MANAGING ESG COMPLIANCE
CHALLENGES FOR UK LISTED COMPANIES

Matthew Townsend, Sally Dewar, James Roe and Anne Kirkwood of Allen & Overy LLP examine current environmental, social and governance laws and regulatory codes, the changes in the pipeline for premium-listed companies and how compliance will come into greater focus in light of COVID-19.

The 2019 novel coronavirus disease (COVID-19) pandemic is reshaping how premium-listed companies look at a range of environmental, social and governance (ESG) issues. In recent years, the focus for premium-listed companies has been mainly on the environmental issues and climate-related risks that are financially material to their operations. In addition, societal and community concerns, such as the preservation of human capital and the promotion of a healthy business culture, are high on the agenda for premium-listed companies, their investors and other stakeholders. The final element in ESG compliance concerns the wider corporate governance framework that underpins the other areas.

The proliferation of prescriptive ESG-related laws and guidance has been driven by a combination of: political impetus for change; increasing investor and consumer pressure owing to the general rise in public concern for social equity and for the environment; shareholder activism; and increased regulation and enhanced scrutiny by regulators. This creates a backdrop against which businesses need to articulate and communicate their approach to ESG issues in order to protect their corporate reputation.

The raft of shareholder resolutions in recent UK company AGMs have looked at ESG matters across the board. As well as broader corporate governance issues, particular concerns have included: executive remuneration and pensions; board diversity and gender equality; and human rights issues in supply chains. All of these concerns are expected to continue to receive much greater focus in companies' disclosures and also from investors and other stakeholders that will demand greater transparency and high-quality data.

A wide range of reporting requirements, standards and targets have emerged. This means that there is a growing need for both companies and investors to measure and manage ESG-related risks. There is also a greater recognition that companies which manage and address effectively ESG risks in their operations and disclose accurate data may, in the long term, perform better. This is likely to drive a different approach to ESG risk management, due diligence and disclosure for companies to ensure that their ESG compliance is fit for purpose.

This article examines:

- The current reporting obligations for large listed companies in the UK.

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- What the reporting obligations mean in practice for the three elements of ESG; that is, the governance, societal and climate change aspects.

- Some current areas of focus and the possible impact of COVID-19 on ESG compliance.

CURRENT RULES AND CODES

Successful sustainable risk management starts with scoping the risks associated with ESG factors (*see boxes "The three facets of ESG" and "Why is ESG important?"*).

UK premium-listed companies have a number of obligations to report or announce information regarding ESG matters, including through periodic disclosures in their annual reports and accounts.

In March 2020, the Financial Conduct Authority (FCA) proposed a new continuing obligation that, if implemented, would require premium-listed companies to disclose more information about climate change impacts (*www.practicallaw.com/w-025-1800*) (*see "Enhanced disclosure" below*).

Investors are now subject to the Stewardship Code and their expectations of the quality of listed company compliance are expected to lead to enhanced ESG compliance (*see "Stewardship Code" below*) (*see News brief "New Stewardship Code: focusing on outcomes and effectiveness", www.practicallaw.com/w-022-9641*).

The three facets of ESG

The three facets of environmental, social and governance (ESG) issues cover a wide variety of concerns.

Environmental factors include:

- Pollution.
- Waste.
- Water.
- Natural resource management.
- Land use and deforestation.
- Energy.
- Climate change.

Social factors include:

- Health and safety.
- Human rights.
- Modern slavery.
- Stakeholder and community engagement.
- Employee relations.
- Conflict zones and conflict minerals.

Governance factors include:

- Anti-bribery and corruption.
- Anti-money laundering.
- Executive pay.
- The gender pay gap.
- Diversity and inclusion.
- Conflicts of interest.

The duty to promote success

Section 172 of the Companies Act 2006 (2006 Act) (section 172) imposes a duty on the directors to promote the success of the company for the benefit of shareholders while having regard to several broader factors, including: the likely consequences of any decision in the long term; the company's reputation; and the interests of the company's employees, suppliers, customers, community and the environment. There are many ESG elements to this oversight responsibility (*see "Governance" below*).

Companies are required to have regard to the factors listed in section 172 when making decisions. Listed companies are required to report annually in their annual reports and accounts how they have done so in a section 172 statement. Boards are therefore likely to be acutely aware of their duty to promote the success of the company.

Board members need to consider and deal with events as they arise, and also try to envision the long-term consequences of decisions made or not made, and their impact on all the factors in section 172. It is advisable that a company records an overview of its section 172 analysis at the time that the board makes any decision regarding ESG compliance.

UK Corporate Governance Code

Under the UK Corporate Governance Code (the Code), premium-listed companies are expected to demonstrate, throughout their reporting, how the governance of the company contributes to its long-term sustainable success and achieves wider objectives for stakeholders (*see feature article "Corporate governance reforms: widening responsibilities", www.practicallaw.com/w-016-1385*). The Code applies to all companies with a premium listing, whether incorporated in the UK or elsewhere, with respect to accounting periods beginning on or after 1 January 2019. The Listing Rules require these companies to make a statement as to how they have applied the Code's Principles in a manner that will enable stakeholders to evaluate how they have been applied in practice (*see "Governance" below*).

Non-financial information statements

UK-incorporated premium-listed companies are required to include, in their strategic reports, information about the company's position and policies with respect to: environmental matters; the company's employees; and social, community and human rights issues. They must also include information about the effectiveness of these policies, to the extent necessary for an understanding of the company's development, performance and position and the impact of its activity. Companies are also required to report on their environmental performance using environmental key performance indicators (KPIs). These non-financial information statements are required under sections 414CA to 414CB of the 2006 Act.

Where relevant, large companies should also include analysis using non-financial KPIs. In addition, as a result of the implementation of the Non-Financial Reporting Directive (*2014/95/EU*) (the Directive), since 2017, companies that qualify as large public interest entities (PIEs) must include a non-financial information statement as part of their strategic reports.

The environmental information that is required to be included in a non-financial information statement by large PIEs goes beyond what is required (under section 414C) from quoted companies that are not large PIEs. The non-financial information statement for large PIEs also needs to include a description of: the due diligence processes implemented by the company in respect of environmental matters; the principal environmental risks; and how the company manages those risks.

In the case of quoted companies, the strategic report must include a description of the company's strategy and a description of the company's business model. This may include ESG matters for many companies.

In June 2019, the European Commission (the Commission) published guidelines on reporting climate-related information (the 2019 guidelines), which are supplemental to the 2017 guidelines on non-financial reporting (*www.practicallaw.com/w-021-3660*).

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Although the 2019 guidelines are not legally binding, they are intended to demonstrate good practice when complying with the Directive.

Given the pervasive effects of climate change, the Commission expects that most companies covered by the Directive will conclude that climate change is a material issue. The 2019 guidelines apply to reports covering financial year 2019 and beyond, and include an annex explaining how the reporting requirements in the Directive can be combined with the recommendations made by the Task Force on Climate-related Financial Disclosures (TCFD) (TCFD recommendations) (*www.fsb-tcfd.org/publications/final-recommendations-report/*) (*see "TCFD recommendations" below*).

The Directive is subject to review (*see "Current areas of focus" below*).

Why is ESG important?

The importance of environmental, social and governance (ESG) issues is influenced by:

Investor pressure

Pressure from investors is led by issues such as:

- A general rise in public concern for the environment and social equity.
- New requirements for pension funds.
- The view that ESG compliance is good business practice.

Risk management

Financial and prudential regulators see climate change as a systemic risk to financial systems. Investors and companies are also gaining a much more detailed understanding of the risks associated with ESG issues, including:

- Direct risks, for example, the effect of climate-related flooding on infrastructure.
- Indirect risks, for example, changing consumer preferences.

Increased regulation

Changes in law across different ESG areas have raised the profile of ESG as a whole, for example:

- Modern Slavery Act 2015 statements.
- Enhanced climate change-related disclosures.
- Gender pay gap disclosures.
- Human rights due diligence developments.

Influence of key organisations

Key codes and guidance include:

- The United Nations (UN) Principles for Responsible Investment.
- The UN Sustainable Development Goals.
- The Corporate Governance Code.
- The London Stock Exchange guide to ESG reporting.

Streamlined energy and carbon reporting

The streamlined energy and carbon reporting (SECR) regime was introduced by the Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018 (*SI 2018/1155*) (2018 Regulations) (*see feature article "Climate change reporting: preparing for a zero-carbon future", www.practicallaw.com/w-022-4370 and Briefing "Climate change: turning up the heat on corporate governance", www.practicallaw.com/w-020-5133*). It applies to financial years commencing on or after 1 April 2019.

The 2018 Regulations amended the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (*SI 2008/410*) (2008 Regulations) to require additional information from quoted companies, as well as to impose a new duty on large unquoted companies. The 2018 Regulations also amended the Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (*SI 2008/1911*) to impose a similar new duty on large limited liability partnerships (LLPs).

The SECR regime applies to:

- Quoted companies, which will have to continue reporting on the same things as before under the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 (*SI 2013/1970*) along with some additional matters, in particular, the underlying global energy use that is used to calculate greenhouse gas emissions and any energy efficiency actions taken.

- Large unquoted companies, including large private companies, which have a new reporting duty that is very similar to the duty imposed on quoted companies under the 2008 Regulations as amended by the 2018 Regulations.

- Large LLPs, which will have a new reporting duty that is very similar to the duty imposed on large unquoted companies, except that, as LLPs are not required to produce a directors' report, they will have to produce a separate energy and carbon report in order to comply with the SECR.

In March 2019, the government published revised environmental reporting guidelines, which cover environmental KPIs and the new SECR regime (*www.gov.uk/government/publications/environmental-reporting-guidelines-including-mandatory-greenhouse-gas-emissions-reporting-guidance*). These guidelines do not stipulate a specific climate change-reporting framework but state that companies should consider reporting in line with the TCFD recommendations.

Green Finance Strategy

In recognition of the fact that the TCFD recommendations have become the leading global climate reporting framework, the government announced in the Green Finance Strategy policy paper, published in July 2019, that it expects all listed companies and large asset owners to disclose in line with the TCFD recommendations by 2022 (*www.gov.uk/government/publications/green-finance-strategy*).

The government has set up a taskforce to examine the most effective way to approach these disclosures, including exploring the appropriateness of mandatory reporting (*www.gov.uk/government/publications/accelerating-green-finance-green-finance-taskforce-report; see feature article "Climate-related financial risk: spotlight on reporting", www.practicallaw.com/w-014-2731*).

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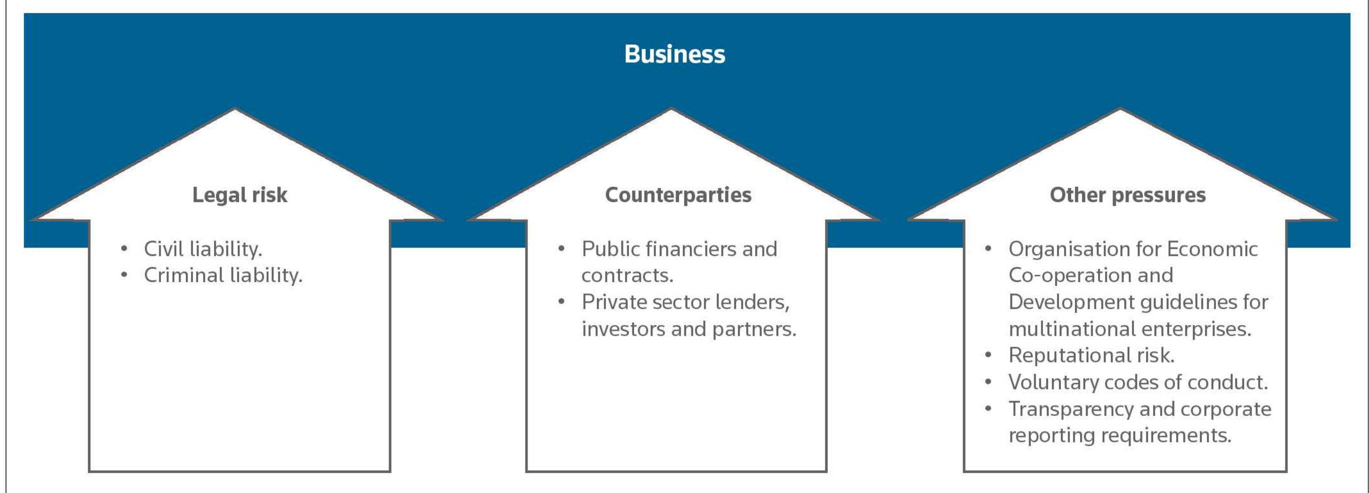
Effect of business and human rights risk on companies



At the inaugural TCFD summit on 8 October 2019, the Governor of the Bank of England (BoE) (the Governor) highlighted that support for the TCFD recommendations has increased dramatically within just two years of the final recommendations having been published and that current supporters of the recommendations control balance sheets totalling $120 trillion and include the world's top banks, asset managers, pension funds, insurers, credit rating agencies, accounting firms and shareholder advisory services (*www.bis.org/review/r191008a.pdf*).

The Governor stated that more needs to be done to improve disclosures of climate change risks and that companies, their banks, insurers and investors must: increase the quantity and quality of disclosures; refine disclosure metrics to determine which ones are most useful to decision making; and spread knowledge on how to assess strategic resilience.

To help organisations achieve this, the Governor recommends that the TCFD shares best practice to increase the quantity and quality of climate-related disclosures; for example, the TCFD is working on templates to help businesses carry out climate scenario analysis.

Stewardship Code

The impact of stakeholder engagement is expected to be a developing area for listed companies, driven by the Stewardship Code, which sets ambitious expectations for investment managers' stewardship activities and investor expectations, as well as changes to legislation and the Code. The Stewardship Code took effect for financial years starting from 1 January 2020 and the Financial Reporting Council (FRC) will begin accepting signatories to it in the first quarter of 2021.

Influential non-UK investor bodies, such as the International Corporate Governance Network (ICGN), have also published codes (*http://icgn.flpbks.com/icgn-global-stewardship-principles/files/extfile/DownloadURL.pdf*). Although these codes are voluntary, the views of these bodies carry significant weight.

Inside information

Issuers and other market participants need to ensure that inside information is appropriately identified, handled and disclosed, remembering that in the context of ESG risks, the nature of information that is material to a business's prospects may alter during the COVID-19 pandemic and what now constitutes inside information should be carefully assessed. Procedures, systems and controls that are in place to comply with disclosure obligations under the Market Abuse Regulation (*596/2014/EU*) (MAR) should continue to be assessed to ensure that they remain adequate to mitigate any ESG risk developments.

Listing Principles

The Listing Principles underpin the detailed Listing Rule requirements and are enforceable as rules. In particular, Listing Principle 1 requires listed companies to take reasonable steps to establish and maintain adequate procedures, systems and controls to enable them to comply with their obligations as listed companies. That includes the Code requirements described in this article and any new Listing Rule with respect to climate-related risk disclosures (*see "Enhanced disclosure" below*). Premium-listed commercial companies will therefore need to review their procedures, systems and controls to ensure that they support these requirements.

Secondary fundraising disclosure

Where an issuer of shares undertakes a non-exempt offer or admission to trading on a regulated market in the EU, it will be required to publish an approved prospectus in compliance with the Prospectus Regulation (*2017/1129/EU*) (*see feature article "The new Prospectus Regulation: regime changes", www.practicallaw.com/w-020-4530*). The detailed content requirements already require the disclosure of material ESG information. The European Securities and Markets Authority (ESMA) has consulted on draft guidelines on disclosure requirements under the Prospectus Regulation (*www.practicallaw.com/w-021-8103*).

In the usual way, it will be important that issuers provide carefully drafted ESG disclosure in the prospectus to investors and the market, given the relative size of the offering and the associated impact on the listed issuer. This is to ensure that investors understand the investment proposition. The prospectus can protect the issuer, its directors and the underwriters from litigation risk in relation to potential claims from investors that disclosure was inaccurate or misleading when judged with the benefit of hindsight.

ESG issues will impact on the business model and equity story (that is, the reasons why investors should invest in the company) for secondary equity capital raising. Material ESG opportunities and risks will therefore need to

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Impact of COVID-19 on the ESG agenda

The 2019 novel coronavirus disease (COVID-19) crisis has brought into sharp focus the immediate economic priorities for governments and businesses. This raises the issue of where this leaves the environmental, social and governance (ESG) agenda. The 2008 recession was characterised by a noticeable shift away from environmental priorities for a prolonged period. Some commentators believe that the same dynamics will be seen at work in the current crisis while others believe that an environmentally and socially sustainable recovery is likely.

While the full effects of the COVID-19 crisis are still to unfold, a number of immediate observations can be made that suggest a more intense focus on achieving and regulating ESG-based policy objectives is likely:

- Companies will need to better map and mitigate their physical risks. The COVID-19 crisis is unique among post-war recessions in that it is driven by physical risk and not just financial risk. This will inevitably lead businesses to reassess their physical asset and supply chain risks. Other physical threats, such as climate change, are therefore likely to come into sharper focus in business contingency planning.
- The crisis has triggered a significant growth in government command and control measures. Coupled with the need for major economic rebuild programmes across Europe, this will provide the European Commission (the Commission) and national governments with a stronger interventionist platform from which to drive their environmental agendas. Governments may therefore have more levers at their disposal in order to pursue ESG-based policy objectives.
- The level of state aid across Europe has increased significantly. In certain EU member states such as France, this has come with ESG conditions attached, for example, in the case of Air France. These types of opportunistic measures may prove popular among governments committed to ambitious net zero carbon targets.
- The human impact of the COVID-19 crisis has been immense. This will likely trigger businesses to look more closely at their human capital and community impacts. The rebuild following COVID-19 will need to focus on social cohesion. In addition, unlike at the time of the 2008 financial crisis, businesses are now much more wary of the reputational harm that immediate response measures will have. However, unfortunately, many businesses will have little choice over the measures that they have to take. At least in the medium term, there may be a shift in emphasis from efficiency to business resilience and long-term sustainability, although these three factors should not be seen as mutually exclusive.
- There are already signs of growth in new socially linked financial products such as: green equity; social or COVID-19 bonds which are linked to medical research or equipment; and projects to alleviate unemployment in the most badly affected regions. As the longer term effects of the pandemic become clearer, more issuances can be expected, giving further impetus to the hitherto less significant social element of ESG-focused financial products (*see feature article "Green bonds: financing a sustainable future", www.practicallaw.com/w-008-4811*).
- There is likely to be an acceleration in efforts to decarbonise economies. This will partly be driven by social forces as populations have experienced a drop in emissions and cleaner air but, more significantly, by national governments building sustainability into their economic recovery programmes. These programmes will likely be significant and present governments with a real opportunity to shape their economies for the years ahead, although the effects of a low oil price will need to be addressed.
- The COVID-19 crisis is providing a wake-up call for better corporate risk governance. While only a few commentators predicted the potential for a major virus outbreak, the need for businesses to better understand and manage physical risks is urgent. Contingency planning has, for many, focused on areas such as data breaches, security, and environmental or health and safety accidents. It will need to broaden.
- It is too early to tell what the impact of the crisis will be on the EU's ambitious Green Deal (*see "Directive review" in the main text*). A number of the measures set out in the Green Deal will be delayed and priorities will need to be reassessed. The proposed allocation of the Just Transition Fund will also come under scrutiny given the scale of government deficits. However, for the reasons discussed, countries may deploy their recovery programmes in a way that provides a major stimulus to the environmental and digital transition that the Commission President, Ursula von der Leyen, has called for.
- Only when the focus shifts from rescue to recovery will it be possible to gain an understanding of the deeper impact of COVID-19. The crisis has clearly put the sustainability of national economies and the preservation of human capital at the forefront of the agenda and, in this sense, the effects of the COVID-19 crisis will be starkly different to those felt after the 2008 financial crisis.

be reflected in business plans and models, and in enterprise risk management. ESG KPIs will need to be identified. ESG KPIs will need to be: relevant; specific and complete; clear, balanced and understandable; consistent over time; comparable; and reliable, verifiable and objective. ESG KPIs will become increasingly relevant in benchmarking, positioning and valuation.

The ongoing discussions of what ESG information is material for disclosure to investors in annual reports and accounts is relevant to what information is material for disclosure in the context of a transaction. Alignment between disclosure in prospectuses and offering documents, and periodic disclosures, such as annual reports and accounts, would create efficiencies.

GOVERNANCE

Corporate bonds and equities with high ESG ratings have, despite the pandemic, markedly outperformed MSCI's index. Evidence suggests that investors are focused on ESG issues. Sustainability-themed funds saw record inflows globally in the first quarter of 2020. Companies whose executive team

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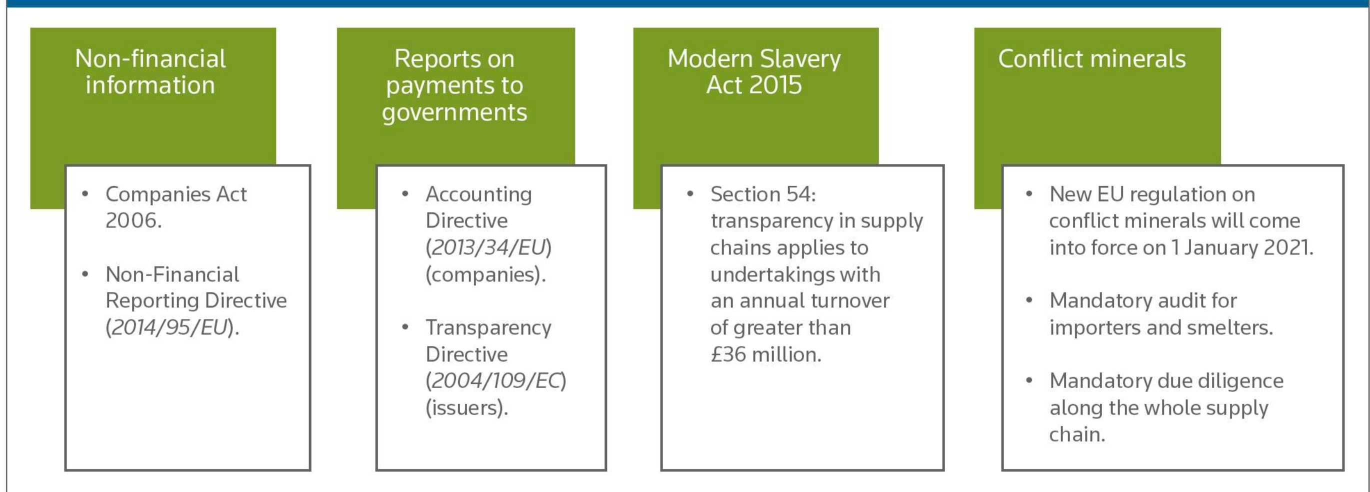

considers environmental and social factors, and abides by high standards of corporate governance may well be better equipped to ride out the aftermath of the COVID-19 pandemic (*see box "Impact of COVID-19 on the ESG agenda"*).

Under the Code, premium-listed companies are expected to demonstrate, throughout their reporting, how the governance of the company contributes to its long-term sustainable success and achieves wider objectives for stakeholders (*see box "Mandatory business and human rights reporting obligations"*). Investors must be able to evaluate: the company's approach to governance; how the company's board has articulated its purpose and strategy; how objectives have been met; and how the company's desired outcomes have been achieved through decisions made by the board.

One of the core aims for the FRC in updating the Code was to encourage companies to give more thought to long-term sustainability and their impact on wider society. Further, the strategic report of a listed company must include, as well as reporting on ESG compliance issues, a section 172 statement (*see "The duty to promote success" above*). This must be clearly identifiable and separate from the main body of the report, and include an appropriate level of detail sufficient to show which wider stakeholders featured in the board's decision making and how the interests of those stakeholders were treated during board deliberations.

The following factors indicate that good governance will be increasingly important for UK companies.

Stakeholder engagement

This is a developing area for listed companies, driven by changes to legislation, the Code, the Stewardship Code, and investor expectations. Workforce engagement has been the most high-profile area, but there has also been a focus on meaningful engagement with a wide range of stakeholders depending on a company's business and sector.

The COVID-19 pandemic has put a renewed spotlight on social and employee issues including, in particular, how companies are safeguarding human capital and treating workers given the negative impact of the crisis on employees and other stakeholders. Recent issues have included: senior management resignations in protest at a company's firing of whistleblowers who were raising employees' concerns about COVID-19 risks; a board chairman of a listed company having to reverse decisions about delays to payments of staff wages in the face of huge negative publicity from employees and investors; and the CEO of a UK plc having to issue a public apology for breaching government guidance to shut stores during the COVID-19 lockdown, again as a result of pressure from stakeholders. The reputational damage of these types of negative stakeholder engagements is likely to be significant.

Businesses, globally, are increasingly seeking to gain stakeholder credentials by emphasising their responsible policies relating to the environment, employees and community engagement. For example, when Airbnb was forced to cut staff as a result of falling revenues during the COVID-19 pandemic, the CEO gave those workers who were laid off benefits such as equity stakes, job advice and healthcare insurance for a year.

Dividend reductions or cancellations may be a flash point. Regulators and influential investor bodies such as the ICGN have asked companies to preserve long-term value and be socially responsible, preserving capital to protect employees instead of paying dividends to shareholders (*www.icgn.org/sites/default/files/6.%20ICGN%20Letter%20to%20Corporate%20Leaders_23%20April%202020_0.pdf*). Many companies are complying, and ESG factors appear to be at work in nudging this compliance. However, the US is lagging behind in this regard, as executives may consider it important to keep paying dividends despite any ESG pledges.

Engagement strategies are important. As some of the world's largest asset managers, such as BlackRock, are becoming more activist in relation to climate change, the development of engagement strategies is likely, especially for companies in the mineral sector. Recent examples include announcements in May 2020 by: JP Morgan Chase that its lead independent director would be demoted after climate activists urged the bank not to renominate the former CEO of an oil and gas company to the bank's board; and Legal & General Investment Management, the largest asset manager in the UK, that it would vote against the appointment of the board chair of an oil and gas company because of the company's alleged lack of strategic ambition around climate change.

Diversity targets

In February 2020, the Investment Association (IA) warned businesses about a potential backlash from investors at upcoming AGMs because of the lack of women in senior roles (*www.theia.org/media/press-releases/one-fifth-ftse-350-companies-cautioned-lack-*

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gender-diversity-senior-leadership). "Red top" alerts were issued to investors over gender diversity issues. The IA has updated its voting policy during 2020 to require British businesses to promote more women into senior leadership roles. Progress has been made on this issue since the publication of the Hampton-Alexander review, which named companies with both good and bad records on the issue of representation of women on boards of FTSE 350 companies (*www.practicallaw.com/w-023-7487*).

Executive remuneration

Governance considerations mean that there is a significant reputational risk to companies if employees are made redundant or subject to salary reductions while senior executives retain enhanced remuneration packages. For this reason, many executives have responded to the COVID-19 crisis by accepting voluntary pay cuts, particularly in those companies that have taken government bailouts or are in heavily affected sectors such as hospitality, travel or discretionary consumer products. Decisions for companies in relation to bonuses may also have a reputational impact.

Other key considerations on remuneration for 2020 include:

- The reduction of pension provisions for new executive hires.
- The role of the remuneration committee on executive terminations.
- The slowing down of additional remuneration requirements requested from investors.

Director elections

Investors are increasingly more active in voting against the re-election of directors in relation to certain key issues of concern, particularly concerns that some independent non-executive directors may have too many commitments (so-called "overboarding"), and a lack of diversity or independence, or both, on the board.

The independence requirements for board members and the chair are the Code provisions that are the least complied with, according to the FRC's annual review of the Code published in January 2020 (*www.practicallaw.com/w-024-1500*). In these cases, the FRC commented on the quality of the explanations given for non-compliance by the various companies.

The IA's public register for AGMs held in 2019 shows that executive remuneration and director elections remain the highest areas of focus for investors.

The Code recommends that the chair should not remain in post for longer than nine years. While this is not a rigid rule, and there is some flexibility if the company can give a reasonable explanation of the circumstances, boards need to be thinking about tenure as an issue. Managing the transition is often challenging and strategic advance planning of succession is key.

Practical considerations

In practical terms, the board's strategic planning on governance issues, and particularly stakeholder engagement, should include a consideration of whether:

- Board arrangements are effective, independent and sufficiently diverse to provide meaningful checks and challenges, and ensure that the executive management benefits from board engagements. This will include a consideration of the quality of management information and the effectiveness of the escalation protocols for developing risks, and whether the board regularly asks itself if a proposed course of action is the right thing to do.
- The company's leadership takes steps to maintain or, in times of crisis, increase communications and to remain visible to employees, including by the use of webinars and virtual "town halls", and to remind employees of the company's purpose, values and cultural expectations.
- The board has assessed that the company's government affairs, press, communication and public relations strategy is fit for purpose to encompass the requirements of shareholders, clients, customers and suppliers.
- The company has taken the opportunity where possible to demonstrate concern for customers, clients, employees and the communities in which it operates, for example, by supporting local communities through volunteering staff time.
- The board has considered the longer-term strategic implications of the current and likely future economic conditions, and whether it remains alert to emerging commercial opportunities that align with stakeholder expectations and corporate strategy and purpose.

SOCIETAL IMPACTS

Listed companies face increasing pressure from shareholders and stakeholders to show that they respect business and human rights. This is driving a desire to report formally on how the company addresses business impacts, including by tracking the effectiveness of their response to these business impacts and providing sufficient information to evaluate the adequacy of the company's response to these impacts.

Businesses may have a direct impact on human rights, for example through environmental impacts, such as pollution or deforestation. They may also indirectly impact human rights, for example, through child or indentured labour in their upstream supply chains.

The UN Guiding Principles on Business and Human Rights (UN Guiding Principles) provide a framework for discussing the role of companies, which is increasingly referenced in assessing a business's societal impacts (*www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf*). The government has adopted a National Action Plan to implement the UN Guiding Principles. The UK does not yet have a mandatory human rights due diligence law, like that found in France and proposed EU-wide. However, reporting requirements regarding human rights can be found in the 2006 Act and the 2015 Act.

Following a landmark decision by the Supreme Court, in certain circumstances there may be liability in the UK for companies involved in human rights impacts by way of their subsidiaries (*Vedanta Resources PLC and another v Lungowe and others [2019] UKSC 20; see News brief "Parent company liability: your place or mine?", www.practicallaw.com/w-020-1794*) (*see box "Effect of business and human rights risk on companies"*). Significant reputational impact is also likely. In practice, the latter threat is likely to drive compliance.

All companies should have in place strong human rights compliance systems to avoid risks and the expectations of listed companies are particularly high. Companies today are expected to consider the impact of their business activities, including but not limited to how they treat their employees, develop and market their new products and procure

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goods and services from suppliers. A code that sets out the day-to-day values and behaviours that are expected of all staff is also likely to be helpful in shaping a culture which manages business risk and respects human rights.

Some specific areas of business conduct that may present particular issues for listed companies are discussed below.

Employee and customer privacy

Data breaches and the misuse of employee or customer information may result in human rights violations, particularly if sensitive financial information is disclosed. Companies should ensure that all collected data is protected through regular security upgrades and adequate employee training (*see feature article "GDPR one year on: taking stock", www.practicallaw.com/w-020-0982*). Arbitrary interference with privacy is considered a human rights violation under Article 8 of the European Convention on Human Rights.

Supply chains

Under section 54 of the Modern Slavery Act 2015, companies that supply goods and services and have an annual turnover of at least £36 million must make a slavery and human trafficking statement which sets out the steps taken with regard to due diligence, risk management and training of staff to ensure that there is no slavery or trafficking in the supply chain. Companies face increased pressure from investors to develop effective policies, systems and controls to ensure transparency in the supply chain.

Companies whose businesses procure products or services are at risk of contributing to forced labour and human trafficking in their supply chains (*see feature article "Supply chain reporting: complying with the Modern Slavery Act 2015", www.practicallaw.com/6-622-9282*). To avoid these risks, it is crucial to conduct supply chain mapping to identify the greatest risks, investigate compliance with local laws and, where possible, remediate violations (*see Focus "Transparency in supply chains: the latest UK developments", www.practicallaw.com/w-020-9323*).

Equal pay and discrimination

A company with 250 or more employees in the UK has a duty to report on how it is addressing its gender pay gap under the Equality Act 2010 (Gender Pay Gap Information) Regulations 2017 (*SI 2017/172*). The employer does not have to be a UK company (*see News brief "Gender pay gap reporting: context is key", www.practicallaw.com/w-020-1791*).

Companies should ensure that their employees receive equal pay for equal work and remediate if inequalities are found. Beyond the gender pay gap, companies should also clearly avoid discriminating against minority groups in hiring, promotion and workplace cultural practices (*see News brief "Parker review on ethnic diversity: driving real change", www.practicallaw.com/w-024-1613*). It is advisable for companies to address these issues directly through policies, procedures and training related to workplace discrimination and sexual harassment (*see feature article "Sexual harassment in the workplace: a ticking time bomb", www.practicallaw.com/w-014-2736*). Companies should monitor and engage their workforce to prevent discriminatory practices.

Anti-bribery and corruption

UK companies are subject to the Bribery Act 2010 with respect to their overseas business activities. Corruption remains pervasive in certain countries and can profoundly affect vulnerable communities, either by misdirecting funds that could be spent on healthcare, education or other public goods, or by preventing participation in the democratic process.

Infrastructure and development

Human rights issues are increasingly proving to be material to shareholders, particularly in the context of infrastructure projects. Project finance requires robust due diligence on issues involving land rights, displacement and forced relocations, particularly in countries where access to remedies for these violations is curtailed or non-existent. Companies should ensure that infrastructure projects are built only under strict adherence to international norms regarding consultation, compensation and population relocation.

Customer due diligence

Although the law is not yet developed in the UK this area, there may be an emerging expectation that companies perform human rights due diligence throughout their value chains, including with respect to customers. Robust "know your customer" processes are critical.

Sector due diligence

Investing companies should conduct due diligence to identify whether their investments in other companies, infrastructure projects or other entities would contribute to human rights violations. Sector due diligence should consider operation-specific impacts as well as the geographic context in which the investment will take place.

Due diligence

When evaluating the risks and opportunities of specific transactions, operational decisions or business relationships, companies can take a number of steps to identify and assess material human rights aspects including:

- Taking legal advice on the potential business conduct and human rights issues to look out for.
- Ensuring that local counsel check compliance with local laws and practices.
- Ensuring that what is proposed is compliant with international human rights standards.
- Considering who to conduct due diligence on. This could include not only immediate targets or project companies but also supply chains, contractors and counterparties.
- Putting in place policies, processes and procedures to minimise future risks.

Transaction documents

To manage business conduct and human rights risk in transaction documents, companies can consider:

- What conditions, representations or warranties are needed.
- What they need to do to comply with any conditions, representations and warranties.
- How to strike the right balance in any joint venture agreements with local partners to avoid risks arising while not unnecessarily assuming legal liability for them.
- How to adhere to international human rights standards even when local law requirements diverge.
- What sort of remedial processes to put in place to address any problems before they escalate.

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- Responsible exit rights in the event that breaches of law or standards are discovered.

CLIMATE CHANGE

Companies may choose to make voluntary disclosures in addition to those required by law (*see "Non-financial information statements" above*). Drivers of voluntary disclosure in this area include: climate-based litigation risk; the growing pressure on large oil companies; the physical and transition risks of climate change; and the application of ESG criteria by financial investors such as investment and infrastructure funds.

Disclosures consistent with the TCFD recommendations will go some way to satisfying these mandatory and voluntary requirements.

TCFD recommendations

The TCFD recommendations are aimed at helping companies and other organisations disclose clear, comparable and consistent information about the risks and opportunities associated with climate change. They are intended to help investors, lenders and insurers make better informed decisions. They consist of four overarching recommendations based on four core elements of how organisations operate: governance; strategy; risk management; and metrics and targets. They are supported by 11 recommended disclosures and guidance regarding their implementation. There is supplemental guidance for the financial sector (banks, insurance companies, asset owners and asset managers) and for certain non-financial sectors with greater exposure to climate change (energy, transportation, materials and buildings, and agriculture, food and forest products), and a technical supplement on the use of scenario analysis.

Enhanced disclosure

In March 2020 the FCA consulted on new Listing Rules for premium-listed issuers of shares to improve climate-related disclosures in corporate reporting by requiring disclosures consistent with the TCFD recommendations (*www.practicallaw.com/w-025-1800*). This follows the government's statement in its Green Finance Strategy policy paper that UK listed companies should be required to report in line with the TCFD recommendations by 2022 (*see "Green Finance Strategy" above*). This view was echoed by the FCA in its discussion paper and feedback statement on climate change and green finance (*www.practicallaw.com/w-017-7342; www.practicallaw.com/w-022-9526*). It is also consistent with the review of the Directive (*see "Current areas of focus" below*).

The proposed Listing Rules would require premium-listed companies, including sovereign-controlled commercial companies but not investment trusts (that is, funds that are listed on the stock market), to include a statement in their annual report and accounts setting out:

- Whether they have made disclosures consistent with the TCFD recommendations in their annual financial report.
- Where they have not made disclosures consistent with some or all of the TCFD recommendations, or where they have included some or all of the disclosures in a document other than their annual financial report, an explanation of why they have done that; that is, "comply or explain".
- Where in their annual financial report or other relevant document the various disclosures can be found.

The FCA notes that, although some companies have already voluntarily applied the TCFD recommendations, there are still significant gaps and inconsistencies, and that improved disclosure is necessary to support better asset pricing and enable investors to make more informed choices about where to allocate their capital, which, in turn, will support the UK's transition to net zero greenhouse gas emissions by 2050.

The FCA has indicated that it may, in the future, apply the new rules to standard-listed issuers of shares and may make compliance with the disclosures mandatory. It is also considering how best to enhance climate-related disclosures by regulated firms, including asset managers and life insurers.

The FCA is also consulting on a new technical note which would apply to all UK listed companies from both an equity and debt perspective, and would clarify how existing requirements under the Listing Rules, the Prospectus Regulation, MAR, the Disclosure Guidance and Transparency Rules, and corporate governance rules may already require disclosures in respect of climate change and other ESG matters.

The consultation closes on 1 October 2020, which is an extension in light of the COVID-19 outbreak. The FCA aims to publish a policy statement along with the finalised rules and the technical note. On the basis of the proposal as published, the new Listing Rules would apply for financial years commencing on or after 1 January 2021. This means that the first disclosures would be made in 2022.

CURRENT AREAS OF FOCUS

A number of initiatives, as well wider global attention, are expected to result in increased attention from lenders, investors and wider stakeholders on companies' sustainability policies, with an increase in active engagement from banks and asset managers and an increase in climate or ESG-themed shareholder resolutions.

FRC scrutiny

The FRC is increasing its scrutiny of how companies report on climate change in their annual reports and non-financial statements (*www.frc.org.uk/news/february-2020-(1)/frc-assesses-company-and-auditor-responses-to-clim*). The FRC has concluded that current climate reporting by companies is falling short of investors' expectations and it recommends reporting in line with the TCFD recommendations.

The FRC expects companies to improve the quality of reporting of: forward-looking information; the potential impact of emerging risks on future business strategy; the carrying value of assets; and the recognition of liabilities. In its view, a failure to report on these crucial areas undermines trust in business and can lead to the conclusion that management is either unaware of their potential impact, is being opaque, or is not managing them effectively. In times of uncertainty, the FRC's opinion is that investors and other stakeholders expect greater transparency of the risks to which companies are exposed and the actions that they are taking to mitigate the impact of those uncertainties.

The FRC expects companies to think beyond the period covered by their viability statement and identify those keys risks that challenge their business models in the medium to longer term and have a particular focus on environmental issues. In October 2019 the FRC's Financial Reporting Lab published a helpful document setting out the questions companies should ask themselves about climate change, recommended climate

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disclosures and examples of what other companies are doing (*www.practicallaw.com/w-022-9725*).

Directive review

The Commission is undertaking, as part of the European Green Deal, a review of the Directive in 2020 to encourage greater disclosure of climate-related information by companies and financial institutions (*www.practicallaw.com/w-023-7583; www.practicallaw.com/w-024-5782*). This is tied with the Commission's wider sustainable finance strategy and, in particular, the implementation of the Taxonomy Regulation, which is expected to be formally adopted very soon (*https://ec.europa.eu/transparency/regdoc/rep/1/2020/EN/COM-2020-155-F1-EN-MAIN-PART-1.PDF*).

The Taxonomy Regulation will set up a framework for identifying whether financial products are as environmentally sustainable as they say they are. This is designed to redirect investment into companies with stronger sustainability credentials and stamp out greenwashing in the financial sector. Although not directly aimed at corporate entities, the Taxonomy Regulation will require investors and asset managers to disclose additional, better information about their investment portfolios which, in turn, will require the portfolio companies to disclose better information about sustainability and climate change risks and opportunities. It is anticipated that one of the disclosure items that will be required under the Taxonomy Regulation will be the percentage of revenue, capital expenditure and operating expenditure.

Stress testing

In December 2019 the BoE has consulted on the UK's first ever climate change stress test of the UK's financial system (*www.bankofengland.co.uk/-/media/boe/files/paper/2019/the-2021-biennial-exploratory-scenario-on-the-financial-risks-from-climate-change.pdf*). This will require large banks and insurers to assess carefully the vulnerability of their corporate customers to climate change physical and transitional risks. There are similar plans afoot for other central banks in the EU, for example, the European Banking Authority Action Plan on Sustainable Finance (*https://eba.europa.eu/sites/default/documents/files/document_library//EBA%20Action%20plan%20on%20sustainable%20finance.pdf*).

UN climate summit

The government, in particular, will have climate change very much in its sights as the UK is due to host the next important UN climate summit in Glasgow. The event has been postponed from its original November 2020 date, owing to the impact of COVID-19.

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Related information

This article is at practicallaw.com/w-025-9225

Other links from uk.practicallaw.com/

Topics

Access to environmental information	topic6-103-1229
Climate change	topic6-103-2064
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Environmental management and reporting	topic1-103-2066
Equality	topic3-540-5391
Financial and narrative reporting	topic3-103-1240
Human rights	topic6-103-1253
Modern slavery	topic7-639-0985
Policies and procedures: employment	topic9-382-7461

Practice notes

2018 UK Corporate Governance Code: overview: financial years beginning on or after 1 January 2019	w-012-6764
A guide to Practical Law's UK corporate governance materials	3-502-1005
Climate change issues for companies	2-378-9392
Climate-related and environmental disclosures: guidance and voluntary reporting frameworks	1-501-2747
Corporate responsibility (CR) and environmental, social and governance (ESG) guidance: tools for companies and investors	w-013-0458
Environmental, social and governance (ESG): policy and legal measures	8-501-7176
Gender pay gap reporting obligations	0-624-3865
Modern Slavery Act 2015: slavery and human trafficking statement	6-606-9165
Narrative reporting: climate-related and environmental disclosures in annual company reports: overview	5-592-3688

Previous articles

Climate change reporting: preparing for a zero-carbon future (2019)	w-022-4370
GDPR one year on: taking stock (2019)	w-020-0982
Climate-related financial risk: spotlight on reporting (2018)	w-014-2731
Corporate governance reforms: widening responsibilities (2018)	w-016-1385
Gender pay gap reporting: planning for a gap year (2017)	9-639-0989
Green bonds: financing a sustainable future (2017)	w-008-4811
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Greenhouse gas emissions reporting: burden or opportunity? (2016)	1-626-4150
Supply chain reporting: complying with the Modern Slavery Act 2015 (2016)	6-622-9282
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