Client Alert | Environment & Climate Change

Directors put on notice over climate change related disclosures

September 2019

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The Australian Securities and Investments Commission ("**ASIC**") has recently released updates to its existing regulatory guidance on effective disclosure, to clarify its position on the disclosure of climate change-related risks ("**climate change risks**") and opportunities.

The updates are contained in:

- Regulatory Guide 228: Prospectuses: Effective disclosure for retail investors; and
- Regulatory Guide 247: Effective disclosure in an operating and financial review.

The hardwiring of climate change-related disclosure guidance in ASIC's regulatory regime marks a new direction for the corporate regulator, and follows a series of other milestones in the push to include climate change on the global regulatory agenda.

Importantly, there is now a sharp focus on directors and their assessment of climate change risks and the consequential disclosures and potential for liability that may follow.

ASIC Commissioner, John Price, stated in ASIC's media release to accompany the updated guidance that,

"*While disclosure is critical, it is but one aspect of prudent corporate governance practices in connection with the mitigation of legal risks. Directors should be able to demonstrate that they have met their legal obligations in* ***considering, managing*** *and* ***disclosing*** *all material risks that may affect their companies. This includes any risks arising from climate change, be they physical or transitional risks.*"

Key take-aways

1. **Annual reporting:** The operating and financial review ("**OFR**") should contain a discussion of a company's prospects for future financial years, including material business risks that could adversely affect the achievement of financial prospects described in those years. ASIC now lists climate change as a "systemic risk that could have a material impact on the future financial position, performance or prospects of entities."
2. **Misleading and deceptive:** It may be *misleading* and *deceptive* to discuss prospects for future financial years without referring to foreseeable material business risks that could adversely affect the company, such as climate change, during such time. This has a direct impact on directors and their ongoing duty to act with due care and diligence.
3. **Discharging duty with due care and diligence:** ASIC believes the updated guidance makes clear that the risk of directors being found liable for a misleading or deceptive forward-looking statement in an OFR is minimal provided that:
    - the statements are based on the best available evidence at the time;

- the statements have a reasonable basis; and
- there is ongoing compliance with the company's continuous disclosure obligations when any such events are realised in the future.

Recommendation: Boards should consider whether their company has a probative and proactive approach to identifying and assessing climate change risks, including whether the company has the skills, systems and diligence required to assess the impact of risks associated with climate change on the company's business model now and in the future.

4. **Global trends:** ASIC recommends that directors consider "whether it would be worthwhile" to disclose additional information that would be relevant under, for example, the recommendations of the Task Force on Climate-related Financial Disclosures ("**TCFD Recommendations**"). Activist investment group Market Forces recently surveyed the public disclosures of the 72 ASX100 companies (as of December 2018) that operate in sectors highlighted by the TCFD Recommendations as facing the highest levels of climate risk and reported that while only two companies have achieved full adoption of the TCFD Recommendations, another ten companies have achieved comprehensive or partial disclosure. ASIC also reports that it believes the TCFD Recommendations are emerging as the preferred market standard in disclosing meaningful and useful climate risk-related information to investors.

   Recommendation: Boards should consider whether the TCFD Recommendations are an appropriate tool to utilise in assessing climate change risks and opportunities applicable to their company, and how and what to disclose with respect to any such risks.

5. **Prospectus disclosure:** When preparing for an initial public offering, a company must explain the industry in which the company operates in its prospectus, including any external threats facing that industry, such as climate change. A company must assess the potential impact of any such external threats on the industry and disclose the foreseeable effect on the company's business model.

6. **Material risk:** Climate change is listed as an "example of a common risk that may need to be disclosed" in a prospectus, including an assessment of any (i) transitional risks (*e.g.* risks flowing from a transition to a lower-carbon economy that may entail extensive policy, legal technology and market changes to address mitigation and adaption requirements related to climate change) and (ii) physical risks (*e.g.* risks flowing from events (acute) or longer term shifts (chronic) in climate patterns resulting from climate change) that may affect the company's business model in the foreseeable future.

   Recommendation: Companies seeking to list in the future should identify material climate change risks affecting their industry in general and make an informed (and specific) assessment of the foreseeable impact on the company's proposed business model and disclose any such risks in the prospectus.

Background

Task Force on Climate-related Financial Disclosures

In 2015, the Financial Stability Board, an international organisation established to promote world financial stability, was tasked by the G20 group of nations to review how the financial sector could address climate change risks. Later that year, the Task Force on Climate-related Financial Disclosures ("**TCFD**") was established, with a mandate to "consider the physical, liability and transitional risks associated with climate change and what constitutes effective financial disclosures in this area," and to "develop a set of recommendations for consistent, comparable, reliable, clear and efficient climate-related disclosure."

What resulted was a set of recommendations published in December 2016 (with the final report published in June 2017) on best practice for the disclosure of climate change risks and opportunities in four general areas: governance, strategy, risk management, and metrics and targets.

The TCFD Recommendations are, as the TCFD states, "widely adoptable," and are not viewed as controversial. For example, in June 2019, the Equator Principles Association released a consultation draft on updates to the Equator Principles, the risk management framework adopted by financial institutions for determining, assessing and managing environmental and social risk in projects, which includes a commitment to improve the availability of climate-related information, such as set out in the TCFD Recommendations.

Compliance with the TCFD Recommendations remains voluntary; however, as more companies and peak bodies seek to adopt them, there is an increased focus on their utilisation by companies in Australia (as discussed below) in helping to address climate change risk disclosures and the board's oversight of climate change risks and opportunities.

Climate Change and Directors' Duties

In that same year, Noel Hutley SC and Sebastian Hartford-Davis released a legal opinion on "*Climate Change and Directors' Duties*" dated 7 October 2016 ("**Hutley Opinion**") for the purposes of the business roundtable hosted by the Centre for Policy Development and the Future Business Council. The Hutley Opinion was and remains an important perspective on the relationship between a director's duty of care and diligence, and the assessment of the impact of climate change and how it affects their business. Hutley and Hartford-Davis concluded that climate change risks are both:

- capable of representing risks of harm to the interests of Australian companies, which would be regarded by a court as being foreseeable at the present time; and
- relevant to a director's duty of care and diligence to the extent that those risks intersect with the interests of the company.

Hutley and Hartford-Davis found that it was conceivable that "directors who fail to consider "climate change risks" now could be found liable for breaching their duty of care and diligence in the future."

On 26 March 2019, Hutley and Hartford-Davis released a supplementary memorandum of opinion to the Hutley Opinion to consider, among other things, the significant developments as set out above. After taking into account the TCFD Recommendations, decisions in cases focusing on climate change, and changes to the guidance of various Australian regulatory bodies to account for the shift in focus on climate change, the authors concluded that:

"As time passes, it is increasingly obvious that climate change *is and will inevitably affect the economy, and it is increasingly difficult in our view for directors of companies of scale to pretend that climate change will not intersect with the interests of their firms. In turn, that means that the exposure of individual directors to "climate change litigation" is increasingly, probably exponentially, with time."*

Carbon risk: a burning issue

Following the release of the TCFD Recommendations and the Hutley Opinion, the Senate Economics Reference Committee released its report, "*Carbon risk: a burning issue*" in April 2017 ("**Senate Report**"). The Senate Report referred to the TCFD Recommendations and the Hutley Opinion, and concluded that there should be "better disclosure of carbon risks by more Australian firms" and, importantly for directors, that carbon risk "is a business risk, and it is important for it to be treated as such." The Senate Report also flagged the idea that climate change risks are a hybrid ethical and economic dilemma, saying that consideration of a company's carbon emissions "is not just a question of ethics – it is a question of good business judgment."

One of the key recommendations proposed by the Senate Report, which was later agreed by the Australian Government in principle, was that ASIC review its guidance to directors to ensure that it provides a proper understanding of the manifestations of carbon risk and reflects evolving asset measurement implications of carbon risk.

Climate risk disclosure by Australia's listed companies

With this backdrop, ASIC set out to survey the market and conducted a review of climate risk disclosures using a sample of 60 ASX 300 listed companies and 25 recent initial public offering prospectuses. This resulted in the publication of ASIC Report 593 "*Climate risk disclosure by Australia's listed companies*" in September 2018 ("**ASIC Climate Report**"). ASIC found that only 17 percent of listed companies in the sample (being 10 out of 60 listed companies) identified climate change risk as a material risk in their OFR, while 48 percent (being 29 out of 60) disclosed, to some extent, climate change risk more generally in their annual report outside of the OFR.

Furthermore, out of the 25 prospectuses in the sample reviewed by ASIC, none of the companies expressly identified any *physical* climate change risks, and only one prospectus identified a *transitional* climate change risk as a material risk. ASIC found that while environmental and regulatory risks were cited as risks to the business model generally, "there was insufficient detail disclosed to enable an investor to determine if climate risk formed part of those broader risk categories, and if so, how and to what extent."

In the ASIC Climate Report, ASIC recommended, among other things, that directors and officers of listed companies should adopt a probative and proactive approach to emerging risks, including climate risk, and that specific disclosure is more useful than general disclosure, suggesting that the TCFD Recommendations may help listed companies in considering how to disclose material climate risks and what type of information to disclose.

Impact

The *Corporations Act 2001* (Cth) requires listed entities to prepare a director's report for each financial year, which must contain information that shareholders would reasonably require to make an informed assessment of the entity's operations, financial position, business strategies and prospects for future years. This section of the director's report is commonly referred to as the "operating and financial review" or "OFR."

It is here, in the OFR, where the company and the directors are charged with presenting a balanced discussion of the company's future prospects. In the updated Regulatory Guide 247: *Effective disclosure in an operating and financial review* ("**RG 247**"), ASIC states that it "is likely to be misleading to discuss prospects for future financial years without referring to the material business risks that could adversely affect the achievement of the financial prospects described for those years."

Following the ASIC Climate Report, and the recommendation in the Senate Report that ASIC review its guidance to directors with respect to carbon risk reporting, ASIC has updated RG 247 to clearly state that climate change is "a systemic risk that could have a material impact on the future financial position, performance or prospects of entities." The identification of climate change as a "systemic risk" squarely places the onus on directors to undertake a comprehensive assessment of climate change risks as they apply to their company and determine whether or not disclosure is required, with an express warning that ASIC intends to conduct surveillance of climate change-related disclosure practices by selected listed companies.

In the Hutley Opinion, Hutley and Hartford-Davis conclude that "climate change risks can and should be considered by company directors, to the extent that those risks intersect with the interests of the company," and that this could occur, "in a number of ways, ranging from the emergence of a corporate opportunity to the perception of a foreseeable risk of harm."

Foreseeability is a key legal factor in a director's assessment of the materiality of climate change risks. Foreseeability is not the same as "probability," and is set at the much lower threshold, being something that is not "far-fetched or fanciful." Indeed, Hutley and Hartford-Davis opine that certain categories of climate change risks would be regarded by a court as being foreseeable at the present point in time, and that a plaintiff in an action against the directors as a result of the materilisation of these risks would have to prove that the directors' failure to act with the requisite degree of care and diligence in assessing such risks "involved or took place against a background of foreseeable risk."

Importantly, Hutley and Hartford-Davis note that it would be difficult for a director "to escape liability for a foreseeable risk of harm to the company on the basis that he or she did not believe in the reality of climate change, or indeed that climate change is human-induced," stating that the court "will ask whether the director *should have known* the danger."

What next for directors?

Climate change is now, more than ever, on the board meeting agenda. Directors have been put on notice by ASIC that climate change risks, be it physical or transitional, must be investigated, considered and assessed by the board either when their company is seeking to list, or annually as part of its periodic reporting and ongoing disclosure requirements.

Even when the effects of climate change and the likely impact on a company's future business model are not fully realised by the board or the company, the duty of care and diligence "obliges a director to *obtain* the knowledge, sufficiently to place themselves in a position to guide and monitor the management of the company'" Hutley and Hartford-Davis go as far to say that directors should consider and, if it seems appropriate, take steps to inform themselves:

- about climate change risks to their business;
- when and how those risks might materialise;
- whether they will impact the business adversely or favorably;

- whether there is anything to be done to alter the risk; and
- otherwise to consider how the consequences of the risk can be met.

With the shift in focus from climate change as an ethical issue to one of foreseeable business and financial risk, the benchmark for assessing and disclosing climate change risks has been raised. This is especially so in circumstances where the pressure from investors to mitigate a company's exposure to climate change risk has never been greater. It is therefore imperative for directors to ensure that listed entities in particular have the frameworks in place to adequately deal with contemporary and emerging risks such as climate change, as is recommended in the 4th edition of the ASX Corporate Governance Principles & Recommendations, which come into effect from 1 January 2020.

While ASIC suggests that directors will face minimal risk of being found liable for a misleading or deceptive forward-looking statement in an OFR, or indeed in a prospectus, by following the updated guidance and ensuring their company's ongoing compliance with its continuous disclosure obligations, there is no doubt that directors have been put well and truly on notice over climate change.

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