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Ministry for the Environment, and
Ministry of Business, Innovation & Employment
Wellington

By email: crfd@mfe.govt.nz

Climate-related financial disclosure – consultation

The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the Ministries' discussion document, *Climate-related financial disclosures – understanding your business risks and opportunities related to climate change* (discussion document).

The Law Society's Commercial and Business Law Committee has considered the discussion document, and responses to consultation questions within the Law Society's expertise and mandate are set out below.

Question 6: What are the implications of section 211 of the Companies Act 1993 for the disclosure of material climate-related information in annual reports?

In our view, it is problematic to assume that the existing annual return mechanism in section 211 of the Companies Act 1993 either naturally fits with or can be easily adapted to meet the policy goals for the proposed climate-related reporting:

- The two sets of information are fundamentally different and created for different purposes. As the discussion document notes, a company's annual report (and its financial statements) are backward-looking, focused on what happened in the most recent accounting period, with the resulting information premised on empirical certainty. Reporting on climate-related issues is a necessarily forward-looking, speculative and uncertain exercise. The annual report is intended to inform shareholders of the state of the company's business in the last accounting period. The climate-related disclosure regime is intended to inform shareholders of the directors' views about the company's possible exposure to climate-related risks but also, ultimately, to provide a means to springboard a shift in the culture of our economy.

- The information to be provided in an annual report is the minimum a company must provide to its shareholders, with failure to do so carrying a risk of criminal liability. The purpose of the proposed disclosure regime appears to be aimed at a different goal: namely, to ensure enterprise-wide assessment of specific risks and to increase the quality of on-going disclosure. The aim is to encourage disclosure on an on-going and constantly improving basis, not to punish directors. The risk of criminal liability for non-compliance does not seem to fit well with that goal.

- Other than to provide the specific (essentially factual) information listed in section 211 (including a description of matters affecting the company's business which arose in the financial year which the directors have assessed to be “material”), there is no requirement to include discussion of any particular matters. There is nothing to stop a company from providing more information in its annual report than section 211 specifically requires. However, to avoid liability, the company and its directors must be confident any such information is accurate and able to be substantiated. The nature of climate-related information makes this assessment virtually impossible.

Question 7: What are the implications of the NZX Listing Rules for the disclosure of material climate-related information by (a) equity issuers; and (b) debt issuers?

Non-financial reporting – Environmental, Social and Governance (ESG) Guidance Note

NZX already encourages issuers to disclose (non-financial) climate-related information in annual reports (whether alongside the financial information or as a standalone report), under the NZX Corporate Governance Code dated 1 January 2019 and specifically the ESG Guidance Note (dated 11 December 2017). Such disclosures are not mandatory, in the sense that they are on a “comply or explain” basis.

There are similarities between the matters referred to in the ESG Guidance Note and the Task Force on Climate-related Financial Disclosures (TCFD) framework proposed to form the basis of the proposed mandatory disclosure regime. The ESG Guidance Note specifically refers to the TCFD framework (among other sustainability reporting frameworks that exist) and the list of climate-related matters that the ESG Guidance Note recommends directors consider are similar to those that are the focus of the TCFD framework.

Continuous Disclosure

We do not consider the continuous disclosure regime provided for in the NZX Listing Rules well suited to meeting the policy goals for the proposed climate-related reporting.

It is unclear how directors of listed issuers could confidently disclose climate-related information (of the sort proposed under the TCFD framework) under the continuous disclosure regime. Critically, it is very difficult to see how directors of relevant entities can be sufficiently certain about the accuracy and likely impact of prospective, climate-related information to meet the threshold tests that are relevant to continuous disclosure obligations under the NZX Listing Rules, whether for debt or equity securities. A breach of the continuous disclosure rules is also a breach of section 270 of the Financial Markets Conduct Act 2013 which can give rise to a civil penalty or a significant pecuniary penalty under section 385 of the same Act. Given the points made above, this appears an inappropriate consequence for climate change reporting. Any change to the disclosure rules under the NZX Listing Rules would also obviously need to be promulgated by NZX and approved by the Financial Markets Authority (FMA).

Question 9: Do directors’ legal obligations in New Zealand result in consideration, identification, management and disclosure of climate-related risks?

Yes. We consider it is now difficult to argue that New Zealand statutory directors’ duties do not include a requirement to consider climate-related matters. As noted below (Q10), we agree with the discussion on these issues in the legal opinion dated October 2019 prepared for the Aotearoa Circle.

Question 10: Do you agree with the legal opinion prepared by the Aotearoa Circle?

Yes. The opinion is thorough and comprehensive and has been peer reviewed by an eminently qualified senior counsel.

Question 11: Do you favour the status quo or new mandatory disclosures?

A new mandatory disclosure regime seems necessary if the government is to achieve the stated policy goals.

The existing disclosure requirements apply to a limited number of entities, and each for specific purposes not aligned to the policy in question. The existing disclosure obligations do not provide the comprehensive and consistent disclosures necessary to achieve the policy results sought.

Question 19: What are your views about providing a transition period where incomplete disclosures would be permissible?

A transition period is likely to be of considerable assistance for reporting entities and their directors in meeting the new compliance requirements with confidence.

This is particularly so given that the regime will deliberately apply to 'apex' organisations within the financial sector (banks, insurers, asset owners and asset managers). These tend to be large and/or complex organisations, which will need to incorporate the new regime in their existing governance, risk management, compliance and reporting regimes. They may also need to modify personnel structures in order to cope with the new requirements. Another practical issue is the extent to which the relevant entities are able to access the assistance they need to properly assess their climate-related risks and conduct appropriate scenario analysis – whether by employing personnel with the requisite skills or using external consultants. Those people will be in demand, and there may be shortages.

There appear to be two stages to a company's ability to meet the reporting requirements set out in the TCFD framework, and the regime will need to allow both stages to occur before requiring full compliance. The first is to create and embed the framework, involving (for a large organisation) creating a new board governance and risk management process, conducting enterprise risk assessment reviews and scenario analysis, devising internal policy documents, compliance plans, operational risk-testing processes and reporting models. The second stage is to understand the nature and extent of the impacts of the risks as assessed, allow the new processes time to run and the information to flow, and from there frame the related disclosures.

It seems likely that allowing these matters to occur in an ordered fashion – perhaps by requiring the first stage to be completed in Year 1, and then the second stage in Year 2, will result in disclosures that are more accurate and so more meaningful for both the company concerned, and the market players reading those disclosures.

Questions 21 & 22: Should all of the following classes of entity be subject to mandatory (comply-or-explain) climate-related financial disclosures: listed issuers, registered banks, licensed insurers, asset owners and asset managers? / Should any other classes of entity be required to disclose?

We understand the policy drivers for requiring disclosure from this group of entities, being either public (listed) entities, or significant entities within the economy whose failure would have a disproportionate impact on the financial system (along 'too big to fail' lines). The theory seems to be that to make these entities disclose their climate-related issues will likely disseminate relevant messages through the economy quickly and drive relevant behaviour among those entities' stakeholders.

In our view, it is critical that the policy decision as to which private and public entities must disclose, and which do not have to, is clear so that all entities know where they stand, and are able to approach their obligations on a 'confident compliance' basis. Such policy statements are not clear from the discussion document.

An alternative starting point could be to apply the (public) reporting obligations to those entities which already have 'public accountability' (a term which is used in financial reporting standards) – whether they are for-profit or public benefit entities. As a result, there would be a logical connection between the existing obligations of entities to make their financial statements available to an audience that is wider than just stakeholders – and then to also make climate-related financial disclosures.

Questions 23 & 24: Should there be an exemption for smaller entities? / criteria to be applied.

Yes. From a practical perspective, smaller entities are unlikely to have the capacity to consider the full ramifications of the proposed reporting, and it seems inappropriate to require smaller entities to be exposed to a public disclosure regime.

A logical extension of the approach suggested in response to Questions 21 & 22 is that the same financial thresholds that apply to financial reporting obligations are applied in determining which classes of entity (in the private and public sectors) are required to make climate-related financial disclosures. See also our comments in relation to the topic of independent assurance (Q28).

Question 25: What are your views about our proposal to have a stand-alone climate-related financial disclosure report within the entity's annual report?

A stand-alone climate-related disclosure report seems appropriate given the legislative purpose of the disclosure regime, and the interests of creating legislation that can prompt 'confident compliance' by those subject to the obligations.

As we understand what is proposed, the legislative purpose of mandatory climate-related reporting (via the TCFD reporting framework) is not to prompt disclosure per se, but as an indirect ('soft law') means to prompt culture change within the New Zealand economy towards a low-emissions economy. Reporting entities must consider their climate-related risks (physical and transitional) comprehensively, and then inform stakeholders and other recipients of the annual report of certain matters that follow from the risk assessment and strategy considerations. That audience is then left to make its own assessment of the likely impact of those risks on the reporting entity concerned. This process is aimed at prompting change in behaviour of those reporting entities.

Liability for non-compliance with the disclosure regime must be appropriate and designed specifically with the regime's goals in mind. The proposed regime does not seek to punish reporting entities (or their directors) for making incorrect assessments of the impact of climate-related risks. Rather the regime seeks to encourage reporting entities to consider the various climate-related elements that affect the entity, take steps to mitigate those risks and inform the audience for the report of the entity's risk exposure and responses to climate change-related matters such that the audience can make informed decisions about their stake in or dealings with that entity. Those decisions will then prompt the appropriate / different behaviour amongst similar entities at a fast rate.

This standalone report should have its own compliance regime which differs from the current compliance regimes for reporting such as Companies Act annual reporting and the continuous disclosure regime. As discussed earlier, this is because climate change-related issues are typically more nuanced and uncertain than normal matters which companies report on. This should be reflected in the level of liability imposed on directors for failure to disclose matters at all or fully.

We have made the following assumptions in relation to the proposed stand-alone climate-related financial disclosure report within the entity's annual report:

- We assume that much of the new report will be based on a narrative (rather than numerical) assessment of likely climate-related risks facing the reporting entity into the future, and so not be subject to scrutiny on empirical grounds.
- The report could be delivered alongside the annual report (but not form part of it), and so be subject to its own liability regime, suited to its purpose.
- Each "set" of disclosures would represent a coherent whole, but (as applies under existing law) directors will need to ensure that the two documents together properly represent the state of affairs of the reporting entity at the relevant point in time, given the requirements of each set of disclosures.

Question 28: Should there be mandatory assurance in relation to climate-related financial disclosures?

We agree with the conclusion at paragraph 122 that it appears to be too soon to consider mandatory assurance obligations. International standard-setting is likely to be critical to both the nature and timing of any assurance obligations.

On a practical note, using the experience of Tier 1 financial reporting entities on ESG matters as a guide, it is likely directors will make their own decisions about the need for independent expert input into such reports. In this area the relevant skillsets are only now developing and making assurance mandatory is not practical at this early stage.

Question 35: Do you have any views about the legislative means for implementing new mandatory (comply or explain) disclosure requirements?

We have commented below on a few matters we consider relevant to this issue. Many of these matters concern legal detail that cannot be assessed until the relevant Bill is available for comment. We nonetheless outline now the matters we consider important.

Clear legislative purpose

The obligations should be prefaced with a clear legislative purpose, as a key first step to aid statutory interpretation.

The legislative purpose in this instance will be particularly important, and perhaps not immediately obvious on its face. The discussion document (and associated information) makes plain that the policy goal of requiring mandatory disclosure is (a) to implement a means to solve the problem of the lack of information available to stakeholders and other recipients of periodic reports about the impact of climate-related matters on reporting entities, and (b) to start the process of transitioning New Zealand to a low-emissions economy capable of meeting the newly approved carbon emissions targets. That such a 'soft law' disclosure approach has been selected specifically (at this stage) should be clear and express, from the outset.

Obligations must be clear and unambiguous.

The statement of obligations must be clear and unambiguous, using terminology that is capable of objective interpretation and appropriate within the company law framework (or comparable frameworks depending on the type of reporting entity). Given the proposal to include disclosure information in annual reports, it would be sensible to use existing company law terminology where possible.

It must also be clear to whom the disclosure duty is owed and who will have standing to bring an action in the event of breach.

No conflict with existing obligations

The new reporting requirements must complement, and not conflict with, any other reporting obligations to which the reporting entity is subject.

Any new reporting obligations must be framed, and must be able to be met (from a practical perspective), alongside all other standards of care and other obligations to which the relevant reporting entities and their directors are subject, under other statutes (including the Companies Act 1993, the Financial Markets Conduct Act 2013, the Public Finance Act 1989 and the Fair Trading 1986) and at common law. This is particularly so in relation to forward-looking and inherently speculative reporting presented alongside (and against the background of) existing financial reporting premised on historical information and empirical certainty.

Appropriate liability

Potential liability for reporting entities and their directors arising from non-compliance with the proposed reporting framework must be appropriate, given the policy background and legislative purpose.

No adverse unintended consequences

New legislative obligations should not create adverse unintended consequences. The practical elements of compliance with disclosure obligations will need to be considered in order to prevent unintended consequences arising.

An example could be the impact of the TCFD reporting framework on smaller entities who form part of a reporting entity's value chain, but who are not intended to be subject to disclosure obligation themselves.

A deliberate goal of the proposed disclosure regime is that those with primary reporting obligations (such as Financial Markets Conduct (FMC) reporting entities, banks, insurers, and relevant public sector agencies) are 'apex' entities within the financial system in New Zealand, being those likely to have the greatest impact on the move to a low emissions economy. Such entities are critical providers of goods and services in the economy. Those reporting entities are therefore at risk if their customer or asset base is at risk (as demonstrated by the GFC). It follows therefore that the reporting entity must have a clear understanding of the risks facing the entities within its value chain (customers, suppliers, other operating assets) in order to understand its cumulative risk profile. As a result, compliance with reporting obligations in respect of climate-related exposures could potentially require gathering of relevant risk information from the entire value chain, or a significant portion of it. This could well include, necessarily (for the reporting entity), smaller entities that are, for policy reasons, exempt from the disclosure regime.

The question then is how, practically, the primary reporting entities will be able to satisfy their required disclosure obligations, without requiring all those in their value chains to provide 'back to back' compliance information – including those who are not subject to the reporting obligations in their own right.

Question 36: Do you consider that there is a role for government in relation to guidance, education, monitoring and reporting?

Yes, particularly given that the broader purpose (discussed above) of the proposed climate-related financial disclosure framework is to expedite the transition to a low emissions economy.

We see a role for government agencies and relevant regulators in providing supporting materials for use by reporting entities, and the market more generally, so that a consistent approach is taken to relevant matters. The support could be (a) to assist reporting entities to consider their climate-related risks and their financial impact on the entity and sector concerned, and the economy as a whole; (b) to offer compliance assistance to those entities who may be unused to considering such matters; and (c) to report on relevant themes and matters that arise from the disclosures provided through the regime.

Examples could include:

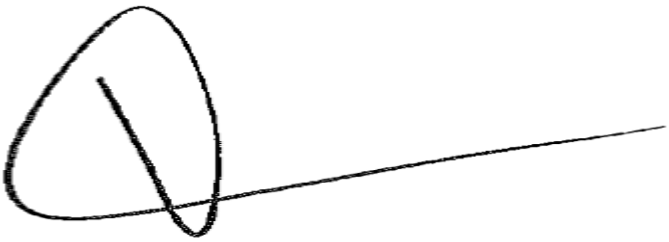
- Information in relation to the likely indirect impacts of physical risks and about transition risks generally (which could well be a new concept to many reporting entities).
- A clear outline, including likely effects and timelines, for legislation and regulation likely to impact transition risks.
- Approved guidance on scientific matters likely to affect assessments of physical risks. The proliferation of information available currently, with such varying conclusions drawn, makes clear assessments difficult. Consider, for example, the ESG reporting by NZX–listed 'Gentailers' (generator-retailers) in the energy sector.
- Guidance notes for compliance with key elements of the reporting framework (akin to the Guidance Notes released by the External Reporting Board, NZX and the Takeovers Panel).
- Compliance checklists for smaller entities (not subject to a primary reporting obligation) who will inevitably be required by a reporting entity whose supply chains they are in to provide compliance-related information to enable that entity to provide quality disclosures themselves.
- A central repository for disclosure information.
- Regular reporting on themes (etc) identified from disclosures.

Final comment

It will be important that climate-related disclosure obligations created for the private sector are developed alongside, and consistently with, the public sector. The public sector (including central and local government agencies) plays a significant role in the New Zealand economy as employers and providers of goods and services; given the interdependence between the two sectors, private sector reporting obligations should be developed in partnership with those affecting public sector entities.

If further discussion about these comments would assist, please do not hesitate to contact the convenor of the Law Society's Commercial and Business Law Committee, Charlotte McLoughlin, via Law Society Law Reform Advisor, Emily Sutton (emily.sutton@lawsociety.org.nz).

Yours faithfully



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