers, investors and other stakeholders need and are entitled to expect to make informed decisions.

- Our analysis of annual reporting published in 2021[1] suggests that companies are discussing climate change and environmental impacts, risks, and opportunities more than in the past. However, there is a pervasive lack of clarity on what action on climate change companies are actually taking, and/or are committed to taking at, or by, some future date. Companies are increasingly providing information that is unclear, incomplete, and potentially misleading. Such reports may give rise to greenwash, in that statements made may lead investors, consumers and other stakeholders to believe businesses are doing more to combat climate change than is really the case, with negative consequences. It follows that where information of this nature is incomplete or misleading, consumers and investors are put at risk, and may even be prevented from directing capital in line with net zero or other sustainable transition commitments.

- Further, it is clear from the IPCC's recent sixth assessment report (the "**2021 IPCC Report**") that we must, globally, achieve rapid emissions reductions and transition to net-zero emissions by 2050, in line with the IPCC's very low emissions scenario,[2] to limit warming to 1.5°C by the end of the century. Mandatory, transparent climate-related disclosures are a necessary first step to achieving this transition by: (i) facilitating the timely reallocation of capital away from carbon-intensive business; and (ii) ensuring accountability in relation to harnessing (or failing to manage) climate change, including its associated risks, impacts and opportunities.

- This document sets out ClientEarth's response to CP21/18 and our recommendations on improving climate-related reporting. We believe that our recommendations, if adopted, will:

  - facilitate the timely disclosure of more granular and company-specific information about climate change-related risks, impacts and opportunities for investors, consumers and other stakeholders, which is material to their investment and stewardship decision-making[3];

[1] See ClientEarth's 'Accountability Emergency: A review of UK-listed companies' climate change-related reporting (2019-20)' (4 February 2020)
[2] See Scenario SSP1-1 of the sixth assessment report from the Intergovernmental Panel on Climate Change, 'Climate Change 2021: The Physical Science Basis' (9 August 2021)
[3] See, for example, Climate Action 100+'s 2020 Progress Report on investor-engaged focus companies' growing net zero commitments, related IIGCC press release, and most recently the Climate Action 100+ Net–Zero Company Benchmark

- ensure that financial accounts reflect these matters and are aligned with the goals of the Paris Agreement[4] ("**Paris Goals**") and the UK's commitment to achieve net zero emissions by 2050, in line with investor expectations[5]; and

- better enable the FCA to: (i) meet its statutory objectives to make markets function well, protect consumers, enhance the integrity of the financial system and promote competition;[6] and (ii) meet its remit from HM Treasury to take into account the UK's net-zero target[7].

1. Key recommendations

1. Transition plans: While we support the FCA's proposals to require in-scope companies to disclose transition plans, the FCA must specify that transition plans must **at a minimum** be aligned with the temperature goals of the Paris Agreement and the UK Government's emissions reduction commitments, in line with the best available science.
2. Enforcement: The FCA must procure that it is adequately empowered and resourced to hold laggards accountable for failures to satisfy climate change-related reporting obligations, and must commit to taking such action.
3. Mandatory basis: The rules should be introduced on a clear mandatory basis, not a weak and confusing 'comply or explain' approach.
4. Accounts: The FCA should require all in-scope companies to align their financial accounts with the Paris Goals and the UK's emissions reduction targets, including the underlying assumptions and estimates.
5. Scope 3 emissions: The FCA must expressly require that all in-scope companies, across all sectors, disclose all categories of scope 3 emissions for which they are responsible.
6. Audit of annual report: Auditors must at least be required to provide a 'limited assurance' opinion in relation to climate-related disclosures included in the annual report.
7. Listed debt: Issuers of standard listed debt (and debt-like) securities should be included within scope of the new rules.
8. GDRs and non-equity shares: The new rules should apply to standard listed issuers of global depositary receipts (bank-issued certificates which represent shares in the issuer) and standard listed issuers of shares other than equity shares.

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[4] In particular, Article 2.1a of the Paris Agreement under the United Nations Framework Convention on Climate Change sets the goal of *"Holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above preindustrial levels"* and Article 2.1.c sets the goal of *"Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development"*.

[5] Investor Expectations for Paris-aligned Accounts (November 2020, IIGCC)

[6] Section 1B(2), Financial Services and Markets Act 2000 (as amended)

[7] Letter from the Chancellor of the Exchequer to the Chief Executive of the Financial Conduct Authority (FCA) providing recommendations for the FCA (24 March 2021). This is also reflected in the Financial Services Act 2021 and the new section 143G Financial Services and Markets Act 2000 (FSMA) (coming into force from 1 January 2022).

9. Overlap with BEIS disclosures: Companies that fall within scope of the FCA's climate-related disclosure proposals under CP21/18 and the BEIS climate-related disclosure regime for quoted and large companies should be required to make a single disclosure in the strategic report fulfilling both sets of rules.

2. Consultation Question Responses

Q1: Do you agree with our proposal to extend the application of our existing TCFD-aligned disclosure requirement (set out in LR 9.8.6R(8)) to issuers of standard listed equity shares, excluding standard listed investment entities and shell companies? If not, what alternative scope would you consider to be appropriate, and why?

Yes, we support the FCA's proposals to extend the application of LR9.8.6R(8) to issuers of standard listed equity shares in principle, subject to our comments below on the FCA's 'comply or explain' approach (see our responses to Questions 4 and 8). See also our responses to Questions 2 and 3 in relation to GDRs (as defined), non-equity shares and standard listed debt and debt-like securities.

Q2: Do you consider that issuers of standard listed GDRs and standard listed issuers of shares other than equity shares should also be subject to our TCFD-aligned disclosure requirements? If not, what alternative approach would you consider to be appropriate, and why?

Yes. The new disclosure rules should apply to standard listed issuers of global depositary receipts (bank-issued certificates which represent shares in the issuer) ("**GDRs**"), and standard listed issuers of shares other than equity shares.

GDRs convey a similar interest in the issuer to equity share ownership. Holders of GDRs therefore have a similar interest as investors in equities in obtaining climate-related disclosures in line with the TCFD framework, including to assess the resilience of relevant issuers to climate change. Similarly, investors in non-equity shares (such as preference shares) have an interest in the solvency of issuers and in assessing the resilience of issuers' business models to risks, including climate risks. In addition, holders of GDRs and investors who are motivated to invest in environmentally and socially responsible businesses will require information on the environmental impacts that issuers are either exposed to or responsible for, to inform their decision-making and/or portfolio compositions. Accordingly, issuers of GDRs and non-equity shares should be required to make disclosures in line with the TCFD Recommendations and Recommended Disclosures, as well as the additional proposals in this consultation response (including our response in relation to Paris-aligned transition plans at Question 4).

Q3: We welcome views from market participants on whether to apply TCFD-aligned disclosure rules to issuers of standard listed debt (and debt-like) securities, and how best to do this. In particular, we seek input on the following:

a. **What climate-related information from issuers of these securities would market participants find decision useful and how far would these information needs be met by TCFD-aligned disclosures?**

Investors in listed debt have an interest in the solvency of issuers and in assessing the resilience of issuers' business models to risks. They therefore have a similar interest to investors in equities in obtaining information on issuers' climate risk management systems, governance, strategies, metrics and targets (in line with the TCFD framework). In addition, investors (in both listed debt and equities) who want to invest in environmentally and socially responsible businesses will require information on the environmental impacts that issuers are either exposed to or responsible for, to inform their decision-making and/or portfolio compositions. Accordingly, issuers of listed debt should be required to make disclosures in line with the TCFD Recommendations and Recommended Disclosures, as well as the additional proposals in this consultation response (including our response in relation to Paris-aligned transition plans at Question 4).

b. Do market participants' information needs differ according to the different types of issuer in LR 17?

We consider mandatory TCFD-aligned reporting would provide sufficient flexibility to allow companies to disclose according to their size and circumstance. In our view, that framework, if implemented, would be capable of accommodating differing information needs among market participants in relation to different types of issuers.

c. If you consider that we should apply TCFD-aligned disclosures rules to issuers of standard listed debt (and debt-like) securities, should some issuer types be excluded from the rule to deliver an effective and proportionate approach? If so, which types of issuers should be included/excluded and how can the scope best be defined?

We consider that TCFD-aligned disclosures, as a principles-based approach, should apply to **all** issuers. However, we note that the FCA suggests in the consultation that *"the TCFD's recommendations may not be an effective and proportionate framework for disclosures by certain public sector and non-operating company issuers"*. If the FCA does introduce tailored disclosure requirements for such entities, we recommend that the full suite of TCFD Recommendations and Recommended Disclosures should nevertheless apply to all other types of company/organisation that issue listed debt (and debt-like) securities, for the reasons set out at Question 3a above.

d. Are there any other matters we should take into consideration – eg, competitiveness, complexity of the application of the rule, burden on issuers in LR 17, or the feasibility to comply with any potential rules?

We reiterate that (as we indicate above in response to Question 3b) we consider a mandatory TCFD-aligned reporting requirement would offer sufficient flexibility to allow companies to disclose according to their size and circumstance, and so the implementation of such a rule to all issuers would be appropriate and proportionate.

Q4: Do you agree with our proposal to mirror the structure and wording of LR 9.8.6R(8) and LR 9.8.6BG to LR9.8.6EG for companies with a UK premium listing? If not, what alternative approach would you consider to be appropriate, and why?

As we explained in our response to the FCA's consultation CP20/3 on enhancing climate-related disclosures by listed issuers, which resulted in Policy Statement PS20/17 and the introduction of LR9.8.6R(8) last year[8], we consider that the newly introduced Listing Rule for premium listed companies does not go far enough, in that the rule does not mandate TCFD-aligned disclosures or Paris-aligned transition plans. While we appreciate the FCA is not currently consulting on amendments to LR9.8.6R(8), we would welcome proposals to enhance it in this regard.

[8] See paragraphs 1 and 3 of ClientEarth's briefing, 'FCA Consultation CP20/3: Proposals to enhance climate-related disclosures' (August 2020), and PS20/17, published on 21 December 2020

Given this, and for the reasons set out below, the FCA should depart from the wording of LR 9.8.6R(8) by requiring companies to: (i) ensure their transition plans are consistent with the Paris Goals and **at a minimum** the UK's emissions reduction commitments; (ii) reflect their transition plans, as well as the Paris Goals and the UK's emissions reduction commitments, in their financial statements; (iii) disclose scope 3 emissions; and (iv) where the company is also within scope of BEIS' proposed disclosure regime for large companies, make a single climate-related disclosure satisfying both regimes. In addition, see our response to Question 8 below in relation to the rules being put on a **mandatory** basis (instead of 'comply or explain').

Paris-aligned transition plans

The FCA's proposals would require all in-scope companies to disclose transition plans in their TCFD entity reports, by virtue of incorporating the TCFD's upcoming revised guidance on metrics, targets and transition plans (the "**TCFD Proposed Guidance**").[9] While we support the introduction of a requirement to disclose transition plans, we would urge the FCA to go further than the TCFD Proposed Guidance and specify detail on their content in line with our recommendations below.

Transition plans must be aligned with limiting warming to 1.5°C above pre-industrial levels (in line with the best available science). **At a minimum,** this must include:

(i) Emissions reduction targets (covering scopes 1-3)[10] that are aligned with the UK Government's commitment to achieve net-zero emissions by 2050 and to reduce emissions by 68% and 78% (compared to 1990 levels) by 2030 and 2035 respectively,[11] and with the sectoral emissions reductions under the balanced net-zero pathway in the Climate Change Committee's Sixth Carbon Budget.[12]

(i) A credible, science-based strategy for meeting emissions reduction targets. In order to be credible, the strategy must not unreasonably rely on unproven or un-costed emissions reduction technology, and should only rely on carbon offsets in relation to residual emissions which it is not technologically feasible to eliminate.[13]

(ii) Short term (e.g. 2 to 5 year) and medium term (e.g. 6 to 10 year) interim emissions reduction targets.

(iii) Plans covering all aspects of their business, including capital expenditure plans.[14]

(iv) A description of the company's strategy for shareholder engagement and/or divestment in relation to relevant carbon-intensive sectors.

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[9] Which was set out in draft in the TCFD's Consultation on Proposed Guidance on Climate-related Metrics, Targets and Transition Plans (2021). The revised guidance on transition plans states: *"An organization should release a transition plan component of its strategy if an organization determines it has material climate-related transition risks, including if it operates in a jurisdiction with an emissions reduction commitment, has made an emissions reduction commitment, or seeks to meet emissions reduction expectations from financial market participants"*.

[10] For the avoidance of doubt, companies should include emissions from any investment and/or underwriting portfolios they have, within their scope 3 emissions reduction targets.

[11] The Government's 'UK Nationally Determined Contribution' (2020) commits to reduce emissions by 68% (compared to 1990 levels) by 2030, and the Carbon Budget Order 2021 implies a 78% reduction in emissions (compared to 1990 levels) by 2035.

[12] See 'The Sixth Carbon Budget The UK's path to Net Zero' (UK CCC, December 2020)

[13] For more information on issues with carbon offsets, see ClientEarth's response to the TCFD's consultation proposed guidance on metrics, targets and transition plans for more information on offsets at paragraph 8 onwards (11 July 2021).

[14] See the Climate Action 100+ Net-Zero Company Benchmark (2021) at Disclosure Indicator 6.

(v) The company's underlying methodologies for setting targets and measuring progress (including detailing any material assumptions and uncertainties in those methodologies).

In addition, the disclosures on governance should allocate responsibility for implementing the transition strategy to specific individuals within the company, and set out a remuneration policy that incentivises senior managers to implement the company's transition strategy and to meet the targets.

All companies should be required to adopt transition plans containing the above emissions reduction targets. Any companies that fail to set such targets (in breach of the rules) should be liable to potential enforcement action for non-compliance with these requirements.

A mandate that all companies specifically target such emissions reductions is necessary because:

(i) Companies must align with national emissions reduction commitments in order to mitigate transition risks in an effective and orderly manner (including the burden of responding to further regulatory and legal step changes to achieve the IPCC's very low emissions scenario, which we consider is inevitable in circumstances where the UK Government's roadmap for climate related disclosures[15] is currently out of step with that scenario).

(ii) The urgency of the climate emergency and escalating government action mean that investor information needs and company disclosures have evolved beyond the TCFD framework's focus on risks and opportunities towards disclosure of alignment with the Paris Goals.[16] Investors are demanding information about companies' strategic alignment with the Paris Goals[17] and are clear that such information is material to their investment and stewardship decision making.[18] In addition, the increasing number of industry and company-led initiatives demonstrates that expectations regarding climate-related disclosures have shifted towards Paris-alignment (see for example the Glasgow Financial Alliance for Net-Zero, Net-Zero Asset Owner Alliance, Net-Zero Asset Managers Initiative, Net-Zero Insurance Alliance, Principles for Responsible Banking and Science Based Targets Initiative).[19] Failure to reflect this reality in the new disclosure obligations will cause confusion for companies and undermine investor efforts to secure material information to guide their decision-making.

(iii) The FCA must ensure the new rules incentivise companies to reduce emissions at least in line with UK Government's emission commitments, in order to meet its new remit from HM Treasury

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[15] A Roadmap towards mandatory climate-related disclosures (2020).
[16] For example, see Climate Action 100+, 'Net-Zero Company Benchmark' (2020); Transition Pathway Initiative, 'TPI State of Transition Report 2021' (2021); ISS, 'Climate & Voting – 2020 Review and Global Trends' (2021). The TCFD states in its Consultation on Proposed Guidance on Climate-related Metrics, Targets and Transition Plans (2021) that: *"Since the publication of the IPCC special report, the concept of net-zero targets has entered mainstream corporate and political debate, with many leading companies, financial institutions, and a growing number of governments setting net-zero targets for mid-century."*
[17] For example, see Larry Fink's 2021 letter to CEOs which states *"we are asking companies to disclose a plan for how their business model will be compatible with a net zero economy"*; 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'. Climate Action 100+, 'Net-Zero Company Benchmark' (2020).
[18] For example, see 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). The Institutional Investors Group on Climate Change has 250 members across 16 countries with over €33 trillion in assets under management.
[19] See: Science Based Targets Initiative; the UN's Net Zero Asset Owner Alliance, Net Zero Insurance Alliance and the Principles for Responsible Banking; the Net-Zero Asset Managers Initiative, and press release, 'New Financial Alliance for Net Zero Emissions Launches' (UNCC, 21 April 2021).

on climate change[20]. Requiring companies to disclose and manage their own financial risks is not sufficient to incentivise them to meet these emission commitments, and will not effectively mitigate systemic climate risks (i.e. risks that climate change poses to the stability of the economy and financial sector as a whole). Instead, it is necessary to mandate that companies specifically target net-zero emissions, as the UK's Climate Change Committee has recommended in respect of the financial sector[21]. Given the UK Government's emission commitments and the FCA's enhanced remit on climate change, as well as the urgency of the climate crisis, we urge the FCA to go beyond the TCFD's current position on transition plans (and, similarly, cannot wait for standards on transition plans from the International Sustainability Standards Board ("**ISSB**")).

(iv) Failure to introduce requirements to disclose Paris-aligned transition plans will create costly inconsistency with new EU requirements, which will require such disclosures.[22]

(v) It is clear, in light of the TCFD Proposed Guidance, that the direction of travel is for all companies to be disclosing Paris-aligned transition plans. The UK has a timely opportunity to take the lead on mandating this and in setting the standards for credible and effective transition plans.

(vi) While currently there are a wide variety of frameworks and methodologies being used by companies in order to set Paris-alignment or net-zero targets, the lack of a single market standard should not be used as an excuse for inaction. Numerous initiatives are now underway to standardise and consolidate the different approaches being used, and Climate Action 100+ (representing $54 trillion investments) has issued a Net-Zero Company Benchmark[23], which provides a framework to assess companies' climate strategies. In the interim, some flexibility can be permitted to allow issuers to select the most appropriate approach for their business, as long as assumptions are reasonable, evidence-based and transparently disclosed. ClientEarth's 2020 Position Paper on Principles for Paris-alignment provides an example of a flexible and principles-based form of disclosure obligation which could be adopted, while standards and methodologies continue to develop.[24]

Paris-aligned accounts

Narrative disclosures alone, even when aligned with the TCFD and including a transition plan, are not enough. Companies need to accurately reflect climate-related risks and opportunities in their financial accounts (for example, reflecting climate-related asset impairments). To set and implement credible transition plans and provide investors with decision-useful information, company accounts need to reflect that transition plan, and take account of: (i) their narrative climate-related disclosures (including their transition plan); and (ii) the impact that the upcoming transition of the wider economy (in line with UK

[20] HM Treasury's letter dated 23 March 2021 requires the FCA to have regard to the UK government's net-zero commitment, as set out in the Climate Change Act 2008, when advancing its objectives and discharging its functions.
[21] For example, the Advisory Group on Finance for the UK's Climate Change Committee recommended in 'The road to Net-Zero Finance' (2020) that the UK must mandate that financial institutions make net-zero plans, rather than solely seek to mitigate financial risks.
[22] See European Commission, Proposal for a Directive amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting (2021).
[23] See the Climate Action 100+ Net-Zero Company Benchmark (2021).
[24] See ClientEarth's Position Paper on Principles for Paris-alignment (October 2020)

emissions reduction commitments and the Paris Goals) will have on financial trajectories. Assumptions must also be clearly disclosed, so they too can be assessed.

The requirement to disclose transition plans must therefore be supplemented by a requirement for companies' financial accounts to be aligned in this regard. The IIGCC has set out expectations for Paris-aligned accounts, which renders our recommendation in this regard proportionate and could serve as a basis for the FCA or FRC to produce their own guidance on the issue.

At a minimum, companies' accounts should include:

(i) an affirmation that the accounts are aligned with the Paris Goals and UK emissions reduction commitments (and if accounts cannot be so aligned, companies should disclose what adjustments would be required for them to be aligned) and disclosure of the assumptions used;[25]

(ii) adjustments to assumptions and estimates to ensure that they are aligned with the Paris Goals and UK emissions reduction commitments;

(iii) disclosure of the results of sensitivity analysis to variations in those assumptions and estimates;

(iv) disclosure of the implications of aligning with the Paris Goals and UK emissions reduction commitments to dividend paying capacity; and

(v) confirmation that the accounts and underlying assumptions are consistent with narrative reporting on climate risks, impacts and opportunities (including the company's transition plan).

In addition, the accounts should be tested by auditors against Paris-aligned assumptions and estimates (and the auditors must flag to shareholders where any assumptions fall short). Investors have made clear that they expect auditors to test that climate factors are properly reflected in Paris-aligned accounts.[26]

Proper testing of assumptions and estimates against the Paris Goals and UK emissions reduction commitments (including reflecting climate-related risks, impacts and opportunities) will reduce the risk of inaccurate cost and return information (for example, failing to reflect asset impairments), which left unchecked could mislead both investors and directors. Further, accurate information will better enable companies to set and adhere to credible transition plans, in line with investor expectations. However, currently, companies are largely failing to align their accounts with the Paris Goals, even where they disclose climate risks in line with the TCFD's recommendations.[27]

Scope 3 emissions

Now that data and methodologies have matured sufficiently[28], we urge the FCA to expressly require that all in-scope companies, across all sectors, disclose all categories of scope 3 emissions for which they are responsible.[29] This will facilitate better decision-making by all stakeholders, including on company strategy

[25] See also our recent response to the BEIS consultation on restoring trust in audit and corporate governance (8 July 2021) on these issues.
[26] Ibid.
[27] Investor Expectations for Paris-aligned Accounts (November 2020, IIGCC)
[28] See the TCFD's recent consultation documents, '*Proposed Guidance on Climate-related Metrics, Targets, and Transition Plans*' and the associated '*Measuring Portfolio Alignment: Technical Supplement*' (FSB-TCFD, July 2021) which states that it is now appropriate for all companies to disclose scope 3 emissions.
[29] For the avoidance of doubt, companies should disclose emissions from any investment and/or underwriting portfolios they have, within their scope 3 emissions disclosure.

and adaptation measures. We consider this recommendation critical to facilitating the low carbon economy transition, because:

(i) Scope 3 emissions are the largest source of a company's emissions in most sectors[30], meaning disclosure of scopes 1 and 2 only presents a dangerously incomplete picture of emissions reduction.

(ii) The current voluntary framework is not fit for purpose, in that our analysis has found the majority of companies opt out[31].

(iii) The TCFD Recommended Disclosures (which are incorporated in the proposed new disclosure rules) are not sufficiently clear on the requirement to disclose scope 3 emissions. They provide that companies should disclose scope 3 emissions *"if appropriate"*,[32] which could lead to some companies electing not to disclose their scope 3 emissions. It is imperative that the FCA clarify that all companies must disclose them.

Overlap with BEIS disclosure

CP21/18 and BEIS' proposed climate-related disclosure regime for quoted companies and large companies and LLPs[33] both propose to impose requirements for companies to make climate-related disclosures consistent with the TCFD Recommendations and Recommended Disclosures in their annual report. The FCA should specify that companies that fall within the scope of both regimes should make a single disclosure in their strategic report fulfilling the requirements of both regimes. A single disclosure would be clearer, more straightforward and more readily comprehensible for investors, rather than providing separate differing disclosures in multiple locations in the annual report. This would also help to reduce the already significant burden on investors and other users of this information to review disclosures and identify material disclosures.

Q5: Do you agree that, subject to the TCFD's final guidance materials being broadly consistent with those proposed, we should incorporate them into our existing and proposed handbook guidance provisions as described (including both the existing guidance relating to LR 9.8.6R(8) and our proposed new guidance relating to LR 14.3.27R):

a. the and TCFD Annex

b. the TCFD's proposed standalone guidance document on metrics, targets and transition planning

c. the TCFD's technical supplement on measuring portfolio alignment.

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30 Science Based Target Initiative, 'Value Change in the Value Chain: Best Practices in Scope 3 Greenhouse Gas Management' (2018). It is estimated that the scope 3 emissions of oil and gas companies are six times their scope 1 and 2 emissions (see MSCI, 'Scope 3 Carbon Emissions: Seeing the Full Picture' (2020)) and that the portfolio emissions of global financial institutions are over 700 times greater than their operational emissions (see CDP, 'Financial Services Disclosure Report 2020: The Time to Green Finance' (2020).).

31 Two thirds of FTSE 250 companies in 2019-2020 did not disclose their scope 3 emissions, and those that did were often not fully transparent about the methodology and exclusions applied in calculations – see our 'Accountability Emergency, A review of UK-listed companies' climate change-related reporting (2019-20)' (4 February 2021).

32 The TCFD's consultation on metrics, targets and transition plans states that disclosure of scope 3 emissions is now appropriate for all sectors, but nevertheless retains the caveat in the Recommended Disclosures that scope 3 emissions need only be disclosed *"if appropriate"*.

33 Set out in BEIS Consultation on requiring mandatory climate-related financial disclosures by publicly quoted companies, large private companies and Limited Liability Partnerships (LLPs).

If not, what alternative approach would you prefer?

We agree that the proposed rules and guidance should incorporate the TCFD Final Report and TCFD Annex in their updated versions, and the TCFD's proposed guidance on metrics, targets and transition plans and the proposed technical supplement on measuring portfolio alignment. However, there are some areas where the FCA needs to go further than the TCFD's Recommendations and Recommended Disclosures and the TCFD Proposed Guidance, as set out in this consultation response. In particular, see our response to Question 4 above in relation to Paris-aligned transition plans. Further detail on our position on the TCFD's proposed guidance can be found in our response to the TCFD's consultation.[34]

Q6: Do you agree that we should update the Technical Note 801.1 to reflect the proposed new rule and associated guidance in this CP?

Yes. We agree that Technical Note 801.1 should be updated to reflect the new rules and guidance.

Q7: Do you agree with our encouraging listed companies to consider the SASB metrics for their sector when making their disclosures against the TCFD's recommended disclosures, as appropriate? If not, please explain.

We have no comments in relation to this question.

Q8: Do you agree with our approach to maintain a 'comply or explain' compliance basis until such time as a common international reporting standard has been published and adopted in the UK? If not, what alternative approach would you prefer, and why?

Mandatory basis

We strongly recommend that the TCFD-aligned disclosure requirement should be introduced on a clear mandatory basis, not a weak and confusing 'comply or explain' approach[35]. This is because:

(i) Investors already expect issuers to use the TCFD Recommendations and Recommended Disclosures to provide material climate-related information to satisfy existing disclosure requirements.[36] Anything less than a clear, mandatory, disclosure requirement risks depriving investors and other stakeholders of the 'decision useful' information they need now and are entitled to expect.

(ii) This recommendation, if adopted, would better enable the redirection of capital urgently required to achieve the IPCC's very low emissions scenario, which is critical in light of the findings of the 2021 IPCC Report.

(iii) Any additional liability risk to companies from mandating climate-related disclosure would be proportionate, and would be limited in any event because existing laws protect companies and directors from frivolous or unfounded litigation in respect of good faith climate-related disclosures[37]. Conversely, a confusing 'comply or explain' approach

[34] See ClientEarth's response to the TCFD's consultation proposed guidance on metrics, targets and transition plans for more information on offsets at paragraph 8 onwards (11 July 2021).
[35] See ClientEarth's 'FCA climate risk disclosure consultation briefing' on LR9.8.6(8) – in particular paragraph 1 (7 August 2020)
[36] For example, see Larry Fink's 2021 letter to CEOs which states *"we asked all companies to report in alignment with the recommendations of the Task Force on Climate-related Financial Disclosures"*.
[37] See CCLI, 'Concerns misplaced: Will compliance with the TCFD expose directors to liability risk?' (2017)

may lead to material omissions, increasing legal risk and uncertainty, and undermining the credibility of the UK's growing sustainable finance market.

(iv) Given the UK Government's emissions reduction commitments and the FCA's remit, as well as the urgency of the climate crisis, we urge the FCA to mandate climate-related disclosures now. We recognise that standards for climate-related disclosures are evolving (for example, the ISSB will be issuing standards). However, given the urgency outlined above, this is not a reason to delay mandatory TCFD-aligned disclosure.

Enforcement

While a clear and mandatory reporting mechanism is essential, it is also crucial that the FCA closes the accountability gap on climate-related reporting. Specifically, it must procure that it is adequately empowered and resourced to hold laggards accountable for failures to satisfy climate change-related reporting obligations – both those existing and to be implemented – via robust, consistent, and timely enforcement action. This will enable the FCA to fulfil its new remit to have regard to the UK Government's commitment to achieve a net-zero economy by 2050 when considering how to advance its objectives and discharge its functions[38]. If the FCA does not secure compliance, it risks being ignored by those it regulates, in turn posing a direct threat to market function, consumer protection, and the integrity of the UK's financial markets.

Q9: Do you agree with our approach not to require third party audit and assurance for issuers' climate-related disclosures at this time? If not, what additional requirements would you consider to be appropriate?

No. Given the urgency with which climate risks, impacts and opportunities must be priced into the market and be able to be properly assessed, we strongly recommend that auditors must at least be required to provide a 'limited assurance' opinion in relation climate-related disclosures included in the annual report.

Consideration of material climate change-related trends and risks facing a company, including whether such trends and risks might have implications for assumptions and estimates used in preparing financial accounts themselves[39] is part of the analysis by investors when making decisions on any (re)allocation of capital. Independent, third party assurance provides investors with greater confidence the information can be trusted. This serves a critical role in providing investors with assurance (to the standard set by relevant International Standards on Auditing) that information disclosed by companies about trends and risks facing their business has been prepared in accordance with the relevant legal requirements, is free from material misstatements, and is otherwise fair, balanced and understandable.

Q10: Do you agree that our new rule should take affect for accounting periods beginning on or after 1 January 2022? If you consider that we should set a different timeframe, please explain why.

The 2021 IPCC Report underlines the urgency with which action to reduce emissions is required, in order to meet its very low emissions scenario.[40] Mandatory, transparent climate-related disclosures are a necessary first step to achieving such reductions, by: (i) facilitating the timely reallocation of capital away

[38] Letter from the Chancellor of the Exchequer to the Chief Executive of the Financial Conduct Authority (FCA) providing recommendations for the FCA (24 March 2021). This is also reflected in the Financial Services Act 2021 and the new section 143G Financial Services and Markets Act 2000 (FSMA) (coming into force from 1 January 2022).

[39] See further, our recent response to the BEIS consultation on restoring trust in audit and corporate governance (8 July 2021)

[40] Scenario SSP1-1.

from carbon-intensive business; and (ii) ensuring accountability in relation to harnessing (or failing to manage) climate change, including its associated risks, impacts and opportunities.

In view of this, the FCA's new rules should be introduced for **all** in-scope companies for periods beginning on or after 1 January 2022. While ambitious, we consider this timeframe is realistic and proportionate given advancements in data and methodologies, which can be further refined through common use. Uncertainty is not a reasonable excuse to delay implementation[41].

Q11: Do you agree with the conclusions and analysis set out in our cost benefit analysis (Annex 2)?

We have no comments in relation to this question.

Q12: If future changes were considered in relation to the UK prospectus regime, we would welcome views on also taking the opportunity to introduce specific requirements in relation to UoP bond frameworks and their sustainability characteristics?

We have no comments in relation to this question.

Q13: Should the FCA explore supporting the UoP bond market by recognising existing standards (eg, ICMA Principles), potentially through our recognition of industry codes criteria and process?

We have no comments in relation to this question.

Q14: We would also welcome views on more ambitious measures the FCA could consider, for example to require that the central elements of UoP bonds be reflected in contractual agreements and set out in the prospectus

We have no comments in relation to this question.

Q15: We would welcome views on the potential harm set out above and what, if any, actions the FCA or the Treasury should consider.

We have no comments in relation to this question.

Q16: Should the FCA, alongside the Treasury, consider the development and creation of a UK bond standard, starting with green bonds?

We have no comments in relation to this question.

Q17: Do you agree with how we have characterised the challenges and potential harms arising from the role played by ESG data and rating providers? If not, please explain what other challenges or harms might arise?

The potential for conflicts of interest and "ratings shopping" to arise should not be underestimated on the basis that ESG data and ratings providers currently commonly operate an "investor pays" rather than an "issuer pays" model. The use of ESG ratings and data products has grown exponentially in response to investors' mounting interest in investing in companies that take account of sustainability in the way they are run, resulting in the proliferation of participants in the industry, including established credit ratings

[41] 'Uncertainty Is Not an Excuse. Integrating Climate Risks into Monetary Policy Operations and Financial Supervision' (SUERF Policy Briefs No 72, April 2021)

agency participants (directly or through their affiliates)[42]. That growth is expected to continue, with some predicting the market may reach USD 1 billion by 2021, with an expected annual growth of 20%, while ESG indexes could grow by 35%[43]. In light of this, and as demand for sustainability and/or ESG-linked financial products increases we expect that asset managers, among other users, will turn to ESG ratings and data to demonstrate or justify portfolio alignment. As such, in addition to preferring providers on a reputational basis, as the FCA has identified, users may be driven to 'shop' for the highest available ratings to justify claims as to the sustainability of products, and to demonstrate that they have fulfilled their duty to act in the best interest of their clients.

The resulting pressure on ESG data and ratings providers from any such "ratings shopping" will, further, inevitably increase the risk of conflicts of interest by incentivising those providers to issue higher or "best-in-class" ESG ratings in order to gain or retain existing investor clients, causing potentially significant harm to market functioning.

Finally, we note the FCA's acknowledgement that ESG ratings and data are subject to data gaps because they generally rely on publicly available data to support providers' rating judgments. If left unchecked, inconsistent or inaccurate ESG ratings and data, which do not take proper account of all relevant factors, including climate-related risks and impacts, may give rise to the risk of greenwashing investors and other users. In other words, investors and other users may be misled to believe that financial products or companies are doing more to address ESG issues than they really are. This can give rise to potentially significant negative consequences such as market and share price instability[44], preventing the desired (re)allocation of capital towards a lower carbon economy, the mispricing of investments, and/or increased liability risk across the financial sector[45].

Other regulators are already probing some of these issues[46]. As we explain below in response to Question 19, this consultation presents a timely opportunity for the FCA to pre-empt and mitigate these risks by implementing new due diligence requirements for users to verify the quality of ESG data and ratings, and to bring ESG data and ratings providers inside its regulatory perimeter.

Q18: Would further guidance for firms on their use of ESG ratings – and potentially other third-party ESG data – be useful, potentially clarifying expectations on outsourcing arrangements, due diligence, disclosure and the use of ratings in benchmarks and indices? Are there other aspects such guidance should include?

While we would support the issuance of guidance for firms on their use of ESG ratings and data as proposed, in our view this will not be sufficient to mitigate the risks we have described above. To ensure the transparency, credibility and decision-usefulness of ESG ratings and data (and in line with our response to Question 19, below) we strongly recommend that the FCA take this opportunity to implement new due diligence requirements for users and to bring ESG data and ratings providers inside the FCA's regulatory perimeter.

Q19: We would welcome views on whether there is a case either to encourage ESG data and rating providers to adopt a voluntary Best Practice Code, or for the FCA to engage with the Treasury to

[42] See for example IOSCO's recent consultation, CR02/21 on Environmental, Social and Governance (ESG) Ratings and Data Products Providers (July 2021)
[43] Ibid.
[44] See '<u>Deutsche Bank's DWS Slumps After U.S., Germany ESG Probe</u>' (Bloomberg, 26 August 2021)
[45] See 'Deutsche Bank's ESG Probe Triggers Review at Asset Managers' (Bloomberg, 2 September 2021)
[46] See '<u>Fund Managers Feel Heat in SEC Crackdown on Overblown ESG Labels</u>' (Bloomberg, 3 September 2021)

encourage bringing ESG data and rating providers' activities inside the FCA's regulatory perimeter.

We understand that the FCA is shortly due to publish its Climate Adaptation Report[47]. The Chancellor also announced in his Mansion House speech on 1 July 2021 that the Government intends to introduce new economy-wide Sustainability Disclosure Requirements ("**SDR**") that will require reporting for the first time on environmental and sustainability impact, alongside the financial risks/opportunities these pose to business. These new requirements will, we understand, seek to bring together and streamline all UK sustainability reporting requirements, including the Chancellor's commitment to mandatory TCFD disclosures that require firms to report on the financial risks and opportunities posed to their business from climate change. If such a framework is implemented then the accuracy, transparency, and credibility of ESG data and ratings will be of critical importance to those seeking to demonstrate compliance with the SDR, as well as for those seeking to leverage that information for investment decision making.

The FCA's consultation CP21/18 therefore presents a timely opportunity for the FCA to pre-empt and mitigate the risks we identify in response to Question 17 above, to prevent the integrity and transparency of ESG data and ratings being further called into question and to enhance trust in the market. Accordingly, we strongly recommend that the FCA:

(i) introduce a new requirement that asset managers and other FCA-regulated entities using ESG data and ratings when marketing funds with a sustainability and ESG focus, or to otherwise describe their investment strategies[48]:

a. consider the fitness for purpose of ESG data and ratings providers in meeting investors' information needs;

b. exercise due skill, care and diligence when entering into, managing or terminating any arrangement with third party providers in relation to the performance of ESG risk management activities;

c. establish methods for the ongoing assessment of the standard of performance of ESG third parties; and

d. disclose details of that due diligence in a clear, accessible and comprehensible manner;

(ii) engage with the Treasury to procure that ESG data and ratings providers (or **at a minimum** ESG ratings providers) are brought inside the FCA's regulatory perimeter. While there is a close connection between credit rating agencies and ESG data and ratings providers, we do not think that amending the existing UK Credit Rating Agencies Regulation[49] to take account of ESG ratings and data services would be appropriate. This is because ESG scores differ greatly from credit ratings in terms of how and for what purpose they are used, who they are used by, and in terms of incentives. Instead, we believe that protecting consumers and the integrity of the UK's fast-growing sustainable financial markets, and promoting effective competition, would best be achieved by creating an ESG data and ratings specific legislative and regulatory

[47] https://www.fca.org.uk/publication/business-plans/business-plan-2021-22.pdf
[48] This would be consistent with the FCA's recent guiding principles to authorised ESG & Sustainable Investment Funds (21 July 2021)
[49] The current EU Credit Rating Agencies Regulation was onshored into UK law on 31 December 2020, with the necessary modifications contained in the CRA Regulations 2019.

framework based on principles already applicable to credit ratings agencies. In particular, we strongly recommend that framework should require that ESG ratings providers:

a. disclose details of the methodologies and governance systems in place for providing ESG ratings; and

b. take all necessary steps to ensure that the issuing of an ESG rating or outlook is not affected by any existing or potential conflicts of interest[50].

These recommendations, if adopted, would be consistent with and help to inform the current global focus on transparency and conflicts of interest[51], and significantly help to address the live risks we identify above in response to Question 17.

Q20: If there is a case for closer regulatory oversight of ESG data and rating providers, we welcome views on:

a. Whether transparency, governance and management of conflicts of interest are the right aspects of ESG data and rating providers' operations and activities to prioritise in regulatory oversight, and if not, what other aspects should be considered

We have no comments in relation to this question beyond our comments in response to Questions 17, 18 and 19 above.

b. Whether and how regulatory priorities should differ between ESG rating providers and other ESG data providers

We have no comments in relation to this question beyond our comments in response to Question 19 above.

c. The similarities and differences between the policy issues that arise for ESG rating providers and those that arise for CRAs, and how far these similarities and differences might inform the appropriate policy response

We have no comments in relation to this question beyond our comments in response to Questions 17 and 19 above.

Q21: What other ESG topics do you consider that we should be prioritising to support our strategic objective?

Please explain.

We have no comments in relation to this question beyond our responses to Questions 17 to 20 above.

[50] This could take the form of a requirement broadly consistent with that set out in Article 6 UK CRA, 'Independence and avoidance of conflicts of interest'
[51] See 'French and Dutch financial market authorities call for a European regulation of ESG data, ratings, and related services' (AMF France, 15 December 2020)

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