THE FCA CLIMATE CHANGE CONSULTATION PAPER: A US CAPITAL MARKETS PERSPECTIVE

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Legal Briefings

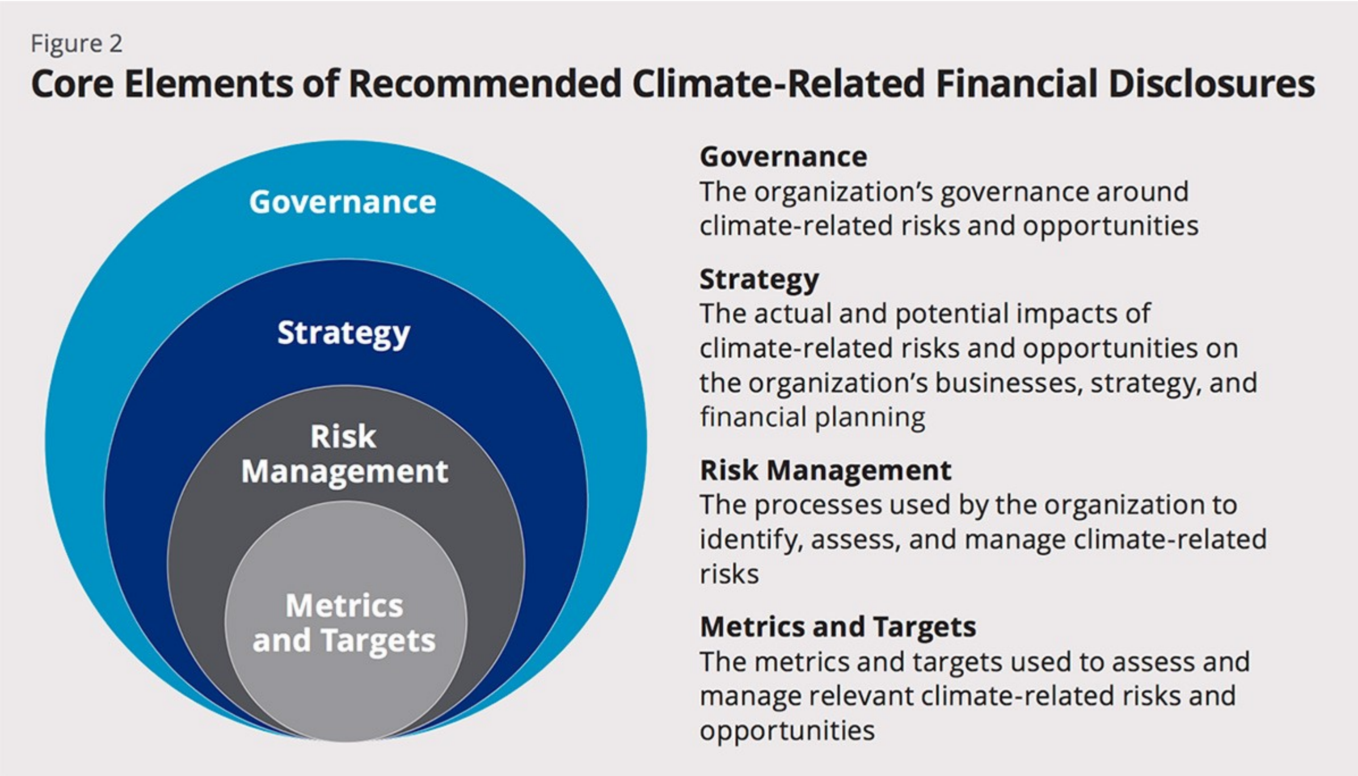
Amid mounting calls for consistent standards, we explore the UK market regulator's attempt to bolster climate-related reporting.

INTRODUCTION

Climate-related disclosure has become one of the most widely discussed issues in capital markets in recent years. Many influential institutional investors have called for specific, consistent and reliable disclosures of the risks and opportunities related to climate change to guide investment, lending and underwriting decisions. In his letter to CEOs earlier this year, Larry Fink, Chairman and CEO of BlackRock, emphasized that "climate change has become a defining factor in companies' long-term prospects".[1] Mark Carney, former Bank of England Governor, has also warned that investors face "potentially huge" losses from climate change action that could leave non-green assets "stranded" and fossil fuels "unburnable."[2] In response to these and other similar calls for action, the United Kingdom has put a stake in the ground to strengthen the disclosure requirements for climate-related matters.

In March 2020, the UK Financial Conduct Authority (the "**FCA**") issued a consultation paper for feedback on proposals to improve climate-related financial disclosures by premium listed companies in the United Kingdom. This proposal draws upon the recommendations by the Task Force on Climate-related Financial Disclosures (the "**TCFD**"). The TCFD is an industry-led task force established by the Financial Stability Board in 2015 to develop a standardized reporting framework on climate-related risks. In June 2017, the TCFD published a framework (the "**TCFD framework**") with four overarching recommendations and 11 specific climate-related financial disclosures to implement these recommendations.

Summarized in the figure below,[3] these recommendations provide a framework to enhance the quality and consistency of climate-related risk and risk management disclosures in public reporting:



Under the FCA proposal, all companies with a premium listing on the London Stock Exchange would be required to include climate-related disclosures in their public reporting on a "comply or explain" basis in accordance with the four recommendations and 11 specific disclosures set out in the TCFD framework. To satisfy this obligation, premium listed companies would need to include a statement in their annual financial report setting out:

1. Whether their report includes the TCFD recommended disclosures;
2. Instances where they have not followed the TCFD recommended disclosures, and the reasons for not including such disclosures;
3. Instances where they have included the TCFD recommended disclosures in a document other than their annual financial report, and why; and
4. Where in their annual report (or other relevant documents) the TCFD recommended disclosures can be found.

The FCA placed particular emphasis on disclosures relating to risk management and governance, stating that a failure to disclose these items should only be "on an exceptional basis". The consultation closed on 1 October 2020.

Although the FCA considers the TCFD framework to be a useful and widely-accepted tool to enhance and structure climate-related financial disclosures, it recognizes the challenges that issuers may face in implementing its proposed rules. Such challenges include:

- the ability of issuers to scientifically evaluate and describe the climate-related risks and opportunities facing their businesses;
- the quality of available data to support this evaluation;
- access to professional service providers that have the capability to develop and apply harmonized standards for climate-related disclosures (similar to the application of IFRS by auditors); and
- the legal liability associated with forward-looking statements involving climate-related issues.

Underlying all of these challenges is the difficulty for issuers in making materiality assessments for climate-related disclosures. Although the TCFD has stated that the “Governance” and “Risk Management” aspects of its framework are not subject to a materiality threshold, issuers will inevitably have to make a determination about what information to disclose regarding these matters, and these judgments will turn on an assessment of materiality. In discussing materiality in its consultation paper, the FCA has recognized that it can be particularly challenging in relation to climate-related issues. The TCFD believes organizations should determine materiality for climate-related issues consistent with how they determine the materiality of other information included in their financial filings.[4] However, under International Accounting Standard 1, the definition of materiality is very broad and includes items that “could individually or collectively, influence the economic decisions that users make on the basis of the financial statements”. In addition, the TCFD has cautioned issuers against prematurely concluding that climate-related matters are not material based on perceptions of the longer-term nature of some climate-related risks.

Wrestling with these challenges could also impact the way in which sponsor financial institutions deal with climate-related disclosures for their clients who are, or are looking to conduct, a London premium listing. As noted in the FCA consultation paper, a sponsor has to satisfy itself that the issuer’s directors understand their obligations under the listing and disclosure and transparency rules. A sponsor is also required to come to a reasonable opinion, after having made due and careful enquiry, that an issuer seeking a premium listing has established procedures to enable it to comply with its obligations under these rules on an ongoing basis. As a result, sponsors may be required to determine whether an issuer’s climate-related disclosures, procedures and systems comply with the UK Listing Rules, including the TCFD recommendations on a “comply or explain” basis.

The task of conducting due diligence to confirm compliance with the TCFD recommendations may be challenging for sponsors, particularly given that climate change is a relatively emerging and multi-faceted area of non-financial disclosure. To help fulfil its obligations under the UK Listing Rules, sponsors may look to rely on specialist service providers which have the expertise to diligence an issuer's climate-related disclosures. These specialists may advise sponsors on the process of integrating climate-related issues into their scenario analysis and risk analytics, but inevitably sponsors will need to help issuers formulate climate-related disclosures for FCA-approved offering and/or listing documents.

To help issuers and sponsors navigate this rapidly changing market and regulatory environment, this bulletin will overlay the four TCFD recommendations with specific guidance from US capital markets practice and interpretations provided by the US Securities and Exchange Commission (the "**SEC**"). As many market participants know, the US SEC has thus far adopted a more principles-based approach to climate-related disclosures, primarily due to many of the same challenges identified above by the FCA in its consultation paper. The SEC has justified this principles-based approach, which is somewhat in tension with investor demands and emerging regulations outside the United States, by arguing that overly prescriptive, climate-specific rules may not work for every issuer. The SEC has also emphasized that investors are still learning how to analyze climate-related financial information, a task which has been complicated by the fact that climate risk metrics and frameworks vary from issuer to issuer and industry to industry. However, notwithstanding the current position of the SEC, the US securities and capital markets have benefitted from a long history of rule-making and interpretations in relation to key disclosure matters, particularly those on which the TCFD has focused for climate-related disclosures (corporate governance, strategy, risk management and targets and metrics). As a result, US and SEC-based disclosure concepts can be particularly helpful in trying to determine the information that should be disclosed to investors in accordance with the TCFD framework.

THE TCFD FRAMEWORK – US PRACTICE POINTS

The TCFD framework consists of recommendations relating to: (i) corporate governance, (ii) strategy, (iii) risk management, and (iv) metrics and targets. For each of these categories, this bulletin will provide a brief overview of the TCFD recommendations and offer some US practice points based on the SEC's rules, regulations and recent guidance.

GOVERNANCE

Disclose the organization's governance around climate-related risks and opportunities.	(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.

The TCFD’s governance recommendations focus on the role of the board and senior management in evaluating climate-related risks and opportunities. In particular, issuers are asked to describe the processes and frequency by which the board and its committees consider climate-related issues in connection with the strategy, major plans of action, risk management, annual budgets and business plans of the company. Issuers are also required to disclose how the board monitors and oversees its progress against certain goals and targets to address climate-related issues.

In addition to discussing the board’s role, the issuer must confirm whether it has assigned responsibilities for assessing and managing climate-related issues to specific management roles or committees. If relevant, the issuer should provide a description of the organizational structure associated with this assignment. The issuer must also describe the processes by which management is informed about climate-related issues and how management monitors these issues.

US Practice Points on Governance

On February 21, 2018, the SEC published new disclosure guidance on cybersecurity risks and incidents (the “**SEC 2018 Cybersecurity Guidance**”). Although this guidance was not focused on climate-related issues, it is useful when thinking about non-financial risks such as climate change. In a speech delivered in 2019, William Hinman, the Director of the Division of Corporation Finance at the SEC, suggested that “[p]arallels may be drawn to other areas where companies face emerging or uncertain risks, so companies may find the SEC 2018 Cybersecurity Guidance useful when preparing disclosures about the ways in which the board manages risks, such as those related to sustainability or other matters.”[5]

The SEC 2018 Cybersecurity Guidance highlights the importance of Item 407(h) of Regulation S-K in preparing governance disclosures. Item 407(h) requires an issuer to disclose the board’s role in the risk oversight of the company. In particular, the issuer should describe how the board administers its oversight function and the effect of oversight on the board’s leadership structure. In thinking about this guidance in the context of climate-related risks, issuers should consider:

- How does a company perceive the role of its board and the relationship between the board and senior management in managing the climate-related risks facing the company?

- How does the board implement and manage its climate risk management function? Is it through the board as a whole, or through a committee, such as the audit committee?

- Do the persons who oversee climate risk management report directly to the board as a whole, to a committee, such as the audit committee, or to one of the other standing committees of the board?

To describe the structure of its climate-related risk management team, the issuer should be prepared to answer the following questions:

- Who is in charge of climate-related risk management?
- What is their role and level of responsibility?
- To whom do they report? The CEO or CFO?

In short, to comply with the governance disclosure requirements set forth in the SEC 2018 Cybersecurity Guidance, an issuer must be able to clearly describe its climate-related risk management organizational chart.

STRATEGY

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.	(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.

The TCFD's strategy recommendations ask the issuer to describe the specific climate-related issues that could have a material financial impact its business for each time horizon (short, medium, and long term), as well as the process(es) used to determine such risks and opportunities. In particular, issuers should consider how these climate-related issues impact their businesses and strategy in the following areas:

- Products and services;
- Supply chain and/or value chain;
- Adaptation and mitigation activities;
- Investment in research and development; and
- Operations (including the types of operations and the location of facilities).

In addition, issuers should disclose how climate-related issues impact their financial planning process, including their operating costs and revenues, capital expenditures and capital allocation, acquisitions or divestments and access to capital.

Lastly, issuers are required to describe the potential impact of climate-related risks and opportunities on their strategy, including whether their strategy is likely to change as a result of any climate-related developments. This discussion should consider the impact of any transition to a lower-carbon economy, consistent with a scenario in which the global average temperature rises to no more than 2°C above pre-industrial levels and, where relevant to the issuer, other scenarios involving significant physical climate-related risks.

US Practice Points on Strategy

On February 2, 2010, the SEC published an Interpretive Release on disclosure relating to climate change matters (the "**SEC Climate Change Guidance**"). The SEC Climate Change Guidance provides issuers with a useful roadmap for thinking about the impact of climate-related risks and opportunities on their businesses, strategy and financial planning. In particular, as described below, this roadmap can help issuers following the TCFD recommendations to supplement the *Risk Factors* section of their offering documents and public reporting with climate-specific disclosures.

(a) Legislation and regulation, including international accords

According to the SEC Climate Change Guidance, pending or new legislation and regulation related to climate change, including international accords, may have a material effect on the businesses, strategy and financial planning of an issuer, including:

- Increase in costs to improve the issuer's facilities and equipment to reduce emissions. This expenditure may be required to comply with the regulatory limits on emissions or to mitigate the financial consequences of a regulatory regime;

- Changes to profit or loss arising from an increase or decrease in the demand for goods and services produced by the issuer. Such changes may arise directly from legislation or regulation, as well as indirectly from changes to the costs of goods sold; and

- Increase in costs to comply with other legislation related to the protection of the environment, including the safe discharge of materials. The SEC also expects the issuer to disclose any material capex estimates related to environmental control facilities for the current period and future periods.

According to the SEC Climate Change Guidance, issuers should disclose the material effects of a pending law or regulation in the *Risk Factors* and, where relevant, the *Management's Discussion and Analysis of Financial Condition and Results of Operations* ("**MD&A**") section of their offering documents and public reporting.

To assess whether a pending law or regulation is reasonably likely to have a material effect on its financial condition or results of operations, the issuer should perform a two-step analysis. First, management must evaluate whether the pending law or regulation is reasonably likely to be enacted. Unless management determines that such law or regulation is not reasonably likely to be enacted, it must proceed on the assumption that it will be enacted. Second, management should consider whether the law or regulation, if enacted, is reasonably likely to have a material effect on its financial condition or results of operations. Unless management determines that a material effect is not reasonably likely, MD&A disclosure is required. In addition to disclosing the potential effect of such law or regulation, the issuer should also describe the uncertainties involved in the timing and form of the law or regulation. In other words, the issuer should explain whether it is clear when the proposed law or regulation will take effect, and acknowledge that there may be differences between the proposal and the form of the law or regulation that is eventually adopted. In the case of legislation related to climate change, there may be further uncertainties if adoption or implementation is dependent on international coordination.

(b) Litigation / legal proceedings

Item 103 of Regulation S-K requires issuers to disclose certain environment litigation matters. Specifically, the issuer must disclose an administrative or judicial proceeding arising under any federal, state or local provisions which regulate the discharge of materials into the environment or otherwise protect the environment if:

- Such proceeding is material to the business or financial condition of the issuer;
- Such proceeding, if resolved against the issuer, would represent a liability of more than 10 percent of the current assets of the issuer and its subsidiaries on a consolidated basis; or
- A governmental authority is a party to such proceeding and such proceeding involves potential monetary sanctions, subject to certain exceptions.

This clear guidance on the materiality of climate-related litigation can help issuers determine whether they should disclose a climate-related proceeding under the TCFD framework.

(c) Physical risks

The SEC Climate Change Guidance acknowledges that the physical effects of climate change, such as severe weather (for example, floods or hurricanes), rising sea levels, arid farmland and limited water availability and quality, could have a material effect on the businesses, strategy and financial planning of an issuer. In particular, the consequences of severe weather could include:

- For issuers with operations concentrated on coastlines, property damage and disruptions to operations, including manufacturing operations or the transport of manufactured products as a result of rising sea levels;
- Indirect financial and operational impacts from disruptions to the operations of major customers or suppliers from severe weather, such as hurricanes or floods;
- Increased insurance claims and liabilities for insurance and reinsurance companies;
- Decreased agricultural production capacity in areas affected by drought or other weather-related changes; and
- Increased insurance premiums and deductibles, or a decrease in the availability of coverage, for issuers with plants or operations in areas subject to severe weather.

In light of these risks, any issuers whose businesses may be vulnerable to severe weather or other climate-related events should consider describing the material consequences of these events in their public disclosure.

(d) Indirect risks and impacts

The SEC Climate Change Guidance recognizes that legal, technological, political and scientific developments regarding climate change may create new opportunities and risks for issuers. These developments may create demand for new products or services, or decrease demand for existing products or services, including:

- Decreased demand for goods and/or services that produce significant greenhouse gas emissions;
- Increased demand for goods and/or services that produce fewer emissions than competing products and services;
- Increased competition to develop innovative new products and services;

- Increased demand to generate and transmit energy from alternative energy sources; and
- Decreased demand for services related to carbon-based energy sources, such as drilling services or equipment maintenance services.

In some cases, the issuer may be required to disclose a change in strategy in the *Business Overview* section of its offering documents and public reporting. For example, an issuer that plans to reposition itself and take advantage of potential climate-related opportunities by acquiring new plants or equipment may be required to disclose this shift in strategy. Issuers should consider their own particular facts and circumstances when evaluating the materiality of these opportunities and obligations.

In addition to these developments, climate-related issues may also create new reputational risks for the issuer. Depending on the nature of its business and its sensitivity to public opinion, the issuer should consider whether the public's perception of any publicly available data relating to its greenhouse gas emissions could result in reputational damage and harm its business operations or financial condition. Any material reputational risks involving climate-related issues should be disclosed under the TCFD framework.

RISK MANAGEMENT

Disclose how the organization identifies, assesses, and manages climate-related risks.	(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.

The TCFD's risk management recommendations are focused on the process by which issuers determine the significance of climate-related risks in the context of their broader risk register. Accordingly, issuers should disclose how they assess the potential size and scope of each climate-related risk, including their use of any specific risk terminology or risk classification frameworks. The TCFD framework also expects issuers to explain how they make decisions to mitigate, transfer, accept, or control climate-related risks. In addition, issuers should describe their processes for prioritizing climate-related risks, including how materiality determinations are made within their organizations. After setting the scene, issuers should explain how these processes are integrated into the overall risk management framework of the business.

US Practice Points on Risk Management

The SEC 2018 Cybersecurity Guidance focuses on disclosure controls and procedures in its discussion of risk management policies. It emphasizes that the issuer should have a clear line of reporting up the chain to senior management of any matter that could require public disclosure, internal compliance, or which could otherwise have a material effect on the issuer. As a starting point, the issuer should consider the following questions when describing its risk management policies:

- What is your understanding of the existing and emerging regulatory requirements on your business? What is the process for monitoring these requirements?
- How do you make materiality decisions?
- Which risks are you currently monitoring? What is the process for monitoring these risks?
- Which processes do you use to manage these risks (including, for example, hedging, mitigation or risk transfer processes)?

An important aspect of the TCFD's risk management recommendations is the ranking of climate risks within a risk management framework, as well as determining the size and scope of such risks. By refining their disclosure controls and procedures in accordance with the SEC 2018 Cybersecurity Guidance, issuers can identify climate-related risks, assess and analyze the impact of these risks on their businesses, provide for open communications between technical experts and disclosure advisors, and draft fulsome disclosures on these risks. In addition, issuers may need to consider the role that their accountants can play to help them establish internal controls and procedures for climate-related risks.

METRICS AND TARGETS

Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.	(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 greenhouse gas (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.

The TCFD framework requires issuers to disclose the key metrics that they use to measure and manage climate-related risks and opportunities. In particular, issuers should consider metrics relating to water, energy, land use, and waste management. Key climate-related metrics should be provided for historical periods to allow for trend analysis. In addition, issuers must provide a description of the methodologies used to calculate or estimate climate-related metrics, unless the methodologies are apparent.

GHG emissions should be calculated in line with the GHG Protocol to allow for aggregation and comparison across organizations, sectors and jurisdictions.[6] Where appropriate, the TCFD framework requires issuers to provide related, generally accepted and industry-specific GHG efficiency ratios. GHG emissions and associated metrics should also be provided for historical periods to allow for trend analysis.

In addition to these requirements, issuers must describe their key climate-related targets, such as those related to GHG emissions, water usage, energy usage, financial goals, financial loss tolerances, or net revenue goals for products and services designed for a lower-carbon economy. When describing their targets, issuers should consider the following factors:

- Whether the target is absolute or intensity based (for example, emissions per unit of economic output);
- The time frames over which the target applies;
- The base year from which progress against the target is measured, and
- Key performance indicators used to assess the issuer's progress against this target.

For industries with high energy consumption, such as transportation and manufacturing, the TCFD recommendations note that metrics related to emission intensity are important to provide.

US Practice Points on Metrics and Targets

On January 30, 2020, the SEC published new disclosure guidance on key performance indicators ("**KPIs**") and other metrics in the MD&A (the "**SEC KPI Guidance**"). KPIs are an important part of MD&A disclosure, and the SEC has emphasized that issuers should identify and describe the key variables and other qualitative and quantitative factors that are both peculiar to the issuer's business and necessary for investors to understand and evaluate the issuer's financial condition and results of operations.

According to the SEC KPI Guidance, the issuer should first consider whether an existing regulatory disclosure framework applies. In other words, the issuer must determine whether a KPI is a GAAP financial measure, a non-GAAP financial measure or an operating or statistical metric. Then, the issuer should consider what additional information may be necessary to provide adequate context for an investor to understand the metric presented. On this point, the SEC generally expects, based on the facts and circumstances, the following disclosures to accompany any KPI metric:

- A clear definition of the metric and how it is calculated;
- A statement indicating the reasons why the metric provides useful information to investors; and

- A statement indicating how management uses the metric to manage or monitor the performance of the business.

The issuer should also consider whether the disclosure of any estimates or assumptions underlying the metric or its calculation is necessary to prevent the metric from being materially misleading. This is a key point in relation to climate-related and sustainability targets, which may be the subject of anti-fraud claims in the United States.[7] In the United Kingdom, it is not clear whether the safe harbor provided by s.463 Companies Act will extend to disclosures made in accordance with the TCFD recommendations. Accordingly, to minimize the risk of directors' liability, the key assumptions behind any of the issuer's climate change targets should be disclosed, and issuers should consider including cautionary language in the legends and disclaimers which accompany their forward-looking statements. This cautionary language should specifically discuss the risk that climate-relate targets are not being met.

These recommendations from the SEC KPI Guidance can help to inform the approach that issuers take to comply with the TCFD framework and effectively describe the metrics used to measure climate-related risks and opportunities.

THE WAY AHEAD

The FCA consultation period on the TCFD recommendations was set to close on June 5, 2020, with the new rule expected to take effect for accounting periods beginning on or after January 1, 2021. The FCA has since announced an extension of the consultation period to October 1, 2020, which may affect when the new rule comes into force. The United Kingdom's withdrawal from the European Union adds a layer of complexity to the regulatory environment that UK issuers will have to navigate in 2021. Under the European Union's Non-Financial Reporting Directive, certain issuers may be required to incorporate the TCFD recommendations into their public reporting on a mandatory basis. As a result, UK issuers with listed securities in the European Economic Area may soon have to reconcile two sets of conflicting rules on climate-related disclosures.

Across the pond, the SEC continues to rely on the longstanding principle that only "material" matters, including climate-related matters, warrant disclosure. The US Department of Labor also remains skeptical of climate-related disclosures; it is currently considering a proposal to limit when and how pension plan fiduciaries may consider non-pecuniary factors, such as climate-related metrics, when making investment decisions.[8] If adopted, this proposal could have a chilling effect on the demand for "green" investment products, which may in turn reduce the level of enthusiasm for climate-related disclosures among US-based asset managers and asset owners.

However, there are signs that the tide may be turning in the United States. In May 2020, the SEC Investor Advisory Committee endorsed the adoption of a disclosure framework focused on environmental, social and governance ("**ESG**") matters, reasoning that such a framework would ensure the flow of capital to US markets, promote the goal of investor protection and level the playing field between issuers. Any shifts in the legislative landscape following the US presidential election in November 2020 could lead the SEC to adopt a more prescriptive approach to climate-related risk disclosure in the United States.

For the time being, the TCFD framework represents the direction of travel in terms of climate-related disclosure, and issuers, sponsors and other advisors will need to find an efficient way to comply with these new rules. Their attention should remain focused on what is "material": information that would be viewed by a reasonable investor as having significantly altered the total mix of information made available about the issuer. This concept of materiality will continue to be the loadstar that guides the assessment and disclosure of climate-related risks and opportunities.

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KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

DINESH BANANI
PARTNER, LONDON

+44 20 7466 2042
Dinesh.Banani@hsf.com

TOM O'NEILL
PARTNER, HEAD OF US SECURITIES, LONDON
+44 20 7466 2466
Tom.ONeill@hsf.com

DENNIS HERMRECK
COUNSEL (US), LONDON
+44 20 7466 2909
Dennis.Hermreck@hsf.com

SARA CANBY
ASSOCIATE (US), LONDON
+44 20 7466 7471
Sara.Canby@hsf.com

GAELEN PERRONE
ASSOCIATE (US), LONDON
+44 20 7466 2179
gaelen.perrone@hsf.com