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On the board's agenda | US

The atmosphere for climate-change disclosure

Introduction

Discussions and debates regarding the importance of environmental, social, and governance (ESG) disclosure have continued their fast-paced trajectory over the past several months. In January 2020, the CEO of the world's largest asset manager stated, " . . . we will be increasingly disposed to **vote against management and board directors** when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them."[1] Specifically, BlackRock is asking the companies they invest in on behalf of their clients to:

- Provide disclosure in line with industry-specific **Sustainability Accounting Standards Board (SASB) guidelines**, or equivalent standard, by year-end
- Disclose climate-related risks in line with the Financial Stability Board's (FSB) **Task Force on Climate-related Financial Disclosures' (TCFD)[2] recommendations**.

1. Larry Fink, CEO, BlackRock, CEO letter: *A fundamental reshaping of finance*, January 14, 2020.
2. The United Kingdom's FSB created the TCFD due to concerns of systemic risk in the financial system related to climate change, including that because such risk is both contested and long term, it may not be well understood and not considered rigorously enough by many organizations. The TCFD's 31 members were chosen by the FSB to include both users and preparers of disclosures from across the G20's constituency, covering a broad range of economic sectors and financial markets. The TCFD seeks to develop recommendations for voluntary climate-related financial disclosures that are consistent, comparable, reliable, clear, and efficient and provide decision-useful information to lenders, insurers, and investors.

Center *for*
Board Effectiveness

Adding to BlackRock's ask of companies, State Street Global Advisors has stated that "Beginning this proxy season, we will take appropriate voting action against board members at companies in the S&P 500 . . . that are laggards based on their R-Factor scores and that cannot articulate how they plan to improve their score."[3]

Also, in January, at the World Economic Forum annual meeting in Davos-Klosters, world leaders focused on the theme of a cohesive and sustainable world. The World Economic Forum Global Risks Perception Survey 2019–2020 set the stage reporting that "Severe threats to our climate account for all of the Global Risks Report's top long-term risks."[4]

The World Economic Forum and International Business Council (IBC) report[5] is another market development emphasizing the need for more standardized, high-quality, and business-aligned ESG reporting. The IBC recommended 22 metrics drawn from existing, recognized sustainability reporting standards, including SASB, TCFD, and the Global Reporting Initiative (GRI). The objective of the report was to serve as a further catalyst to corporates, with a sense of urgency, around how ESG transparency is critical for the market to navigate evolving environmental and societal risks and disruptors. The IBC report emphasizes that for the capital markets to hear this message, ESG disclosure should increasingly be provided through more mainstream disclosures, further emphasizing the importance of effective governance and board oversight.

These and other developments have shone a spotlight on ESG performance and disclosures specific to climate change. It is important for boards and audit committees to be aware of the increased focus being placed on climate-change disclosures and determine how best to exercise their oversight role to respond to this focus. In this capacity, we recommend that boards:

- Engage with management to understand 1) the climate-related risks and opportunities facing the business, 2) how these risks and opportunities impact the company's strategy, and 3) whether these risks are integrated into the company's enterprise risk management activities.
- Evaluate the governance structure to 1) define or refine the role of the board and determine the specific responsibilities of the board and committees, including with respect to oversight of climate-related risk assessment and disclosure, and 2) understand management's roles and responsibilities to be able to effectively measure, manage, and report on climate-related risks and opportunities.
- Understand the landscape with respect to 1) relevant standards and frameworks (for example, TCFD, SASB, and GRI) and 2) expectations of the company's priority stakeholders.
- Engage the audit committee to oversee related disclosures and coordinate with the board or other committee which may have primary ownership of overseeing climate-related risk management.

What has the TFCD recommended?

The Task Force identified four thematic areas for organizations to evaluate and disclose, as part of their financial statement preparation and reporting processes, the climate-related risks and opportunities that are most pertinent to their business activities. The recommended disclosures are intended to provide information that helps investors and others understand how reporting organizations think about and assess climate-related risks and opportunities.[6] There is supporting guidance to assist organizations generally as they develop climate-related financial disclosures, as well as supplemental guidance for specific sectors.[7] This structure encourages integrated thinking across the organization with respect to climate-related issues generally and financial statement impacts specifically (such as asset and liability measurement or impairment).[8]

Four thematic areas of climate-risk disclosures[9]

Governance	Strategy	Risk Management	Metrics and Targets
Disclose the organization's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material.	Disclose how the organization identifies, assesses, and manages climate-related risks.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.
Recommended disclosures: a) Describe the board's oversight of climate-related risks and opportunities. b) Describe management's role in assessing and managing climate-related risks and opportunities.	Recommended disclosures: a) Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term. b) Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning. c) Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.	Recommended disclosures: a) Describe the organization's processes for identifying and assessing climate-related risks. b) Describe the organization's processes for managing climate-related risks. c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management.	Recommended disclosures: a) Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process. b) Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 GHG emissions, and the related risks. c) Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets.

3. Cyrus Taraporevala, CEO, State Street Global Advisors, *CEO's Letter on our 2020 Proxy Voting Agenda*, January 28, 2020. In 2019, State Street launched an R-Factor (the "R" stands for responsibility), a scoring system to evaluate companies on financially material and sector-specific ESG issues. The R-Factor generates unique ESG scores for over 6,000 listed companies globally and leverages SASB guidance.
4. For the WEF 2020 survey, more than 750 global experts and decision-makers were asked to rank their biggest concerns in terms of likelihood and impact.
5. World Economic Forum, *Toward Common Metrics and Consistent Reporting of Sustainable Value Creation*, January 2020.
6. Final Report, Recommendations of the Task Force on Climate-related Financial Disclosures , Section C.1.
7. Financial Stability Board, Implementing the Recommendations of the Task Force on Climate-related Financial Disclosure, June 2017.
8. Final Report, Recommendations of the Task Force on Climate-related Financial Disclosures, Section E.7.
9. Financial Stability Board, Implementing the Recommendations of the Task Force on Climate-related Financial Disclosure, June 2017.

What are the SEC's views on climate-related disclosures?

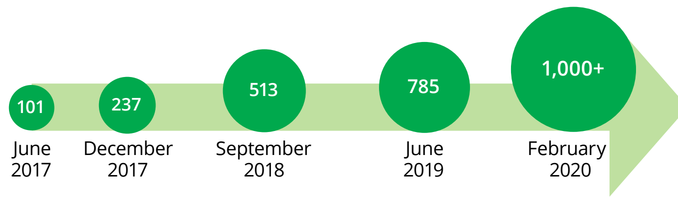
Recent comments by the Securities and Exchange Commission's chairman and other commissioners on climate-related disclosures reiterate that the SEC's 2010 guidance regarding climate-related disclosures remain relevant and further indicate that views vary about whether the SEC should take action beyond what is contemplated in the 2010 guidance.[10]

The 2010 SEC guidance reminds registrants that they "must identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance."[11] William Hinman, current director of the SEC Division of Corporation Finance, has explained "that [the 2010] guidance remains a relevant and useful tool for companies when evaluating their disclosure obligations concerning climate-change matters."[12]

Chairman Clayton has stated: "I am pleased with the Commission's approach to this issue to date and believe it has been consistent with our ongoing commitment to ensure that our disclosure regime provides investors with a mix of information that facilitates well-informed capital allocation decisions. . . . [T]his commitment has been, and in my view should remain, disclosure-based and rooted in materiality, including providing investors with insight regarding the issuer's assessment of, and plans for addressing, material risks to its business and operations."

Commissioner Lee, on the other hand, has stated that it is "clear that the broad, principles-based "materiality" standard has not produced sufficient disclosure to ensure that investors are getting the information they need—that is, disclosures that are consistent, reliable, and comparable" and that "voluntary disclosures, while a welcome development, are no substitute for Commission action for a number of reasons."[13]

Number of TCFD supporters



Sources: TCFD 2019 and 2018 status reports available at: https://www.fsb-tcfd.org/publications/ and TCFD Press Release available at: https://www.fsb-tcfd.org/wp-content/uploads/2020/02/PR-TCFD-1000-Supporters_FINAL.pdf

While views amongst the commissioners vary, Chairman Clayton has reiterated that the SEC continues to evaluate climate-related disclosures in ongoing filing reviews; issue comments on such disclosures when necessary; work with other regulators and standard-setters, including the FSB's TCFD; and engage with issuers and investors on this topic. In particular, the SEC "has been focused on: (1) better understanding the environmental and climate-related information investors currently use and how they analyze that information to make investment decisions on both an issuer- and industry-specific basis and more generally; (2) better understanding the extent to which (and how) issuers identify, assess and manage environmental and climate-related risks in their particular business and industry."[14]

Boards and audit committees should be aware of their risk oversight role with respect to climate-change disclosures and that "to the extent a matter presents a material risk to a company's business, the company's disclosure should discuss the nature of the board's role in overseeing the management of that risk."[15]

10. In 2010, the SEC issued an interpretive release which, among other issues, discusses how the SEC's existing disclosure requirements may apply to climate-related issues.
11. The guidance also provides examples explaining that "businesses that may be vulnerable to severe weather or climate-related events should consider disclosing material risks of, or consequences from, these events." In addition, it notes that "if a company determines that its physical plants and facilities are exposed to extreme weather risks and it is making significant business decisions about relocation or insurance, then, when these matters are material, companies should provide disclosure."
12. Director Hinman also provided the following: "For example, the guidance discusses how companies with businesses that may be vulnerable to severe weather or climate-related events should consider disclosing material risks of, or consequences from, these events. As another example, it notes that if a company determines that its physical plants and facilities are exposed to extreme weather risks and it is making significant business decisions about relocation or insurance, then, when these matters are material, companies should provide disclosure." See Securities and Exchange Commission (SEC), "Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks," March 15, 2019.
13. Commissioner Allison Lee, statement "'*Modernizing' Regulation S-K: Ignoring the Elephant in the Room*," January 30, 2020.
14. Chairman Jay Clayton, "*Statement on the Proposed Amendments to Modernize and Enhance Financial Disclosures; Other Ongoing Disclosure Modernization Initiatives; Impact of the Coronavirus; Environmental and Climate-Related Disclosure*," January 30, 2020.
15. William Hinman, Director of the Division of Corporation Finance, March 15, 2019. Item 407(h) of Regulation S-K and Item 7 of Schedule 14A require a company to disclose the extent of its board's role in the risk oversight of the company, such as how the board administers its oversight function and the effect this has on the board's leadership structure.

Using the COSO ERM framework to consider climate-change risks

Organizations looking to apply risk management concepts and processes to ESG-related risks, including climate change, can look to the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) *Enterprise Risk Management: Applying enterprise risk management to environmental, social and governance-related risks (October 2018)*. When considering how to evaluate evolving risks, this guidance can help organizations enhance resilience, articulate ESG-related risks, improve resource deployment, enhance pursuit of ESG-related opportunities, realize efficiencies of scale, and improve disclosure.

COSO ERM framework—Components	Examples of ESG application[16]
Governance and culture	• Support a culture of collaboration throughout the organization and among those responsible for risk management of ESG issues and consider opportunities for embedding ESG in the entity's culture
Strategy and objective-setting	• Examine the value creation process and business model to understand impacts and dependencies on all capitals in the short, medium, and long term
Performance Identifies risk Assesses and prioritizes risks Implements risk responses	• Identify and express ESG issues in terms of how a risk threatens achievement of an entity's strategy and business objectives • Leverage ESG subject-matter expertise to ensure emerging or longer-term ESG-related risks are assessed and prioritized appropriately • Adopt a range of innovative and collaborative approaches to responding to risks that consider the source of a risk, as well as the cost and benefits of each approach
Review and revision	• Review and revise ERM activities related to ESG in order to evaluate their effectiveness and modify approaches as needed
Information, communication, and reporting	• Consult with risk owners to identify the most appropriate information to be communicated and reported internally and externally to support risk-informed decision-making

Internal controls for climate-change disclosures

When determining appropriate disclosures (if any) and assessing whether the disclosures are subject to appropriate controls, boards, audit committees, and management may consider whether controls are in place regarding:

- **Competence**—Climate-related disclosures are evaluated and prepared by competent individuals familiar with climate change or ESG-related matters and understand potential impacts on the company.
- **Compliance**—The disclosures, if included, meet the SEC's expectations.[17]
- **Consistency of preparation**—A consistent process is in place to consider, evaluate, and prepare climate-change disclosures, and that process considers accepted standards (for example, TCFD recommendations).
- **Data quality**—The quantitative disclosures (if known and estimated) are calculated based on reliable inputs that are subject to appropriate internal control.
- **Accuracy of calculation**—Any metrics that are provided are calculated with accuracy and supported through management's books and records.
- **Transparency**—Descriptions are clear and not confusing.
- **Review**—The disclosures are reviewed by appropriate levels of management.
- **Monitoring**—The company's monitoring function (for example, internal audit, disclosure committee, or audit committee) appropriately reviews the internal controls in accordance with company protocols. In addition, the audit committee is involved in the oversight of the disclosures' preparation.

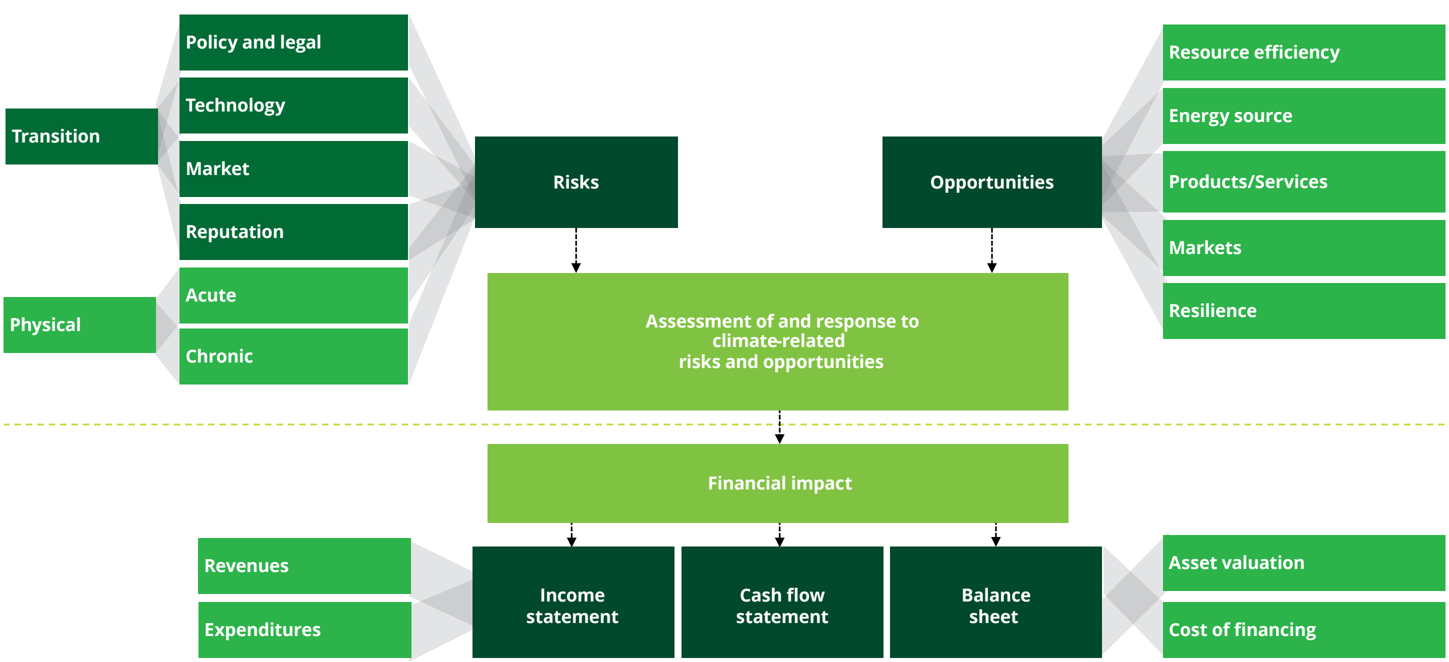
16. Committee of Sponsoring Organizations of the Treadway Commission, *Enterprise Risk Management: Applying enterprise risk management to environmental, social and governance-related risks*, October 2018.
17. For example, SEC Division of Corporation Finance Director Hinman has stated: "I encourage companies to consider their disclosure on all emerging issues, including risks that may affect their long-term sustainability. And as they do so I would suggest they ask themselves whether their disclosure is sufficiently detailed to provide insight as to how management plans to mitigate material risks and how their decisions in the area of risk could be material to the business and their investors." See SEC, "*Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks*," March 15, 2019.

In terms of implementing further controls in relation to risks identified, the organization may want to consider COSO's *Internal Control—Integrated Framework* (the "2013 COSO Framework"), which provides a framework for designing and evaluating internal controls through the use of 17 principles and related guidance. As organizations consider implementing controls related to climate-change risks, particularly those organizations that apply the 2013 COSO Framework in management's assessment of internal control over financial reporting, they should consider the COSO principles in evaluating and designing controls. In addition, Figure 1 below depicts climate risks and opportunities that organizations should consider.

Questions for the board to consider asking:

1. Does the board understand the risks and opportunities to the business with respect to climate change?
2. How does the company identify climate-related risks and opportunities, both from a physical and transition risk perspective, that are material to the business?
3. Are climate-change risks incorporated into the company's enterprise risk management activities?
4. Has management undertaken any form of scenario analysis to evaluate climate risk across different time horizons as informed by leading market initiatives (such as IPCC)?
5. How does the company collect data that supports high-quality disclosure? What processes and controls are in place to address evolving climate-change risks and related disclosure aligned with TCFD recommendations? Does a disclosure committee regularly consider these issues?
6. Does the company obtain external assurance on disclosures of ESG performance?
7. Does the company understand what types of disclosures its stakeholders seek, and how the company and the board respond?
8. How does the board oversee the management of climate-related risks, and is the board's role in the management of that risk disclosed?
9. Where does the oversight responsibility for climate-related risks reside within the board? How about with management?
10. Have climate-related risks been discussed with institutional investors, and how have their responses been considered?

Figure 1. Climate-related risks and opportunities that organizations should consider can be depicted in the following manner[18]:



18. Derived from Final Report, Recommendations of the Task Force on Climate-related Financial Disclosures.

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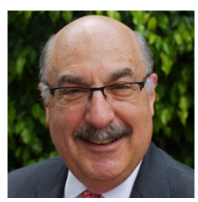

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