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FCA CONSULTS ON EXTENDING CLIMATE RELATED DISCLOSURE REQUIREMENTS AND CERTAIN ESG MATTERS

On 22 June 2021 the FCA published CP21/18 consulting on proposals to extend the application of their climate-related disclosures listing rule to standard listed companies and also seeking views on broader environmental, social and governance (**ESG**) topics in capital markets. This consultation has two limbs. The first, is focused on the extension of the FCA's TCFD aligned 'comply or explain' listing rule and the second, is a more discursive fact finding request seeking views on ESG prospectus disclosure for debt securities and possible regulatory oversight of third party ESG verifiers and ESG rating agencies. The consultation is open until 10 September 2021. We have prepared another briefing considering the FCA's other consultation paper, Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers.

Key issues

- FCA consulting on extension of TCFD disclosure Listing Rule to:
  - standard listed companies; and
  - issuers of debt and debt like instruments
- Overview of other international climate reporting proposals
- FCA seeking views on ESG issues as regards:
  - prospectus disclosure
  - ESG ratings
  - ESG external verifiers

EXTENSION OF THE TCFD COMPLY OR EXPLAIN LISTING RULE

In December 2020 the FCA introduced a new Listing Rule (see box) that applies to equity issuers with a premium listing for financial periods beginning on or after 1 January 2021. The FCA is consulting on extending this rule to apply to issuers of standard listed equity shares (excluding standard listed investment entities and shell companies) for financial years beginning on or after 1 January 2022. This would therefore apply to financial statements published as of 2023 and will apply, like the existing rule, to issuers irrespective of jurisdiction of incorporation. A further 148 companies would be brought into scope of the rule by this change. This extension aligns with the UK Government's stated objective of achieving mandatory TCFD disclosures across the economy by 2025 as set out in its Roadmap in November 2020 (described in our briefing The UK, Sustainable Finance and Climate Regulation: the next steps).

Listing Rule 9.8.6(8) requires that issuers include statements in their annual financial report:

- whether they have made disclosures aligned with the TCFD recommendations in their report;
- if not, why; and what steps they are taking to prepare for TCFD-aligned disclosure ('comply or explain' basis); and
- where the disclosures can be found (whether in the annual financial report or other separate document); where disclosures are contained elsewhere than their financial report, they must explain the reason for this.

Although the rule is structured as comply or explain, the expectation is that issuers do comply and disclose rather than explain. Reasons for when an explanation might be expected would be set out in additional FCA guidance on the application of the TCFD recommendations, for example where the issuer

faces transitional challenges obtaining data or has limited modelling or analytical capabilities.

The TCFD were first published in 2017 and represent what has come to be considered the global "gold standard" on climate related financial disclosures.

The TCFD recommendations (see box) are voluntary but have begun to be widely adopted by large global companies and those who are keen to promote their ESG credentials. However, recent surveys show that the recommendations are not adhered to consistently even among those entities who subscribe to them and that more could be done to bring about alignment. The FCA points to the FRC's climate thematic review in November 2020 which concluded that the current levels of climate disclosures by companies did not meet the needs of investors and other users. The FCA is not alone in looking to promote TCFD and similar reporting standards more extensively (see TCFD and beyond below).

The TCFD Recommendations are principally aimed at ensuring investors, lenders and insurance underwriters have sufficient information about how climate change could affect their actual and proposed investments. However, the Task Force suggests that all companies with public equity or debt should adopt them, both in financial and non-financial sectors.

There are four key areas for disclosure:

- **Governance**: The role of management in assessing climate change risks and opportunities, and oversight by the board;
- **Strategy**: Where material, a description of impacts of actual and potential risks / opportunities from climate change upon the business's strategy and financial planning over different time horizons; and the resilience of the organisation's strategy based on different climate scenarios;
- **Risk Management**: Description of the organisation's process for identifying and managing climate-related risks and how these relate to the organisation's overall risk management framework;
- **Metrics and Targets**: Where material, disclosure of the organisation's Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas emissions, and related risks; and a description of the metrics used to identify risks and opportunities.

Consultation questions

The proposed extension to equity issuers with a standard listing seems relatively uncontroversial and has been widely trailed. The proposed exemptions, being shell companies and investment companies, to the rule seem also sensible. We would note of course that compliance with TCFD will be more onerous for smaller companies, in particular the scenario planning recommendations. The FCA points out that this is one of the reasons for maintaining the 'comply or explain' approach. The FCA also proposes to provide comfort to smaller companies in its guidance which notes that the sufficiency of their disclosures can be assessed in relation to the nature, size and complexity of its business.

The FCA is also seeking feedback on the extension of the listing rule to issuers of debt and debt like securities. Many debt issuers will already be in scope due to existing equity listings and/or, in the case of UK companies, potentially be brought into scope by the BEIS proposals depending on their eventual form (see *TCFD and beyond* below). However, this extension may be more problematic for issuers that are not yet reporting in line with TCFD or overseas issuers with only debt listed in the UK who might not otherwise be caught by climate related reporting requirements. The FCA is also seeking feedback regarding possible exemptions from the application of the rule and the feasibility of complying. SPV or shell issuers should clearly be exempt as their corporate structure does not readily lend itself to the TCFD framework. The suggestion that in some circumstances issuer prospectus level disclosure would be more appropriate and "decision useful" could be problematic. Many issuers have preferred to keep ESG and sustainability related information outside their debt prospectuses given the approach of the debt markets to this type of disclosure to date and the liability standard associated with prospectuses.

The FCA's rationale as to the extraterritorial scope of the rule (both in its existing application and the proposed extensions) is that TCFD is a global standard so compliance should be unproblematic for non-UK companies. And although this does align with global championing of TCFD and similar climate reporting requirements being pursued by other regulators, there are likely to be both timing concerns, depending on which regime comes into effect first, and consistency concerns resulting from the overlapping but not identical regimes.

TCFD and beyond

In June 2021, G7 finance ministers historically committed to mandating climate reporting in line with TCFD, cementing the status of the TCFD in the reporting world. As the TCFD gains international acceptance for its approach to climate reporting, it is inevitable that there will be potential overlap and conflict as different regimes propose references to the TCFD in their own

rules. However, this gives rise to a key concern that groups of companies may need to report on climate impacts in different ways depending on their regulation, or potentially even duplicate reporting for the same company under different regulations in different jurisdictions.

In May 2021, the UK Government consulted on mandatory climate reporting for companies (including listed companies), acknowledging the potential overlap with FCA Listing Rules. The European Commission have also recently launched a consultation on a proposed Corporate Sustainability Reporting Directive (**CSRD**) which would extend to climate reporting (see our earlier briefing). The FCA notes the potential for overlap with the BEIS consultation proposals but does not see this as problematic. However, the potential for duplication under these initiatives is significant. For example, a UK subsidiary of an EU-based group listed on the London Stock Exchange, might have to report (or provide reporting information) under all three initiatives as proposed. While the EU regime will potentially allow reporting under the UK regime to count as equivalent and exempt the UK subsidiary from reporting under the EU regime, there is currently no corresponding rule under the UK proposals. The requirements for reporting and the extent to which they require TCFD reporting are also different which may lead to challenges in monitoring data and preparing analysis for disclosure. For example, the FCA is maintaining its 'comply or explain' approach while the BEIS proposal does not. We have set out in the Annex to this briefing a table illustrating the complexity of the matrix of these emerging regulations.

As the TCFD gains traction as an internationally accepted climate reporting methodology there is a temptation to consider the TCFD as immutable and comprehensive. As the FCA recognises, the TCFD is not a complete corporate reporting standard and there is a need to develop a comprehensive approach to corporate sustainability reporting. A number of initiatives are underway in this regard. These include the 'Group of Five' sustainability organisations who published a 'prototype' climate-related financial disclosure standard. This seeks to broaden reporting to a more general sustainability disclosure standard but building on the TCFD. More generally, in February 2021, IOSCO began work with the IFRS Foundation on plans for an international Sustainability Standards Board, and ultimately an international sustainability disclosure standard, building on existing standards including the TCFD and the Group of Five Prototype. It is clear that the legislative initiatives mentioned above will need to factor in the evolution of reporting under TCFD to their regulatory approaches as well as managing overlap and conflict issues.

ESG INTEGRATION IN UK CAPITAL MARKETS

Chapter 4 of the consultation outlines the discussion topics the FCA wants to engage in with the broader market namely, regulation of green, social and sustainable use of proceeds (**UoP**) bonds; third party verifiers and second opinion providers and ESG data and ratings.

Prospectus rules and disclosure

The current lack of regulation applicable to green and sustainable bond disclosure reflects the organic nature of how this market has developed and absence of agreed definitions of green and sustainable activities. However, given the current size of the market, concerns around greenwashing and the consistency of information being provided to investors it is not surprising that regulators are taking an increasing interest in these products. We know that the European Commission is likely to consider green and sustainable bonds in its upcoming regular review of the Prospectus Regulation – this was

highlighted in recitals to the EU Recovery Prospectus Regulation and in the Strategy for Financing the Transition to a Sustainable Economy. Similarly, the SEC has recently consulted on ESG disclosure requirements for SEC registrants.

In 2019 the French and Dutch securities regulators, the AMF and AFM, put forward a proposal on UoP bonds prospectus disclosure requirements. The broad conclusions were to consider having a green and sustainable bond "annex" under the existing Prospectus Regulation structure. This would mean an issuer that labelled its bonds as green or sustainable to provided information as to whether it intends to:

- comply with green bond voluntary standards (such as the ICMA's Green Bond Principles or the Climate Bond Initiative's Climate Bond Standards);
- report on the use of the green bond proceeds; and
- mandate a third party verification.

It also proposes inclusion of additional information, such as an indication on the publication of the issuer framework (if any), the selection of projects and the management of proceeds.

The FCA focuses on what is one of the key tenets of the UoP bond market which is that while the issuer specifies its intended use of proceeds towards eligible green or sustainable projects and its proposed management of proceeds and reporting processes (in either the prospectus and/or the underlying framework document) there are no contractual obligations that bolster those commitments. This issuer's obligation to apply the use of proceeds to eligible projects is structured on a best efforts basis and there is no bond event of default if the proceeds are not applied as described, the eligible projects to do not have the intended impact or the issuer does not report in the way it has specified. In the green and sustainable bond market the consequence for such non-compliance is predominantly reputational and would be likely to limit an issuer's ability to visit the green bond markets in the future.

Feedback requests on UoP bond regulation

The FCA is seeking feedback on the appropriate way to structure a regulatory response to UoP bonds. It makes three suggestions on broad approach:

- Consider specific changes relating to UoP bond frameworks and sustainability characteristics. While the feedback question does not provide further detail on the FCA's thinking on what this would be it does reference the AMF and AFM position paper; or
- Support the UoP bond market by adopting existing market led standards such as the ICMA Principles; or
- Take a more ambitious stance and consider linking the key aspects of a UoP bond to the terms and conditions of the bond itself.

While different market participants may have differing views, some light touch level of mandated disclosure, in the AMF/AFM mould, could bring a level of consistency to prospectus disclosure at a time where there is a certain amount of flux. This approach could also be combined with the second proposal to support existing standards. The third proposal is, as the FCA identifies, ambitious or even radical. It is not what is envisaged by the existing market participants and a lack of a contractual linkage has not hindered the development of the UoP market to date. If such an approach were taken, particularly if not taken elsewhere, there would be a significant divergence for the UK green and sustainable bond market from the approach taken in other jurisdictions.

Interestingly, there are no specific questions from the FCA regarding disclosure regulation for sustainability linked bonds (**SLBs**).

Verifiers and second party opinion providers

There are a number of different types of external environmental service providers who prepare reviews and reports in the context of UoP bonds and SLBs. Most common are second party opinion (**SPO**) providers and external verifiers. The vast majority of UoP and SLB issuances will be supported by an SPO and some form of external verification, in particular SLBs where external verification of sustainability performance targets (**SPTs**) is a requirement of the ICMA SLB Principles.

Feedback requests on SPO providers and verifiers

The FCA notes that SPO providers and verifiers, in particular in the context of SLBs, perform a critical role in the UoP and SLB markets. The consultation points to the potential conflicts of interest embedded in the current "issuer pays" model of SPO and verifier appointments and also the lack of transparency of the SPO methodology. The consultation asks what action the FCA could take in relation to these identified shortcomings, having pointed out that the EU is intending to establish oversight of these entities under its upcoming EU Green Bond Standard (EU GBS) regime. The FCA also asks if the FCA should develop a UK Green Bond Standard.

ESG data and ratings

ESG ratings are an evaluation of a company based on an assessment of its performance on ESG issues and can be used as a proxy of ESG performance by investors. While ESG ratings are useful to identify risks and benefits that cannot be seen from a financial analysis of the balance sheet there are some obvious downsides.

The Consultation Paper outlines the well-rehearsed concerns that have been levelled against the current provision of ESG ratings relating to metrics and methodology, data gaps and conflicts of interest (see box). It is widely recognised that there is no consistency across the rating providers as to the metrics and methodology used and the weighting applied to each of the "E", "S" and "G" aspect of the rated entity's business. Rating agencies are also challenged by the lack of good quality data relating to the rated entity due to the 'investor pays' model. These factors result in ESG ratings being inherently difficult for investors to both interpret and compare and also to have confidence in the rating providers' methodologies and processes. Potential conflicts of interest issues are also noted.

The FCA recognises that ESG ratings are likely to become increasingly embedded into investment decisions and set outs three different types of potential policy actions:

- Guidance for firms on their use of third party ESG data and ratings;
- Best Practice Code for ESG data and rating providers;
- Regulation of ESG data and rating providers.

Feedback request on ESG data and ratings

The FCA asks whether respondents agree with the challenges they have identified and which of its proposed policy actions would be most appropriate. Some form of regulatory oversight would seem to be the direction of travel, particularly in the EU given the recent ESMA recommendation to the EU in January 2021 and joint AFM/AMF December 2020 position paper, but also perhaps more widely given the promise of an IOSCO report on data providers and ratings by mid-July this year.

The growing importance of ESG data and services also uncovers potential risks for investors and asset managers looking for sustainable investments. In particular, the lack of transparency concerning SSPs' methodologies as well as the role of estimates make it difficult to correctly appreciate what the ratings reflect. This can lead to misallocation of investments or even greenwashing, jeopardising the Commission's objectives on sustainable finance

AMF/AFM Position Paper: Call for a European Regulation for the provision of ESG data, ratings and related services. December 2020

The issues concerning ESG ratings highlighted in Q.18.1 [lack of comparability, consistency, transparency and clarity] have implications for investor protection and financial stability, but also for sustainable development in the long run.

In addition, the inconsistency and inaccuracy of ratings leads to issues down the ESG investment value chain. Capital misallocation is likely, either unintentionally through the composition of ESG-rating based indices, or from greenwashing and product mis-selling.

ESMA Response to EC consultation on a Renewed Sustainable Finance Strategy. July 2020.

Many on the buy and sell sides have signalled how confusing the multiplicity of different ESG rating choices can be, once again raising serious questions about relevance, reliability and greenwashing.

Speech by Ashley Alder, IOSOC CEO, on 23 June 2021.

ANNEX

Table: Recent UK and EU proposals incorporating climate reporting

	Proposed expanded UK Listing Rules	**UK BEIS consultation**	**EU Corporate Sustainability Reporting Directive**
Which entities will be covered?	**Already covered**: Premium Listed companies **New proposal**: Standard listed issuers of equity shares Possible extension to: • standard listed issuers of shares other than equity shares • issuers of standard listed debt and debt-like securities	UK listed companies with more than 500 employees, banking and insurance companies; UK companies admitted to AIM with more than 500 employees; UK companies and LLPs with more than 500 employees and turnover over £500m	All issuers with securities (either equity or debt, unless solely wholesale debt) listed on EU regulated markets (including non-EU issuers) All *large undertakings** and parent undertakings where the group together meets the large undertaking criteria EU SMEs listed on an EU market Credit Institutions and insurance undertakings
Reporting covers UK subsidiaries of overseas parents?	Yes, where parent is listed in UK	Yes	Yes
Equivalence regime for reporting under other regimes?	No	Not proposed	Yes, EU based subsidiaries of overseas parent companies included, unless included in parent's reporting and reporting deemed equivalent to CSRD.
What climate-related reporting is required?	Whether TCFD disclosures made. If not, why, and steps made to prepare for TCFD disclosure. TCFD reporting requires reporting under full 11 TCFD recommendations	Disclosure of current business model and strategy as it relates to climate change, together with how it is expected to change. Include disclosures relating to 4 overarching TCFD pillars: • Governance • Strategy • Risk Management • Metrics & Targets However, reporting under detailed 11 TCFD recommendations not required. Scenario analysis is not mandatory.	Alignment of business model and strategy to Paris-aligned 1.5C target. More generally, resilience to sustainability risks, sustainability impacts and how they are managed, policies and targets on sustainability matters, indicators on all areas of disclosure. Impacts go broader than financial materiality – i.e. to external impacts. Reporting is dependent on new EU sustainability reporting standards. No specific reference to TCFD at this stage, but current non-binding guidance on existing NFRD reporting recommends reporting in line with the TCFD and TCFD is mentioned in the recitals to the proposal.

Where must reporting be made?	Annual financial report or explain why not	Strategic report	Management report
Comply or explain?	Yes	No, mandatory	No, mandatory
When does it come into force?	**Premium listed issuers**: Reporting for financial years beginning on 1 January 2021 or after **Standard listed issuers and others**: Reporting for financial years beginning on 1 January 2022 or after	Reporting for financial years beginning on 6 April 2022 or after	Reporting for financial years beginning on 1 January 2023 or after (1 January 2026 for listed SMEs)
* Large Undertaking which exceeds 2 out of the following 3 criteria: (1) Balance sheet over EUR20m, (2) Net turnover over EUR 40m and (3) 250 employees.			

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