Straining at the floodgates – international developments in climate risk disclosure and litigation

November 2016

> [D]evelopment of the common law, as a response to changed conditions, does not come like a bolt out of a clear sky. Invariably the clouds gather first, often from different quarters, indicating with increasing obviousness what is coming.
>
> *Lord Justice Nicholls, Re Spectrum Plus Ltd (in liq) [2005] 2 AC 680, [33]*

In our recent Alert *A New COP on the Beat – Heightened Expectations for Corporate Sustainability Governance & Disclosure* (available here) we examined international developments raising the bar on corporate governance and disclosure of financial risks associated with climate change. These regulatory signals continue to solidify.

In this Alert, **Sarah Barker** (Special Counsel) and **Maged Girgis** (Partner) discuss a number of notable regulatory investigations in Europe and the United States, and consider what they suggest for the direction of corporate regulation – and litigation – in Australia.

Standard securities laws applied to dynamic economic realities

In recent months, international regulators have continued their application of 'general' securities laws to the disclosure of climate-related risks.

In the UK, the Financial Reporting Council has opened an examination into the adequacy of risk disclosures made the annual reports of two oil and gas exploration companies listed on the London Stock Exchange, Cairn Energy Plc and SOCO International Plc. The investigations, which were prompted by complaints filed by public-interest law firm Client Earth, focus on whether the two companies failed to inform the market about material economic transition risks, and physical risks, relevant to the companies' strategies and business models – in breach of their disclosure obligations under the UK *Companies Act 2006*.

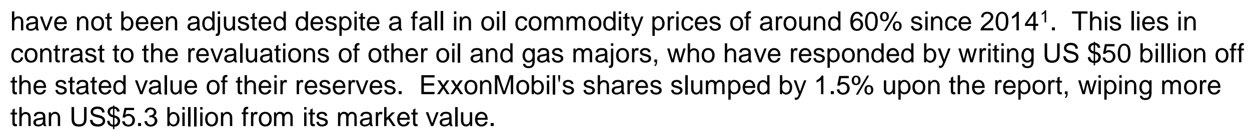
Whilst it may be tempting to dismiss such complaints as predictable activism by environmental interest groups, with little basis in corporate law, this would be both dangerous and inaccurate. Certainly, the merit of the complaints warranted reporting in publications from the Financial Times to The Accountant.

In addition, the Client Earth complaint co-incided with a call to the G20 by 130 large institutional investors, representing US$13*trillion* in assets under management, for greater regulatory scrutiny of climate risk disclosure (see here).

The mainstream credence of such claims is being borne out across the Atlantic, with reports emerging last month that the Securities and Exchange Commission (**SEC**) is investigating whether ExxonMobil's annual reports present a true and fair view of its financial position.

The investigation reportedly focuses on two issues: first, whether ExxonMobil's annual reports accurately convey the extent of the risk to its business from climate change (including regulatory and technological risks) and second, whether balance sheet materially overstates the value of its proven oil reserves, which

MinterEllison



have not been adjusted despite a fall in oil commodity prices of around 60% since 2014[1]. This lies in contrast to the revaluations of other oil and gas majors, who have responded by writing US $50 billion off the stated value of their reserves. ExxonMobil's shares slumped by 1.5% upon the report, wiping more than US$5.3 billion from its market value.

Whilst not driven solely by climate risk-related factors, the reserve revaluation aspect of the SEC's investigation is of particular interest given one of the key economic transition risks associated with climate change: that fossil fuels may be rapidly re-priced as the global economy recalibrates to a low-carbon norm, with booked reserves becoming unrealisable at historical valuations.

This risk has only been compounded with the Paris Agreement coming into force from 4 November 2016, under which 197 countries (including Australia, Brazil, China, Japan, India, Korea, Taiwan, Russia, the US and the major economies within Europe) have agreed to introduce policies to limit global warming to no more than 2°C above pre-industrial average temperatures.

A number of leading institutional reports, from the analysis of Carbon Tracker to that of the Climate Institute and the International Energy Agency, have calculated that the achievement of the < 2°C goal will require a significant proportion of 'proven' fossil fuel reserves currently sitting on corporate balance sheets to remain in the ground, implying marked devaluation (or, in extreme cases, the writing-off) of those assets as Paris commitments are implemented.

The SEC's investigation into ExxonMobil's reserve valuation assumptions provides a stark illustration of the need to ensure that valuation assumptions and methodologies remain current as Paris-driven emissions reductions targets come into force.

It should be emphasised that the developments in the UK and US do not involve the application of any new to disclosure guidelines or regulations. Rather, it illustrates the capacity of general, generic rules around misleading disclosure, and universal corporate obligations to ensure that market disclosures present a true and fair view of both a company's historical performance and its prospects, to apply in a dynamic economic risk environment.

Having said this, specific rules and regulation which mandate specific disclosure on climate change-associated risks are proliferating internationally. As discussed on an earlier Alert in our series (available here), these include:

- the French *Energy & Ecology Transition Law* (Article 173 –VI) (applicable to asset managers, pension funds and insurers from January 2016);
- the voluntary standards suggested by the G20 Financial Stability Board Taskforce on Climate-related Financial Disclosures, chaired by Michael Bloomberg (due for release in December 2016);
- the ASX Corporate Governance Council's 2014 recommendation that companies disclose *material exposure to economic, environmental and social sustainability* ***risks***; and
- Model Guidance of the global peak-body of stock exchanges, the World Federation of Exchanges (of which the ASX is a member) issued in October 2015. The WFE guidance, entitled *Reporting ESG Information to Investors – A Voluntary Tool for Stock Exchanges to Guide Issuers*, identifies 34 ESG metrics that should be included in reports of listed entities as material drivers of financial performance, including 10 metrics that are directly referable to issues associated with climate change. More than 20 of the Federation's 64 international exchanges have already incorporated the Model Guidance into their exchange rules.

These international regulatory developments do not of course comprise the law in Australia. However, they certainly telegraph the potential direction of our own governance and disclosure laws. These developments are also likely to influence both our regulators and, in the event of litigation in relation to corporate disclosure, the courts.

---

[1] From a range between $US80 and $115 per barrel during 2011-2014, to a range largely between US$40 and US$60 per barrel since the start of 2015.

Implications for disclosures by Australian firms?

It is clear that the international regulatory environment on climate risk disclosure is moving rapidly around us. This is not to say the relevant issues are unfamiliar to Australian securities laws.

The *Corporations Act* and ASX Listing Rules already require the disclosure of information necessary to present a true and fair view of a corporation's performance and prospects, including material forward-looking risks.

More specifically, in direct parallel to the SEC's investigation of ExxonMobil, in June 2015 the Australian Securities & Investment Commission (**ASIC**) announced that asset valuations and impairments – particularly in the extractives industries - would be a primary focus area for its review of annual reports (see Guidance Note 15-139MR here).

Only this month, ASIC re-issued its guidance on forward-looking statements in the mining and resources industry (such as production targets, forecast financial information and income-based valuations). The guidance gives specific emphasis to the necessity for reasonable grounds for any forecasts, with disclosure of underlying methodologies and assumptions to allow users to assess their reasonableness (see Information Sheet 214, here). The high-profile cases involving the boards of *Centro* and *James Hardie* evidence the preparedness of Australian courts' to hold a corporation's directors liable for misleading statements in their statutory disclosures.

So what does this mean for annual reporting in Australia more broadly?

In short, it is clear that climate change is no longer an issue that can be consigned to a corporate compliance or public relations silo. It's impact on balance sheet items and forward-looking risk and strategy must be reconsidered, in an integrated manner, in the light of contemporary economic realities. This is critical not only for directors, who sign-off on both financial accounts and narrative managerial statements, but accounting and risk advisors.

*MinterEllison has been at the forefront of international thought leadership on the implications of climate change for corporate governance, insurance, institutional investment and disclosure. We would be delighted to share other recent Client Alerts on point with you upon request. Please contact **Sarah Barker*** and ***Maged Girgis.***

MinterEllison