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

Law Society and City of London Law Society joint response

5 May 2021

City of London Law Society Company Law Committee

BEIS Consultation Paper: Consultation on requiring mandatory climate-related financial disclosures by publicly quoted companies, large private companies and LLPs

A. Introduction

The views set out in this paper have been prepared by a Joint Working Party of the Company Law and the Planning and Environmental Law Committees of the City of London Law Society (**CLLS**) and the Law Society of England and Wales (the **Law Society**).

The CLLS represents approximately 17,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multijurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

The Law Society is the professional body for solicitors in England and Wales, representing over 170,000 registered legal practitioners. It represents the profession to Parliament, Government and regulatory bodies in both the domestic and European arena and has a public interest in the reform of the law.

The Joint Working Party is made up of senior and specialist lawyers from both the CLLS and the Law Society who have a particular focus on issues relating to corporate law and environmental and planning law.

The Joint Working Party thought it would be helpful to set out its overarching comments, before then providing responses in relation to your specific questions. These are set out below.

B. Overarching comments

- **Consistency with existing legislation and standards**:

  The Consultation Paper (the CP) recognises the importance of implementing rules that are in line with existing standards, and which do not conflict with legislative requirements. Equal focus should be given to legislative developments at a UK and international (including EU) level, to ensure the proposals maintain the UK's position as an attractive place to do business and to ensure the proposals remain appropriate to the UK market. Further, any legislative developments should not hinder the convergence of global ESG standards and/or ESG market practices.

  Divergence from the EU and the implications for EU wide-groups

  The TCFD's four pillar framework of Governance, Strategy, Risk Management and Metrics, and Targets differs from the EU Non-Financial Reporting Directive (NFRD) both in terms of reporting materiality thresholds and the substance of the disclosures. The latter requires reporting on external impacts in addition to financial materiality, and across environmental, social and governance metrics (not solely climate). This divergence potentially gives rise to conflicting rules for some companies. Further, the proposed Corporate Sustainability Reporting Directive (CSRD) is seeking to amend and extend the scope of the NFRD regime. The CSRD would capture substantially more companies, and introduce more detailed reporting requirements, potentially resulting in a greater number of groups with businesses in the UK and the EU having to comply with different reporting requirements as between their UK and EU entities.

Also, Article 8 of the EU Taxonomy Regulation potentially brings in wider reporting for organisations covered by the NFRD. The divergence is likely to continue in the context of the UK Green Taxonomy and the EU (or other global) Taxonomy(ies). This divergence across jurisdictions will make it more onerous for EU-wide groups to comply, as they may face different reporting requirements in different jurisdictions.

International alignment

As part of this discussion (and as reflected in the CP), any developments in the UK also need to take into account the rapidly evolving international framework. This international dimension is likely to increasingly involve the US and, specifically, the US Securities and Exchange Commission (SEC). In particular, the SEC has just established a new Climate and ESG Task Force and is assessing climate change reporting obligations.

Overlap and a lack of consistency

Whilst the proposals in the CP appear to show generic alignment, it would be helpful for BEIS to provide more details to ensure consistency with existing legislation and standards. In particular, the potential combination of: (i) the proposals in the CP; (ii) the BEIS consultation document in respect of Restoring Trust in Audit and Corporate Governance (the audit paper); (iii) the Listing Rules; (iv) the Streamlined Energy and Carbon Reporting (SECR) regime; and (v) the proposed CSRD, could result in a company being subject to multiple (and different) reporting obligations on the same issue (i.e. climate change risks and climate change mitigation). There is a real risk that too many different regimes, and fragmentation of these regimes, may hamper proper reporting.

The position regarding the specific overlap with the UK Listing Rules (LRs) is considered below. However, in relation to companies not subject to the LRs, we would particularly highlight the audit paper. Our view is that BEIS should give consideration as to how the proposals in the CP and the outcome of the proposals in the audit paper will fit together to ensure consistency between regimes. For instance, in contrast to the CP, the audit paper proposes to make scenario analysis mandatory.

Another example of inconsistency is that the CP states that the climate-related financial information will be included in the non-financial information statement which forms part of the Strategic Report, but does not indicate in any detail how this disclosure will be accommodated alongside the current requirements. Likewise with regards to the SECR disclosures, as specified in Q9 below. We would urge BEIS to consider carefully how all of the relevant regimes interact and overlap, and what the ultimate cumulative impact is for affected companies and LLPs.

The CP also underlines that the UK Government sees the benefit of further international alignment on the standards used by companies, and will follow developments and seek to align the UK approach where appropriate. The more climate-related financial disclosure standards that can be streamlined, the better this will be for the organisations subject to them.

Finally, we would encourage BEIS to consider introducing a more fulsome climate-related financial disclosure framework long-term. The Trustees of the IFRS Foundation are working on the creation of a global climate-related financial disclosure standard and we would ask BEIS to keep a line of communication open with this initiative.

Interaction with the UK Listing Rules

A particular area of concern in terms of overlap and consistency is the interaction between the proposals in the CP and the recently introduced LR requirements for premium listed issuers. The CP's proposed rules are described as "complementary" to the new LR requirements. However, there are key differences in approach, which create complexities for companies subject to both regimes, and risk resulting in different standards of disclosure across different types of companies.

The LRs require a <u>comply or explain</u> statement about disclosures that are consistent with the four overarching TCFD pillars and 11 recommendations. In contrast, the proposals in the CP <u>require</u> companies and LLPs to disclose climate-related financial information in line with the four overarching pillars of the TCFD, but do not require the additional level of disclosure with the 11 recommendations. However, the proposals in the CP state that if the required climate-related financial disclosures are not made, the non-financial information statement <u>must provide</u> a clear and reasoned explanation for the omission. It would be helpful to clarify how this is intended to interact with the new LR comply or explain statement.

In addition, the LRs focus on requiring disclosures on governance and risk management (and strategy in relation to these two pillars), but are less focused on the metrics and targets pillars. However, the CP focuses on all four pillars. Therefore, it seems that premium listed issuers would be subject to two overlapping but different disclosure obligations (with the further complexity that these would be overseen by different regulators).

Rather than a hierarchical approach, we believe it would be better to have one set of rules applicable to all in-scope companies, instead of having different rules for premium listed issuers from those for publicly quoted companies, large private companies and LLPs. We believe that in reporting against the four pillars of TCFD many companies will also voluntarily report against the 11 recommendations, for example to assist with ratings agencies' assessments. Therefore, it may be preferable to have mandatory compliance with the four pillars of TCFD and a "comply or explain" regime against the 11 recommendations (regardless of materiality) for all in-scope companies, including premium listed companies. This would have the benefit of greater consistency and less fragmentation.

We acknowledge that amended LRs would be required, rather than removing the LR requirement and replacing it with the proposed CP requirement, because the proposed requirement in UK company law would not apply to overseas companies or to premium-listed companies with fewer than 500 employees, and could not be enforced by the FCA.

- **Adequate director protections:**

  The CP recognises that directors' liability attaches to disclosures made by companies. However, the CP does not address ways that directors can be appropriately protected from liability, including where forward-looking climate-related disclosures are made in good faith. Scenario analysis, in particular, is an area where companies and individual directors have the greatest liability concerns.

  "Safe harbour" provisions which refer to a company's use of third party experts, certain recognised standards (i.e. SASB/GRI Sustainability Reporting Standards),

and/or use of scientific research/methods, may encourage such disclosures to help promote the CP's objectives. Currently, s.463 of the Companies Act 2006 provides a "safe harbour" for certain disclosures made in a company's Strategic Report and Directors' Report. However, to the extent that scenario analysis disclosures are not required by law to be in the Strategic or Directors' Report, it is not entirely clear that the protection of s.463 would apply, and s.463 also may not protect directors from liability (for example, liability to shareholders under US securities law). We would urge the Government to consider the liability regime for scenario disclosures and other forward-looking climate-related disclosures, and in particular to clarify the application of s.463 so that liability risk does not deter companies from engaging in scenario analysis.

- **Timing**:

  The proposed timetable is relatively fast and does not leave much time for companies and LLPs to put in place the necessary systems and processes to track climate-change related targets and to start to meet these targets, particularly as a phase-in approach is not suggested. Given the desire to introduce these changes promptly, we would urge that the requirements are kept as straightforward as possible, in particular having regard to consistency with other similar regimes and related proposals.

C. Responses to questions in the CP

1. **Do you agree with our proposed scope for companies and LLPs?**

   - Please see our comments above regarding the interaction of the proposals in the CP with the new LR requirements.
   - We would suggest that the thresholds are smoothed in the same way as certain other thresholds in the Companies Act 2006 (for example, company size thresholds), so that companies and LLPs will need to meet the relevant threshold for two consecutive years before being brought into scope of the requirements. This should help prevent organisations near the threshold from dipping in and out of the requirements.
   - It would also be helpful for BEIS to clarify any intention to extend the scope of these proposals in future.

2. **Our proposed scope includes UK registered companies with securities admitted to AIM with more than 500 employees. Do you have any views on expanding this to include other unregulated markets and Multilateral Trading Facilities (MTFs)?**

   - We suggest that the proposed scope applies to all MTFs, not just AIM. However, it should carve out companies with involuntary listings. There does not seem to be any rationale for including AIM companies within scope but not companies on other MTFs, except (as noted above) where securities are traded involuntarily. The size threshold is self-limiting and would likely exclude most non-AIM MTF companies in any event.
   - We also suggest that the £500m turnover threshold requirement be applied to AIM companies in order to keep the requirements proportionate for smaller AIM companies.

3. **Do you agree with the proposal to require climate related financial disclosures for companies and LLPs at the group level?**

- The CP indicates that reporting should be achieved at the group level on a consolidated basis and there will be a subsidiary exemption if a company's results and relevant climate-related disclosures are included in a consolidated report of a UK parent company. However, this leaves scope for double reporting in the case of multinational groups.

- For example, a UK subsidiary of an EU parent would not be exempt and so would have to make its own disclosures in the UK. We would therefore suggest there be provision for equivalence decisions to be granted in this area, so that the exemption could apply where a subsidiary is included in a consolidated report of a non-UK parent if that consolidated report provides the requisite disclosures. However, we would not recommend that the group level consolidated reporting is compulsory beyond UK groups. Otherwise, this would present non-UK headquartered groups with different regulatory regimes in relation to climate (and associated ESG) disclosures.

- The same issue will apply in reverse, in that a consolidated report of a UK parent may not meet EU standards and so any EU subsidiaries of a UK parent may have to produce separate reports. This could result in multiple overlapping obligations for multinational groups.

- We would suggest that, for consistency and simplicity, grouping should mirror the NFRD/CSRD regime.

4. **Do you agree that the Strategic Report is the best place for the disclosure of climate-related financial information by companies?**

   - We believe it is preferable to include it in the Strategic Report or the Directors' Report, rather than producing a stand-alone document. Which is most suitable depends in part on whether the CP proposals would be combined with the existing SECR regime. SECR information is required to be included in a company's Directors' Report and so this might be the most suitable place. A key consideration is ensuring that all TCFD and SECR disclosures are housed together in one place so that the information can be located easily.

   - By including the disclosure in the Strategic Report or the Directors' Report it would benefit from the safe harbour for directors under s.463 Companies Act 2006, because it is information that is <u>required</u> to be included in the Strategic Report or Directors' Report.

   - Equally it may be necessary to cross-refer to other documents. Whilst it would be helpful to have this flexibility, we are conscious that other documents may not benefit from the s.463 safe harbour. Therefore, we would urge the Government to clarify what protection will be available for directors.

5. **Do you have views on whether LLPs should be required to disclose climate-related financial information in the Strategic Report (where applicable), or the Energy and Carbon Report?**

   - We have no comments on this.

6. **Do you agree that requiring disclosure in line with the four pillars of the TCFD recommendations, rather than at the 11 recommendations level is suitable?**

   - The four pillars of the TCFD are a widely-accepted framework and will enhance the international, high quality reputation of the London market. Reference to globally recognised standards will improve international cohesion of climate-related disclosures by companies and will also assist investors within and outside

the UK to interpret the disclosures, without the need to analyse a new or different framework.

- We therefore support compliance with the four pillars, and we also recommend including disclosure in line with the 11 recommendations of the TCFD on a "comply or explain" basis (regardless of materiality). Currently, the NFRD also encourages disclosure in line with the 11 TCFD recommendations, so this would help create consistency. However, we do have concerns that this differs from the approach taken under the LRs – see our comments above under "Interaction with the UK Listing Rules".

- We believe it will help compliance with the four pillars to include the 11 recommendations, as reporting is easier if a fairly detailed framework is given on a comply or explain basis. We anticipate that most companies will, in any event, fall back on the recommendations as they will represent best practice in reporting. The inclusion of the 11 recommendations also may assist companies in preparing disclosures in a consistent way to companies internationally, as the TCFD framework appears to be widely adopted.

- According to the CP, the proposed Companies Act 2006 requirements will paraphrase the four TCFD pillars. The paraphrasing in the CP is slightly different from the wording in the TCFD report, and from the wording in the LRs. The wording included in the Companies Act 2006 should match the exact wording of the four pillars of the TCFD recommendations, or the wording in the LRs, to provide a consistent approach.

- However, we consider that this is preferable to incorporating the four pillars by reference. We note that there may be difficulty with incorporating the TCFD pillars into legislation by reference, given that they may change from time to time. This may lead to uncertainty in the way the legislation works and effectively devolves control of specific reporting requirements to a third party. Additionally, if the TCFD pillars were to change, it may not be clear from what point a company is required to report against the revised pillars.

- With regards to non-binding Q&A for implementation, the existing relevant guidance produced by the TCFD is likely to be appropriate, is likely to lead to a more consistent approach internationally, and is likely to limit confusion through the development of new and potentially contradictory guidance. Therefore, it would be helpful if BEIS could clarify that the proposed Q&A will be consistent with and/or make reference to the TCFD guidance.

7. Do you agree that information provided in line with the obligations set out above would provide investors, regulators and other stakeholders with sufficient information to assess the climate-related risks and opportunities facing a company or financial institution?

- In the context of encouraging international convergence and consistency, we agree that the TCFD framework appears to be the most appropriate framework for climate-related disclosures.

8. Do you agree with our proposal that scenario analysis will not be required within a company or LLP's annual report and accounts?

- The CP proposes that scenario analysis will be encouraged but will not be required. The flexibility is important for some companies without the necessary skills and expertise, or for whom scenario analysis may be less material. However, if scenario analysis is not mandatory, it should be clarified that the safe

harbour in s.463 of the Companies Act would apply to it. See our comments under “Adequate director protections” above.

9. Would alignment of the scope for climate-related financial disclosures and SECR requirements, such that large unquoted companies and LLPs would be subject to the same reporting requirements under SECR as quoted companies, aid reporting of climate related financial disclosures and simplify reporting procedures? Do you have any views on the continuation of voluntary Scope 3 emissions reporting under SECR requirements?

- We would expect that companies will regard any attempts to align and rationalise energy and carbon reporting (including SECR) as helpful.

- We would expect that it would be possible to address the overlap between the reporting requirements under TCFD and SECR. For example, aspects of the data gathering and reporting under the SECR will be necessary to enable companies to meet the reporting obligations under TCFD. It should be possible to simplify SECR, so that it becomes complementary to the strategic objectives of TCFD.

- More specifically, the objective of simplifying requirements for unquoted companies in the existing SECR requirements was welcomed upon introduction of the SECR regime. However, in practice, the existence of two separate sets of requirements for quoted and unquoted companies has not necessarily achieved simplification, and has in some cases caused unjustified confusion, including where groups include quoted and unquoted companies, or where companies are preparing to IPO. For example, the use of similar but different descriptions of the Scope 1 and 2 emissions required to be reported under the two reporting requirements is unclear and does not appear to reduce the data-gathering burden on unquoted companies.

- Whilst retention of an optional exemption for unquoted companies from reporting on non-UK emissions may help to avoid imposing an extensive, additional data gathering burden on unquoted companies in isolation, global emissions data would likely be required to achieve TCFD compliance. On that basis, the utility in maintaining this distinction may diminish if mandatory TCFD reporting is introduced.

- We do not see a demand for the reporting of Scope 3 emissions to become mandatory, and note the TCFD recommendations themselves state that Scope 3 emissions are to be disclosed “if appropriate”. This is a highly complex area and while reporting of Scope 3 emissions is increasing, it is not yet the norm.

10. Do you have comments on the proposal to permit non-disclosure if the information is not material and the reasons why climate change is not material are properly explained?

- We agree that disclosures should only be included if they are material. However, the CP does not contain much information on when an explanation on non-disclosure would be acceptable and it would be helpful to have greater clarity on this point. At most, companies should be required to explain why they believe relevant disclosures would not be material in the context of their business.

- As noted above, we consider that the 11 recommendations should apply on a “comply or explain” basis. This should be the case regardless of materiality,

however materiality could be a valid explanation as to why a particular recommendation has not been followed.

11. Do you have comments on the proposed timing for these regulations coming in to force?

- Please see our comments under "Timing" above.

12. Do you have any comments regarding the existing enforcement provisions for companies and the BEIS proposal not to impose further provisions?

- The Companies Act 2006 and the relevant LLP Regulations already contain general enforcement provisions which deal with a failure to prepare or file the relevant report. In addition, a director of a company or a member of an LLP is liable to compensate the company or LLP for any loss suffered as a result of any untrue or misleading statement in the Strategic Report or the energy and carbon report. This only applies if the director or member knew the statement to be untrue or misleading or was reckless whether it was untrue or misleading. This seems to be the appropriate standard.

13. Do you have any comments regarding duties and enforcement provisions for LLPs?

- Please see our answer to Q12, above.

14. Do you have any comments on the responsibilities of auditors in relation to climate-related financial disclosures?

- BEIS should give consideration as to how the proposals in the CP and the outcome of the proposals in the audit paper will fit together to ensure consistency. Please see our Overarching Comments on this above.

15. Do you have any comments regarding the proposed enforcement of our disclosure requirements?

- The FRC/ARGA will be responsible for monitoring and enforcing these new Companies Act provisions, but the FCA will be responsible under the Transparency Rules for ensuring compliance with the applicable financial reporting framework. The FCA is also primarily responsible for the enforcement of compliance with the LRs. Therefore, this is another area of overlap and potential inconsistency.

16. Do you have any comments regarding the impact of our proposals on protected groups and/or how any negative effects may be mitigated?

- We have no comments on this.

17. Do you have any further comments about our proposals?

- Overall, there needs to be a proper roadmap for companies to follow, rather than a fragmented approach. As mentioned under "Consistency with existing legislation and standards", there needs to be consistency between the various reporting regimes, and consideration needs to be given to the impact on groups of having numerous overlapping and inconsistent standards, in particular the potential for groups to be reporting twice.

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