A new COP on the beat – heightened expectations for corporate sustainability governance and disclosure

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Sarah Barker *(Special Counsel, Melbourne) and* ***Maged Girgis*** *(Partner, Sydney) examine international developments that are raising the bar on corporate governance, and disclosure of, risks and opportunities associated with climate change.*

Background – economic and regulatory evolution

You may have noticed a subtle change in the emphasis of your morning coffee read. The financial press has begun to devote serious column space to the issue of 'climate change'. So why this mainstream interest on what was, historically, an issue consigned to the 'environmental fringe'?

In short, leading market stakeholders have begun to recognise that issues associated with climate change present significant economic and financial risks (and opportunities) over both long- and shorter-term investment horizons, which cannot be ignored.

Such risks and opportunities arise not only from the physical impacts of climate change (which include an increase in extreme weather events, and 'gradual onset' impacts such as the increase in global average temperatures, rising sea levels due to water expansion and ice melt, and alteration of regional precipitation patterns), but associated regulatory, technological and societal responses.

This was recently underscored by the World Economic Forum in its *2016 Global Risks Report*, in which *'A failure of climate change mitigation and adaptation'* was rated as having *the top impact* of all current risks to the global economy.

The Paris Agreement settled at the Conference of Parties **(COP)** on 12 December 2015 has been recognised as a strong signal of the direction of market travel. The significance of that Agreement should not be underestimated. It represents a commitment by the Governments of 196 signatory countries to a goal of limiting the '*increase in the global average temperature to well below 2 °C above pre-industrial levels*' and to pursue ' *efforts to limit the temperature increase to 1.5 °C above pre-industrial levels*'. And, perhaps most significantly, a commitment by those governments to shift the global economy to an emissions platform of *net zero* by the middle of this century.

In order to meet the Paris goals, each country will need to significantly reduce its 'business as usual' emissions and the global economy, which has been heavily reliant on fossil fuel combustion since the industrial revolution, will need to transform, at scale and with speed.[1] The impacts are likely to be felt across all asset classes and industrial sectors, but in particular by carbon-intensive industries.

As a result, the corporate regulatory landscape – from reporting regulations to litigation trends - is now shifting to keep up with these developments. So what exactly does this suggest for corporate governance and disclosure in Australia?

Policy & regulatory reform – corporate disclosure

Historically, the inherent uncertainty in the scope, distribution and timing of the future impacts of climate change have led many corporations to disclose relevant risks via broad, high level or boilerplate

[1] See for example European Commission, COM(2016) 110 Final, Brussels 3 February 2016.

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language. Such disclosures are rarely decision-useful for investors, and are increasingly recognised as potentially presenting a misleading picture of a company's financial position.

To this end, regulators and private litigants have begun to demand that climate change-related disclosures are both specific to the performance indicator on which they may impact, and to account for uncertainty via stress-testing across the range of plausible climate futures.

Internationally, regulators are increasingly issuing specific (and often binding) guidance on the disclosures. For example:

- On 1 April 2016, the Taskforce on Climate-Related Financial Disclosure (Chaired by Michael Bloomberg) released its *Phase I Report and Public Consultation*. The Taskforce has been tasked by the G20 Financial Stability Board to assess what constitutes effective and efficient disclosure of climate-related issues, to:

  (a) support informed investment credit and insurance-underwriting decisions about reporting companies; and

  (b) enable a variety of stakeholders to understand the concentration of carbon-related assets in the financial sector and the financial system's exposure to climate –related risk.

  The Phase I Report specifically identifies the need for disclosures pertaining to the near-, medium- and long-term impacts of climate-related financial risks by all actors in the investment supply chain, from corporations to asset owners. The Taskforce is due to provide its final report by the end of 2016. Whilst its recommendations are 'voluntary', they are likely to set a baseline for international disclosure expectations;

- From 1 January 2016, under the French *Energy & Ecology Transition Law*[2], all French asset managers, insurers and pension funds must report on how they integrate 'environmental, social and governance' (**ESG**) issues into their investment processes. The French Treasury's *Implementation Decree* prescribes the information that must be included in that report – including:

  - engagement policies (and assessment of their implementation) and methodologies applied in the companies' analysis of climate risk and its results; and
  - specific information regarding the projected impacts of (amongst other things):
    - changes in the availability and price of natural resources and the consistency of their exploitation with climate and environmental goals;
    - the coherence of capital expenditure issues with low carbon strategies, and in particular for actors involved in the development of fossil fuel resources, the underlying hypothesis supporting such expenditures;
    - any policy risk related to the implementation of domestic and international climate targets; and
    - measures of past, current or future greenhouse gas emissions directly or indirectly associated with emitters included in the investment portfolio, including the way the measure is used for risk analysis;[3] and

- In October 2015, the World Federation of Exchanges (the peak association of international stock exchanges, of which the ASX is a member) issued its *Model Guidance on Reporting ESG Information to Investors – A Voluntary Tool for Stock Exchanges to Guide Issuers*. The Guidance identifies 34 ESG metrics that should be included in reports of listed entities as material drivers of financial performance. These include 10 metrics that are directly referable to issues associated with climate change, including direct and indirect GHG emissions and carbon intensity (emissions relative to revenue). 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 indicate the direction of travel 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.

Corporations would be well-advised to have regard to these trends, now, to minimise regulatory – and litigator – scrutiny in that shift .

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[2] See Article 173-VI.

[3] Based on the (unofficial) English translation of the Implementation Decree by the *2° Investing Initiative* available here.

Prevailing 'general' disclosure laws – litigation

Even in the absence of specific 'climate change risk reporting' guidance, allegations of misleading disclosure of risks associated with climate change are being increasingly interrogated under prevailing 'general' disclosure laws. For example:

- On 4 November 2015, the New York Attorney-General issued a subpoena to oil producer ExxonMobil as part of an investigation into whether its regulatory filings had misrepresented the financial risks to their business from climate change.[4] By April 2016, more than 20 US-State Attorneys-General had joined this investigation.
- On 9 November, the Attorney-General announced the resolution of similar investigations into Peabody Energy. The Attorney-General determined that Peabody had contravened State misleading disclosure laws[5] by filing annual reports that mis-represented the potential impact of emissions regulations on its business, and selectively disclosing only favourable International Energy Agency energy and fuel-mix projections from a range of scenarios.[6] The Attorney-General's investigation was settled pursuant to an 'Assurance of Discontinuance', in which Peabody Energy did not admit or deny the allegations of breach.

These claims, whilst untested before the courts, provide a stark demonstration of the potential capacity of prevailing corporations and securities laws to apply in relation to corporate governance and disclosure of risks associated with climate change. In particular, they evidence a growing recognition that issues associated with climate change can give rise to material financial risks and opportunities – of such breadth and significance that failure to properly disclose them to the market warrants regulatory intervention.

This is not to say that risks associated with climate change will be material to *every* corporation in every context. However, given the broader financial market recognition of climate change as a material driver of financial risk, it is increasingly difficult for a company Board to *presume* that climate change will not have a material impact on the company's business.

Any such conclusion must be supported by a robust process of assessment in the circumstances of the company. Directors are expected to apply due care and diligence to this task – to appropriately educate themselves as to relevant issues, proactively inquire where information is lacking or contradictory, continually monitor and reconsider material issues in the face of evolving market conditions, and to actively apply independent judgment in a critical evaluation of relevant matters. For business strategy and performance projections, in particular, a default to historical norms on climate change are simply incapable of accurately conveying prospective market risk/return.

Shareholder activism – but not as you know it

Where corporations have been slow to recognise the potential significance of climate-related financial exposures, they are increasingly subject to 'forceful stewardship' by institutional investors.

Over the last few years, there has been a significant increase in shareholder activism on corporate disclosure of climate change risks: not only by 'activist shareholders' seeking to advance their external agendas, but mainstream, institutional investors with a genuine demand for decision-useful information on what they consider to be a material financial risk issue.

In some of the most high profile examples, in 2015 special shareholder resolutions were passed by oil giants Shell, BP and Statoil requiring them to stress test their forward strategies against potential climate change futures endorsed by the International Energy Agency. These resolutions *were* both supported by the board and passed at the companies' AGMs – with a resounding majority of 98.3, 99.8 and 99.9% of the shareholder vote, respectively. Similar resolutions were passed, again by significant majorities, at the 2016 AGM's of multi-national resource companies such as Anglo American, Rio Tinto and Glencore.

However, this is not only a European phenomenon. The US Securities & Exchange Commission recently refused a petition by the boards of ExxonMobil and Chevron to keep similar resolutions off the ballots at their AGM's on 25 May.

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[4] ExxonMobil, 'ExxonMobil to Hold Media Call on New York Attorney General Subpoena' (News release, 5 November 2015).

[5] Article 23-A, Section 352 *et seq*. of the New York General Business Law (the '*Martin Act*') and Section 63(12) of the New York Executive Law.

[6] Attorney General of the State of New York Environmental and Investor Protection Bureaus, *In the Matter of Investigation by Eric T Schneiderman, Attorney General of the State of New York of Peabody Energy Corporation, Respondent*, Assurance 15-242.

The resolutions failed to attract the support of either management or a majority of shareholders. However, each *was* supported with an unprecedented 38 and 41% (respectively) of the vote. Supporters included institutional heavyweights with more than US$10 trillion in total assets under management, such as the Norwegian Sovereign Wealth Fund, the New York State Common Retirement Fund, Calpers and Hermes Equity Services. The Wall Street Journal characterised the vote as: "*an indication that more mainstream shareholders like pension funds, sovereign-wealth funds and asset managers are starting to take more seriously the threat of a global weaning from fossil fuels.*"[7]

Closer to home, shareholders have also begun to file climate risk-focused resolutions with companies listed (or dually listed) in Australia, particularly in the resources (BHP and Rio Tinto) and financial services (CBA, ANZ) sectors. Although the Rio Tinto resolution, tabled in its dual 2016 AGM's in April (London) and May (Brisbane), is the only one to have passed, the other resolutions have been influential in prompting corporations to disclosure further detail around their recognition and management of risks associated with climate change. This has the effect of raising the disclosure bar for other corporations in their sectors, as investors seek comparable, decision-useful information.

Getting started: five priority areas for director focus

So what can directors and senior executives do *in practice* in the face of the complex issues associated with climate change? We suggest below a set of questions that may be a useful starting point for interrogation of this issue:

1. What are the risk (and opportunity) drivers to our business associated with climate change? Look beyond direct greenhouse emissions to susceptibility to physical impacts including extreme weather events (both for plant, infrastructure and supply chains), water scarcity, heat stress, drought etc; transition risks (including reputational and stranded asset and commodity price risks); and liability risks.
2. What are the potential financial impacts of these drivers under a range of plausible climate change scenarios, in the short, medium and longer term? Consider: what stress-testing do we conduct under what climate scenarios? What actions are we taking to manage and mitigate these risks, and to develop resilience in our operations? How are these risks integrated into our strategic planning assumptions, commercial hurdle rates and risk management frameworks?
3. What does our business model look like in a net zero economy? What is our transition plan, over what time frame?
4. What analysis has been performed, and by whom? How does the board oversee climate risk management?
5. What statements do we make about future growth and business plans – in our annual reports or broader market statements? On what assumptions are these predictions based? Would they be materially impacted under any plausible climate scenario? If so, how do our disclosures note this?

Whilst the above list is necessarily high-level and general, we would be pleased to provide specific advice on those governance steps likely to satisfy a director's duty of due care and diligence in their corporation's unique context.

Minter Ellison 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.***

[7] Bradley Olsen and Nicole Freeman, ' Exxon, Chevron Shareholders Narrowly Reject Climate-Change Stress Tests', *Wall Street Journal*, 25 May 2016.

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