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# ESG Disclosures: The Push for Consistent and Comparable Standards – United Kingdom

## Key Takeaway

- *A number of recent initiatives in the United Kingdom highlight the extent to which a focus on ESG among corporates, investors and financial institutions has become a "new normal."*
- *Proposed rules for listed companies could pave the way for significantly greater use of the Task Force on Climate-related Financial Disclosures ("TCFD") recommendations as a basis for corporate ESG disclosures.*

## Overview

This client memorandum, part of a series that reviews developments in the environmental, social and governance ("ESG") disclosure landscape, provides an introduction to the current ESG regulatory disclosure frameworks of the United Kingdom. The United Kingdom has been an early adopter of ESG regulations and guidelines. For example, the United Kingdom was the first country to set long-term, legally binding emissions reduction targets. We provide below a high-level overview of UK ESG disclosure frameworks.

## UK Regulations

Section 172(1) of the Companies Act 2006 addresses the duty of directors to promote the success of their company for the benefit of shareholders as a whole, taking into account, among other themes, the likely consequences of any decision in the long-term, the interests of employees, the need to foster business relationships with suppliers, customers and others, and the impact of operations on the community and the environment.

Regulations adopted in 2013 extended the scope of mandatory non-financial reporting obligations and introduced a new format for companies to report disclosures (the "strategic report"),[1] and included, among other things, an obligation on listed companies to provide disclosure on emissions. In 2016, the United Kingdom adopted legislation implementing the EU's 2014 Non-Financial Reporting Directive, providing for non-financial statement disclosures contemplated by the EU directive to form part of the strategic report.[2] The UK Financial Reporting Council ("FRC") issued guidance in 2018 in respect of the strategic report incorporating elements of the 2013 and 2016 regulations.[3] Finally, in 2018, Parliament passed the Companies (Miscellaneous Reporting) Regulation 2018, which became effective for reports covering



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periods starting on or after January 1, 2019.[4] Taken together, these imposed on boards of listed companies an obligation to address in their annual strategic reports how they comply with the obligation that forms part of the duty to promote the success of the company to have regard for the impact of the company's operations on the community and the environment, as well as other ESG themes, where material (the so-called "Section 172(1) statement").

With respect to pensions, UK regulations required ESG disclosures for pension schemes as early as 2005, with a requirement that trustees disclose within a pension scheme's statement of investment principles "the extent (if at all) to which social, environment or ethical considerations are taken into account in the selection, retention and realization of investments."[5] In 2018, the UK Department of Work & Pensions amended the Occupational Pension Schemes Regulations to require trustees to document how they have considered ESG factors in making investment decisions.

The United Kingdom has been particularly proactive with respect to ESG disclosure requirements focused on social matters. For example, Section 54 of the Modern Slavery Act 2015 (the "MSA") requires large commercial organizations, with business in the United Kingdom and an annual turnover of at least £36 million, to prepare a "slavery and human trafficking statement" in relation to the company and its supply chain every financial year, obtain sign off by the board or senior management, and publish it on the company's UK website.[6] The legislation was the first of its kind in Europe and second internationally only to California's Transparency in Supply Chains Act. Another important social disclosure requirement in the United Kingdom is the Equality Act 2010 (Gender Pay Gap Information) Regulations 2017, effective April 2017, which require that companies with more than 250 employees report their gender pay gap figures.[7] The UK government also opened a public consultation on ethnicity pay reporting by employers that closed in January 2019,[8] so it is possible that ethnicity pay reporting disclosures could be mandated in the future.

*Green Finance Strategy*

The United Kingdom has also taken several important steps with respect to guidance and regulation focused specifically on climate change. For example, the former governor of the Bank of England, Mark Carney, led a number of initiatives in recent years that focused on climate change and addressed environmental disclosure.[9] UK regulators also addressed the issue in the context of the broader financial markets in a 2018 discussion paper.[10] In 2019, the UK government announced its Green Finance Strategy, which has two objectives and three strategic pillars. The twin objectives are to align the private sector financial flows with clean, environmentally sustainable and resilient growth, supported by government action, and to strengthen the competitiveness of the UK financial sector. The pillars are:

- ensuring current and future financial risks and opportunities from climate and environmental factors are integrated into mainstream financial decision-making;

- accelerating finance to support the delivery of the UK's carbon targets and clean growth, resilience and environmental ambitions; and
- capturing opportunities from the "greening of finance."

The UK government announced as part of the strategy that it expects UK listed companies and large asset owners to align their disclosures with the TCFD recommendations by 2022,[11] and a few months later, the Financial Conduct Authority ("FCA") also issued a Feedback Statement that foreshadowed a consultation process on rules related to the same, as discussed further below.[12]

*Guidance for Banks and Insurers*

In April 2019, the Prudential Regulatory Authority ("PRA") issued its Supervisory Statement (SS3/19) on enhancing banks' and insurers' approaches to mitigating the financial risks from climate change.[13] The Supervisory Statement is predicated on financial risks arising from climate change as being the physical and transition risks, which have the potential to increase underwriting, reserving, credit or market risk for regulated firms. The PRA also cites a third risk – liability arising from parties that have suffered loss or damage from physical or transition risk seeking to recover losses, which could be of particular relevance for insurance companies under directors' and officers' and professional indemnity covers.

The PRA expects a regulated firm's board of directors to understand and assess the financial risks from climate change that affect the firm, and to be able to address and oversee these risks within the firm's overall business strategy and risk appetite. The approach should demonstrate an understanding of the distinctive elements of the financial risks from climate change and a sufficiently long-term view of the financial risks that can arise beyond standard business planning horizons. Where appropriate, the PRA will expect to see evidence of how the firm monitors and manages the financial risks from climate change in line with its risk appetite statement. A regulated firm's risk appetite statement should include the risk exposure limits and thresholds for the financial risks that the firm is willing to bear.

Where the potential impacts of the financial risks from climate change are assessed to be material (for example, as a result of scenario analysis), the PRA expects firms to evidence how they will mitigate these financial risks and to have a credible plan or policies in place for managing exposures. Where proportionate, the PRA expects firms to conduct a scenario analysis to inform their strategic planning and determine the impact of the financial risks from climate change on their overall risk profile and business strategy. Scenario analysis should also be used to explore the resilience and vulnerabilities of a firm's business model to a range of outcomes.

The Supervisory Statement also addresses disclosure obligations. The PRA expects firms to engage with wider initiatives on climate-related financial disclosures and to take into account the benefits of disclosures

that are comparable across firms. The PRA expects firms to consider engaging with the TCFD framework and other initiatives in developing their approach to climate-related financial disclosures.

On July 1, the PRA published thematic feedback to the Supervisory Statement, in the form of a "Dear CEO" letter.[14] In the letter, the PRA indicates that firms should have fully embedded their approaches to managing climate-related risks by the end of 2021. This means that, by that date, firms should be able to demonstrate that the Supervisory Statement expectations have been implemented and embedded throughout the organization as fully as possible (taking account of the extent to which the organization is exposed to climate-related financial risk and the complexity of its operations). The letter also provides the following observations from the thematic review:

- Firms' strategic responses need to be clearer and firms need to continue developing tools that inform business decisions. Climate management information should be communicated more consistently and actively discussed at board level.
- Firms' oversight of climate-related financial risks could better demonstrate an appreciation of the far-reaching breadth and magnitude of the risks and a clearer understanding of their relationship to financial risks. This includes a clearer understanding of the physical and transition risk transmission channels and interactions between multiple lines of business, sectors and geographies.
- Metrics and quantification are the most challenging aspects of assessing climate-related financial risks.
- Risk-management processes are at the early stages of development, and few firms have implemented integrated policies, thresholds, mitigation strategies, monitoring capabilities and risk appetites.
- Firms have significant gaps in their capabilities, data and tools and have not yet integrated scenario analysis into their broader risk assessments. The development of a proportionate and integrated approach to scenario analysis by the end of 2021 will require many firms to increase their capabilities materially in the near-term.
- Firms' appetite for making climate disclosures is limited by capabilities and as a result some firms are yet to make any associated disclosures. Capabilities will need to be materially improved to facilitate future disclosures.

The Dear CEO letter also notes that the Climate Financial Risk Forum ("CFRF"), an industry group that is co-chaired by the PRA and FCA, issued a guide[15] on how each industry sector should approach climate disclosure, risk management, scenario analysis and innovation. The CFRF guide is billed as the first of its kind. In announcing the guide, the CFRF notes that the PRA and FCA have acknowledged that the financial services industry faces significant challenges as a result of the COVID-19 pandemic and, while the pandemic represents a "present" risk, "minimising future risks from climate change requires action now. The

regulators, therefore, remain committed to continuing to work together with industry on this important topic."[16] The guide frames the importance of the issue as follows:

> Climate change will have a significant impact on the financial services sector and will increasingly influence consumer decision-making. For example, it could substantially affect the values of all types of financial assets and how investment managers deliver long-term sustainable value to their clients. It could increase the cost of insurance for some consumers and reduce the availability of insurance for others, which may alter the distribution of risk across the system over time. Borrowers' and counterparties' exposure to climate-related financial risks and opportunities, and how they manage them, could also make them more or less creditworthy. It is against this fast-evolving backdrop that firms need to quickly build up their understanding of climate risks.

### *UK Corporate Governance Code*

The FRC released a revised Corporate Governance Code in 2018 (the "2018 Code"). The 2018 Code provides a framework of best practices for companies with respect to corporate governance, and an updated set of Principles "that emphasise the value of good corporate governance to long-term sustainable success."[17] It does not mandate ESG disclosures. The 2018 Code notes that it operates on a "'comply or explain' basis and [that] companies should avoid a 'tick-box approach.'"[18] In addition to sustainability, the 2018 Code emphasizes the role companies have in "contributing to wider society." For example, it encourages companies to report on actions taken to promote diversity and inclusion with respect to board appointment and succession planning, as well as their outcomes.

### *UK Stewardship Code 2020*

The FRC issues statements of best practice in stewardship for institutional investors and fund managers. The FRC recently undertook a substantial revision to its previous statement, which it calls the UK Stewardship Code 2020 (the "Stewardship Code").[19] The Stewardship Code calls on asset owners and asset managers to integrate in their stewardship and investment activities material ESG issues, including climate change. The Stewardship Code is voluntary, but many asset owners and service providers have become voluntary signatories. In February 2020, the FRC also announced that in 2021, after it reviews reports submitted under the Stewardship Code, it will undertake a major review of how companies and auditors assess and report on the impact of climate change, as well as how investors are addressing climate change in the stewardship of their investments.[20]

### *FCA Climate Change Disclosure Proposal*

In March 2020, the FCA announced proposals to improve climate-change disclosures by commercial companies with a premium listing on the Main Board of the London Stock Exchange.[21] Under the proposed

new listing rule, all commercial companies with a premium listing must either make climate-related disclosures consistent with the TCFD recommendations, or explain why not. The comply-or-explain approach was taken by the FCA in light of the fact that company capabilities in this regard are still developing, and the FCA does not want to set mandatory disclosure requirements that may not yet be fully achievable. The FCA proposes that the listing rule take effect for accounting periods beginning on or after January 1, 2021, such that the first reports issued in compliance with the rule would be published in 2022.

The proposals set out in the FCA's Consultation Paper[22] build upon the TCFD recommendations, and the consultation period closed on June 5, 2020. The FCA notes that they consider this effort as a first step towards adoption of TCFD recommendations more broadly within the FCA's disclosure rules, both as they apply to listed companies and to financial services firms. The FCA also notes that while adoption of the TCFD recommendations has been increasing, take-up is still slow, which, in the FCA's words, supports the case to "intervene to accelerate progress." The proposals are also viewed as consistent with the "direction of travel" in the Green Finance Strategy – namely that, by 2022, disclosures made by listed companies and large asset owners would follow TCFD recommendations.

## Looking Ahead

To date, the United Kingdom and the member states of the European Union have operated in parallel on ESG matters. It remains unclear to what extent the United Kingdom will remain aligned with ESG regulations drafted in Brussels following year-end. That said, a number of initiatives surpass minimum EU standards. Global asset owners and asset managers, who tend to be sensitive to the need for, and benefit of, consistent regulation and consistent standards, can be expected to be watching developments closely as the Brexit transition period comes to an end in December.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:


Mark S. Bergman
+44-20-7367-1601
mbergman@paulweiss.com

Ariel J. Deckelbaum
+1-212-373-3546
ajdeckelbaum@paulweiss.com

Jeh C. Johnson
+1-212-373-3093
jjohnson@paulweiss.com

Brad S. Karp
+1-212-373-3316
bkarp@paulweiss.com

Loretta E. Lynch
+1-212-373-3000

Richard A. Rosen
+1-212-373-3305
rrosen@paulweiss.com

Audra J. Soloway
+1-212-373-3289
asoloway@paulweiss.com

Frances F. Mi
+1-212-373-3185
fmi@paulweiss.com

David G. Curran
Chief Sustainability/ESG Officer
+1-212-373-2558
dcurran@paulweiss.com


*Associates Alexander T. Louis and Sofía D. Martos contributed to this Client Memorandum.*

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[1] *See* The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, SI 2013 No 1970 (available here).

[2] *See* The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016, SI 2016 No 1245 (available here). These regulations differed slightly in scope (covering listed companies with over 500 employees, as well as unlisted banking and insurance companies) from the 2013 regulations (covering all listed companies).

[3] *See* Financial Reporting Council, Guidance on the Strategic Report (July 2018) (available here).

[4] The Companies (Miscellaneous Reporting) Regulations 2018 (available here).

[5] *See* Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), Regulation 2(3)(b)(vi).

[6] The legislation requires disclosure that demonstrates efforts to ensure that slavery and human trafficking is not taking place within the company or along its supply chain. *See* Home Office, "Guidance: Publish an annual modern slavery statement" (available here).

[7] The Equality Act 2010 (Gender Pay Gap Information) Regulations 2017 (available here).

[8] *See* UK Department for Business, Energy & Industrial Strategy, "Ethnicity Pay Reporting: Government Consultation" (available here).

[9] In 2015, the UK Prudential Regulation Authority (under the leadership of Mark Carney) issued a report on the impact of climate change on the UK insurance sector. "The Impact of Climate Change on the UK Insurance Sector" (available here). In 2019, Carney reported that there appeared to be "cognitive dissonance" between insurance companies' assessments of climate

change-related risks as they relate to the liability side of their balance sheets (their coverage exposure) and the assessment made in respect of the asset side (their investments). Mark Carney, "A New Horizon" (March 21, 2019) (available here).

[10] *See, e.g.*, UK Financial Conduct Authority, DP 18/8 Climate Change and Green Finance (2018) (available here).

[11] UK Government, "Green Finance Strategy" (July 2019) (available here). *See also* The Financial Reporting Council, "Climate-related corporate reporting: Where to next?" (October 2019) (available here) (providing a comprehensive set of questions for boards to help companies apply the principles of the TCFD framework).

[12] Financial Conduct Authority, "Climate Change and Green Finance: summary of responses and next steps - Feedback to DP18/8" (October 2019), available here. *See also* Financial Conduct Authority, "Climate Change and Green Finance (DP 18/8)" (October 2018) (available here).

[13] Prudential Regulatory Authority, "Enhancing banks' and insurers' approaches to managing the financial risks from climate change" (April 2019) (available here)

[14] Letter from Sam Woods, Deputy Governor for Prudential Regulation and CEO of the Prudential Regulatory Authority (available here).

[15] *See* Climate Financial Risk Forum Guide 2000: Summary (June 2020) (available here); Risk Management (available here); Scenario Analysis (here); Disclosure (available here); Innovation (available here).

[16] *See* Bank of England and Financial Conduct Authority press release (June 29, 20202) (available here).

[17] *See* Financial Reporting Council, "The UK Corporate Governance Code" (July 2018) (available here).

[18] *Id.* at 2.

[19] *See* Financial Reporting Council, "UK Stewardship Code" (2020) (available here).

[20] *See* Press Release "FRC assesses company and auditor responses to climate change" (February 20, 2020) (available here). The release includes a statement by the FRC Chief Executive, who said, "[n]ot only do boards of UK companies have a responsibility to report their impact on the environment and the risks of climate change to their business, but investors expect them to operate sustainably."

[21] Financial Conduct Authority, Press Release, "FCA announces proposals to improve climate-related disclosures by listed companies" (March 6, 2020) (available here).

[22] *See* Financial Conduct Authority, "Proposals to enhance climate-related disclosures by listed issues and clarification of existing disclosure obligations" (March 2020) (available here).