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28 July 2023
By Email

Dear Sir/Madam,

HSF Submission on 'Climate-related financial disclosure'

Scope of this submission

This submission is made by Herbert Smith Freehills in response to the consultation paper released by the Government in June 2023, seeking views on climate-related financial disclosure (**Consultation Paper**).

Key submissions in response to the issues paper

We welcome the introduction of a mandatory climate reporting regime in Australia, which aligns to the International Sustainability Standards Board's (**ISSB**) standard on climate-related disclosure (**IFRS S2**). While the Consultation Paper addresses a number of issues raised during the initial consultation, we have raised additional areas for enhancement and clarification. Namely that:

- the criteria for reporting entities should be re-visited to ensure that there is an appropriate mechanism in place to allow corporate groups to report as a consolidated group;
- the modified liability approach should apply to reporting entities for their first three reports (rather than falling away from 2027) and it should cover <u>all</u> forward-looking statements required under IFRS S2 as well as continue to protect reporting entities from claims following the end of the modified liability period, in relation to statements made during that period;
- to the extent information is required in the financial statements, modification should be made to the director and management declarations required to be given in relation to financial statements and notes; and
- the modified liability regime in the first three years of introduction should be extended to protect companies and officers from civil claims in relation to continuous disclosure obligations.

In our view, the introduction of climate reporting is a significant development in Australian corporate law and, in its implementation it will be important to ensure an appropriate balance between establishing a baseline for meaningful climate information for stakeholders, while providing companies with adequate protections to support fulsome disclosure and avoid unintended consequences.

Based on our experience advising a significant number of ASX-listed companies with their climate monitoring and reporting to date, we consider this type of reporting to be complex, and involve a significant amount of uncertainty. To help ensure that there is an appropriate balance, we submit that a number of aspects of the Act would benefit from refinement, clarification or amendment. Our detailed positions are set out in **Attachment 1**.

More broadly, we support the Government's proposed approach of introducing IFRS S2 as a matter of priority, with optionality for the regime to be expanded over time. We note that there are likely to be critical bandwidth constraints limiting companies' capacity to adopt a broad sustainability reporting regime at this time including, but not limited to, data collection, internal resourcing and capability, methodologies for quantification and assurance.

Further questions

Please contact [redacted] if you have any questions in relation to this submission.

Yours sincerely,

HERBERT SMITH FREEHILLS

Submission in response to the Consultation Paper

This submission is set out to address each of the proposals put forward in the Consultation Paper.

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Reporting entities *All entities that meet prescribed size thresholds and that are required to lodge financial reports under Chapter 2M of the Corporations Act would be required to make climate-related financial disclosures.*	<u>**Reporting in large corporate groups**</u> We are concerned that the linking of the criteria for reporting entities to Chapter 2M of the *Corporations Act 2001* (Cth) (**Corporations Act**) is likely to cause unintended consequences in the context of large corporate groups and recommend that it be modified to reflect current practices for financial reporting by corporate groups. Within a large corporate group, it is relatively common for there to be multiple entities which meet the criteria to report under Chapter 2M. While many of them will be relieved of their reporting obligations on the basis that they are wholly-owned and meet the conditions for ASIC general class order relief (and have entered into deeds of cross guarantee), it is quite common for certain types of entity to be required to separately report as they do not qualify for class order relief. Examples of these types of entities include: • any group entity that is not wholly owned (eg a joint venture; or an entity where management or employees have an ownership stake); • any AFSL holder (eg a subsidiary engaging in carbon trading; or a responsible entity of a fund or scheme, etc); • a borrower in relation to debentures (eg a treasury company issuing corporate bonds); or • a guarantor of such a borrower. These companies are typically still consolidated into their parent's reporting on the basis they are group entities/subsidiaries, but they also have to individually prepare their own financial

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	reports (covering themselves and their controlled entities) as Chapter 2M reporters in their own right with no applicable reporting relief. Given the framing of the scope of the climate reporting regime (focusing on Chapter 2M reporting entities meeting the relevant phased thresholds), there is the potential for multiple entities within a corporate group to be caught by the proposed regime. Without modification, this would significantly increase the workload, resources and cost involved for those groups as they would be needing to prepare multiple versions of the disclosures (ie emissions profiles from the parent's perspective covering the group; but also emissions profiles from the perspective of each other affected entity). For items like scenario analysis, Scope 3 emissions, analysis of risks and opportunities, the impact could be quite onerous – and the output is likely to have limited incremental benefit for stakeholders overall. **Reporting with a global parent** Similarly, the proposed approach may also duplicate effort in a disproportionate way when reporting for corporate groups with a global parent that is already reporting under IFRS S2. Many companies with overseas-based parents are considered Chapter 2M reporters for the purposes of financial reporting in Australia. While we understand there may be some potential advantages in having the top Australian group entity provide information under the proposed climate reporting regime (e.g. a view of Australian exposures), the Australian subsidiary group will form part of the risk management approach, emissions profile, scenario planning, transition planning and targets/metrics of its global parent – and actually the more meaningful reporting will be occurring at that global group level. Notably, in many cases those entities will have centralised sustainability reporting teams in 'head office' and will not be resourced for the complexity of preparing their own standalone climate disclosures at the Australian level. **Proposed solutions** Having regard to the above matters, we would support revision of the scopes/provisions in the legislation to effect one or all of the following solutions:

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	• an express exclusion from the requirements for group members which are being reported on as part of their parent's consolidated reporting (this would conceptually align to the description of the "single reporting entity" in the ISSB); • flexibility for affected group entities to meet the requirements if they duplicate or cross-refer to their parent's consolidated reporting which includes them; and/or • flexibility for the proposed climate disclosures to be outside the annual report and a mechanism for joint reports to be prepared and published (this is the approach taken by the *Modern Slavery Act 2018* (Cth)). We do not expect that this issue would arise globally - our understanding is that Australia is fairly unique with its approach of applying financial reporting obligations to all large reporting entities (regardless of whether they are part of a consolidated group), then having specific regulatory relief (ie a class order instrument) to relieve them from doing the reports on the basis their parent does consolidated reports (and subject to what are fairly comprehensive conditions, and entry into a deed of cross guarantee). On a similar note, it will also be important that the new regime reflects that companies which are currently relieved of their financial reporting obligations under the existing regulatory relief for wholly-owned subsidiaries are similarly relieved of climate reporting obligations. This would include companies relying on the general class order relief in ASIC Corporations (Wholly-owned Companies) Instrument 2016/785, as well as those which have historical specific relief (sometimes offered to groups which do not meet the conditions for general relief). In our view, Australian companies with an overseas parent should be able to rely on the parent’s reporting under the ISSB standards, provided they provide cross-references to where the relevant reporting information may be found within their Australian financial reports or duplicate it. This would be a similar approach to the *Modern Slavery Act 2018* (Cth), which allows foreign parent entities to prepare group-wide modern slavery statements.

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Proposed roadmap for mandatory reporting requirements *Phased approach for the introduction of mandatory requirements, based on number of employees, consolidated*	We are supportive of a phased implementation of the proposed regime which will require larger corporations, with access to greater resources, many of whom have already started reporting against international climate reporting frameworks, to report first. However, as above, it will also be important for the Government to facilitate reporting by entities on a group basis. In our view, the Government should also be cognisant of the increased burden the reporting criteria will place on 'Group 3' entities. We understand the desire to align Group 3 with the definition of a large proprietary company in section 45A(3) of the *Corporations Act* (and Reg 1.0.02B of the Corporations Regulations), however in practice we expect that it will capture a large number of entities (including large not-for-profits) that may not have the capability to adequately or reliably report under the regime. This threshold is lower than many other jurisdictions, including those proposed by the European Union (€20 million in total assets, €40 million in net turnover and more than 250 employees). We also note that the current thresholds in Reg 1.0.02B were last amended in 2019 and are not indexed, so represent a 'lowering' bar over time. In our experience, climate-related disclosures are particularly technical and require a significant amount of resources – in this regard, we note market commentary in the UK about inconsistent approaches to implementation of the recommendations of the Taskforce for Climate-related Financial Disclosures (**TCFD**) which are considerably simpler. Anecdotally, our experience has also been that many companies had difficulty transitioning to modern slavery reporting under the *Modern Slavery Act 2018* (Cth) which had a comparatively higher reporting threshold of $100 million consolidated revenue. Modern slavery reporting, in our view, is far less complex than climate reporting, and we expect it will be very challenging for Group 3 entities to prepare meaningful and reliable climate disclosures. Accordingly, we recommend that consideration be given to raising the monetary thresholds for Group 3 entities (for example, by raising the consolidated revenue threshold to $100 million) or otherwise having a simplified reporting regime for Group 3 entities.

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Materiality *Principles of financial materiality would apply.*	Further clarification is required around the standard of materiality that the Government expect to apply to different aspects of the IFRS S2 disclosures. The Australian Accounting Standards and ISSB standards have a different concept of materiality to that under Australian continuous disclosure laws – the former, based on a judgement of "decision useful" materiality, and the latter based on quantitative thresholds around changes in share price. The Consultation Paper indicates that the Government's preference is to adopt an approach based on "decision useful" materiality, which we agree is sensible given the alignment with other periodic financial reporting. While materiality will continue to require a case-by-case assessment, it is helpful that both companies and users of reports will have experience in applying the "decision useful" construct to assess materiality. As to which aspects of the required disclosures will be subject to a materiality threshold, this is an area that would benefit from further clarification. For example, it appears that scope 1 and 2 emissions disclosure will be required irrespective of materiality, but for scope 3 there is discretion for companies to apply a materiality lens to what they disclose. We would encourage the Government to provide further clarification on what disclosures are required regardless of a company's materiality assessment, and what disclosures should be subject to materiality assessments.
Reporting Content *From commencement, companies would be required to disclose information about governance processes, controls and procedures used to monitor and manage climate-related financial risks and opportunities.* *From commencement, reporting entities would be required to use qualitative scenario analysis to*	We support the alignment of the Australian climate reporting standards with those of IFRS S2 and expect that disclosures covered by this proposal will be aligned to those standards.

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inform their disclosures, moving to quantitative scenario analysis by end state. *From commencement, reporting entities would be required to disclose climate resilience assessments against at least two possible future states, one of which must be consistent with the global temperature goal set out in the Climate Change Act 2022.* *From commencement, transition plans would need to be disclosed, including information about offsets, target setting and mitigation strategies.* *From commencement, all entities would be required to disclose information about any climate-related targets (if they have them) and progress towards these targets.* *From commencement, entities would be required to disclose information about material climate-related risks and opportunities to their business, as well as how the entity identifies, assesses and manages risk and opportunities.*	
Metrics and Targets *From commencement, scope 1 and 2 emissions for the reporting period would be required to be disclosed.* *Disclosure of material scope 3 emissions would be required for all reporting entities from their second*	In our view, the proposed requirement to disclose metrics and targets, and timeline for requiring these disclosures are appropriate, provided they are aligned with the standards in IFRS S2.

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reporting year onwards. Scope 3 emissions disclosures made could be in relation to any one-year period that ended up to 12 months prior to the current reporting period. *By end state, reporting entities would be required to have regard to disclosing industry-based metrics, where there are well-established and understood metrics available for the reporting entity.*	
Reporting location, frequency and timing	We are broadly supportive of the Government's proposal in relation to the location, frequency and timing of climate reporting. However, some further clarification is required in relation to the circumstances in which a company's climate reporting must be updated. We submit that climate disclosures should only be included in the Operating and Financial Review, which is contained in the Annual Directors' Report required under section 298 of the Corporations Act (and not be required in half-year reporting or the financial statements). We also suggest that updating any disclosures should only be required where a continuous disclosure obligation is triggered. As above, we would also welcome the flexibility of companies to prepare separate reports containing climate disclosures, provided they are cross-referenced in the company's Annual Directors' Report. To the extent that any of the IFRS S2 disclosures are proposed to be included in the financial statements of reporting entities (eg scenario analysis of financial impacts), then consideration should be given to the implications that the changes to the climate reporting regime will have on the ability of company officers make appropriate declarations in relation to directors' reports and financial reports. Under sections 295A and s 298 of the Corporations Act and Recommendation 4.2 of the ASX Corporate Governance Council's Principles and Recommendations (4th edition), company directors and persons performing CEO and CFO functions, must make certain declarations in

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	relation to financial statements and notes. In particular, declarations must be given that financial reports provide a “true and fair view” and comply with accounting standards. Given some of the disclosures contemplated to be required under the proposed regime are forward-forward looking and that such disclosures are inherently uncertain, it would be inappropriate for company officers to make declarations that the relevant disclosures provide a true and fair view. Based on our experience, we are aware that some climate related disclosures would also not adhere to the current accounting standards (for example, where scenario analysis indicates upwards asset revaluations). Accordingly, the required declarations would need to be amended to reflect the lack of certainty required to be disclosed for full compliance with the reporting standards.
Modified liability approach *Climate-related financial disclosure requirements would be drafted as civil penalty provisions in the Corporations Act. The application of misleading and deceptive conduct provisions to scope 3 emissions and forward-looking statements would be limited to regulator-only actions for a fixed period of three years.*	As set out in our previous submission on the first consultation paper, we agree with the Government’s proposal that there should be a limitation on private litigation against reporting entities during the early implementation of the regime, in order to encourage stronger disclosures and allow a baseline of reporting expectations to develop across the market. In our view, having this limitation applied in relation to misleading and deceptive conduct claims flowing from a company’s first three years of reports is the minimum approach that should be considered. **Length of modified liability period** We believe that the length of the proposed modified liability approach is relatively short to enable a proper baseline to be developed. Additionally, we expect that companies will face litigation risk relatively soon after this period ends, notwithstanding the proposal to have a modified liability regime in place. While we acknowledge the view that having a reasonable basis for any statements made will provide protection against civil claims, our experience suggests that there will still be claims brought against reporting entities strategically, with an intention to settle prior to litigation, and as outlined in our submission on the first consultation paper, we consider that this may deter some companies from providing fulsome and meaningful disclosure. In our experience, the

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	prospect of needing to defend such claims, including their cost and the large amounts of management time and energy they involve, can often drive a conservative approach to disclosure. Another issue for consideration is the fact that because Group 2 entities are not required to report until 2026-27, and Group 3 entities until 2027-28, Group 2 entities will only be covered by the modified liability regime for one year, and Group 3 will not receive any benefit under the regime. To ensure that there are adequate protections for companies to develop their disclosures (and noting the issues flagged above about the limited capabilities of Group 3 entities to report under the proposed regime), we suggest that this period be modified so that it covers the first three reports of each reporting entity. Notwithstanding the above, we also seek clarification that upon expiry of the modified liability period, private claims may not be brought against companies regarding statements that they made while the modified liability period was in place. In our view, it would be counter-effective to allow these types of claims to be brought later, because it would cause reporting entities to be reluctant about providing fulsome disclosures. This in turn, would stifle the development of a strong reporting baseline and render the modified liability approach redundant. **Forward looking statements** In our view, the transitional liability approach should apply to all forward-looking disclosures required under IFRS S2 and not only to scenario analysis and transition plans. Given the uncertainty associated with forward-looking statements and the willingness of private claimants to bring claims for purely strategic purposes without a genuine intention to litigate (ie. to disrupt companies, create media attention or to obtain a financial settlement), our view is that it is important to expand the modified liability regime to cover all types of forward-looking statements. A number of forward-looking disclosures required by IFRS S2, that are not currently contemplated to be protected by the modified liability regime, underpin the development of transition plans, highlighting the need for them to be protected so as to incentivise companies to provide useful disclosures to the market regarding their proposed transition. Such disclosures include the requirements for companies to disclose the anticipated effects of climate-related

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	risks and opportunities on the reporting entity's business model and value chain, and the anticipated changes to the reporting entity's business model. In our view, it is highly important for the Government to ensure these types of disclosures are included in the transitional protections to ensure that companies are encouraged to provide fulsome quantitative disclosures in their early reporting against the new climate reporting regime. **Continuous disclosure protections** We submit that the Government should re-consider the need for a safe harbour in relation to continuous disclosure or that the modified liability approach should be extended to cover continuous disclosure issues. As set out in our submission on the first consultation paper, certain aspects of the ISSB standards require estimation or prediction of the impacts of climate and sustainability risks and opportunities even though such disclosure would be necessarily speculative and, in some cases, may be unknowable. In our view, there is a significant continuous disclosure risk in making these disclosures, given the assumptions underpinning materiality that are required in the process of making climate-related disclosures. The primary risk arises as a result of the headwinds companies are currently facing and will continue to face in relation to forward-looking statements as well as the volatility and limitations in technology and capability to adequately forecast and track climate disclosures. In this sense, being able to determine if, and when a matter (for example, the fact that climate targets are going to be missed) becomes material for the purposes of continuous disclosure obligations will be difficult. While we see periodic disclosure as a key to managing this risk, we expect to see – and are already seeing – challenges regarding disclosure of those impacts outside of the control of companies. We acknowledge the existence of the fault element in section 674A of the Corporations Act (which is currently subject to review), which may act as a protection for entities in this context, however we submit that this will not provide adequate protection in managing their continuous disclosure obligations in the context of climate reporting. Based on our experience, the relevant threshold in this test is the 'negligence' element, and negligence is routinely pleaded in class

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	action claims. We recommend that the modified liability approach be extended to cover continuous disclosure obligations and that, to ensure that a level of integrity is maintained during this period, the regulator operates an intensified market surveillance program over that period.