THE LAW SOCIETY
OF NEW SOUTH WALES

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Dr James Popple
Chief Executive Officer
Law Council of Australia
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By email: matthew.wood@lawcouncil.asn.au

Dear Dr Popple,

Climate-related financial disclosure

The Law Society appreciates the opportunity to contribute to the Law Council of Australia's submission to the Treasury in response to its 'Climate-related financial disclosure' Consultation Paper. The Law Society's Climate Change Working Group contributed to this submission.

General comments

The Government has committed to introducing standardised, internationally-aligned reporting requirements for businesses to make climate-related financial disclosures, regarding governance, strategy, risk management, targets and metrics, including greenhouse gases. It is acknowledged that Australia's strong demand for foreign capital requires alignment with global best practice as capital markets and investors demand better quality and internationally comparable disclosures.

Benefits

The Law Society strongly supports harmonised climate-related financial disclosure under the umbrella of the International Sustainability Standards Board (ISSB) standards, to provide a consistent approach across jurisdictions. We recognise significant benefits in aligning with international reporting standards, including greater certainty, consistency, development of international practice, and drawing upon international experts and assurance, to provide investors and other stakeholders with consistent and comparable information on climate-related impacts.

Challenges

However, standards need to be implemented in a way that mitigates current challenges, to promote consistency in practice. The current critical challenge for climate change disclosure is uncertain expectations, with difficulties in predicting market expectations. Many of the disclosures required involve particularly difficult future predictions based on complex and changing evaluative judgements. There is considerable variety in practice, as there is uncertainty and insufficient direction to guide companies to safely disclose in this space.

Moving from a general and amorphous obligation to very specific and detailed disclosure obligations would necessarily appear to change the risk profile and prospect of increased litigation exposure. We suggest that particular difficulties posed by the adoption of ISSB baseline standards concern how to set up systems to capture the relevant data, especially in relation to Scope 3 emissions, and how to analyse it or extrapolate from it for the purpose of making the required disclosures.

While we acknowledge that international practice and in particular global baseline standards for climate reporting are likely to be helpful in achieving greater consistency and development of standard practice, adoption of uniform standards needs to be approached having regard to the legal system where the standards will apply. The strong safe harbour protections existing in some other jurisdictions that are adopting the ISSB standards do not exist in Australia.

Safe Harbour?

The case for

One of the thornier issues relating to implementation of the new standards is the extent, if any, to which safe harbour or other protections should be established. It is generally acknowledged that there are large leaps from the disclosure required under the Taskforce on Climate-related Financial Disclosure (TCFD) recommendations, to TCFD plus Scope 3, to ISSB baseline global standards.

Some members have raised concerns that adopting ISSB standards in Australia, given the breadth and extent to which forward looking information is required to be disclosed, creates a risk of imposing substantial additional liabilities for directors, in the absence of safe harbour protections. Australia's current periodic reporting requirements are principally backward-looking in nature, which affords reporting entities a considerable degree of certainty over their disclosure and carries comparatively lower levels of disclosure risk. By contrast, the new ISSB standards would require reporting entities to make an extensive range of forward-looking statements. Under Australian law, forward-looking statements will be deemed to be misleading unless supported by reasonable grounds. Given the subject matter of the disclosures proposed under the ISSB Standards, establishing 'reasonable' grounds may pose significant difficulties for directors in a number of areas, given the inherent uncertainty of dependencies such as market dynamics, energy transition challenges and the development of new technologies.[1]

Factors that distinguish the legal environment in Australia from other otherwise comparable jurisdictions adopting the ISSB standards, in addition to the lack of a 'safe harbour' exemption, which allows for the exclusion of liability by identifying a statement as a forward-looking statement and including a proximate cautionary statement, is the heightened regulator risk for directors due to the securities regulator ASIC being active in pursuing directors for breach of fiduciary duties, rather than such action being driven solely by private litigants. Australia also has a facilitative class action regime.[2]

Some designs for implementation of a safe harbour regime could include:

- Safe harbour for forward looking information - possibly similar to the protections in the *Private Securities Litigation Reform Act 1995* in the United States (though we note these only apply to private claims);

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[1] See generally, AICD submission to AASB re draft ISSB standards.

[2] Ibid.

- Safe harbour for Scope 3 disclosure - recognising reliance on estimation and third-party data (this is proposed in the Securities Exchange Commission climate reporting rule, but it requires a "reasonable basis") or
- Safe harbour from private claims - similar to continuous disclosure protections introduced in 2021, where private claims can be made only where representations are reckless or negligent.

The case against
Other members are persuaded by the opinion delivered by Sebastian Hartford Davis to a group of institutional investors, including the Investor Group of Climate Change and the Australian Council of Superannuation Investors that, while the ISSB standards may require an evolution of processes and disclosures across industries, '*in practice [it] simply reflects the need for directors to adapt and respond to climate risk issues facing their companies.*'[3] Furthermore, as the Standards would require disclosures of risks material to each company, it is expected that directors would already be considering and measuring those risks. It is argued that the liability risk will actuate the benefits of standardisation by incentivising companies and their directors to make the required disclosures. In the view of Counsel:

> the legal requirement to have a "reasonable basis" for the making of forward-looking statements is capable of being sensitive to the inherent uncertainties in the scope, distribution, impacts and timing of the impacts of climate change. Directors must make a genuine assessment as to the appropriateness of the forward-looking disclosure at the time it is made, but they will not face liability merely because their assessment later turns out to be incorrect.[4]

Other Challenges
It is our view that, whether or not safe harbour exemptions are adopted, the unique settings of the Australian jurisdiction need to be considered in assessing the liability risk for directors. The liability settings for the types of forward-looking statements contemplated by the ISSB standards will need careful calibration to avoid the risk of unhelpful and generalised disclosure that will not meet the expectations of investors.[5]

It will also be necessary to address current data and workforce skill gaps, including the current lack of clear methodologies for key metrics, such as Scope 3 emissions.[6]

Consultation questions
We note that the reform principles which will guide the climate-related financial disclosure reforms and the final design of new requirements, include supporting climate goals, that is, the transition to net zero. Our responses to the issues in the consultation paper focus on the legislative management of climate risks, rather than impacts, noting that climate impacts are increasingly priced into markets and therefore the two are highly correlated (i.e. emissions are priced as climate-related investment risks).

Our comments in relation to some of the consultation questions are set out in Annexure A to this letter.

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[3] Sebastian Hartford Davis has provided advice to the IGCC & Australian Council of Superannuation Investors: https://acsi.org.au/media-releases/issb-standards-consistent-with-existing-requirements-for-company-directors-legal-opinion-confirms/
[4] https://acsi.org.au/wp-content/uploads/2023/02/Legal-opinion-on-ISSB-Draft-Standards.Feb23.pdf. 2
[5] Ibid.
[6] AICD (1) 2.

Please do not hesitate to contact Liza Booth, Head of Commercial and Advisory Law Reform on 02 99260202 or liza.booth@lawsociety.com.au if you would like to discuss this in more detail.

Yours sincerely,

Cassandra Banks
President

ANNEXURE A

Question 1: What are the costs and benefits of Australia aligning with international practice on climate-related financial risk disclosure (including mandatory reporting for certain entities)? In particular:

1.1 What are the costs and benefits of meeting existing climate reporting expectations?
1.2 What are the costs and benefits of Australia not aligning with international practice and in particular global baseline standards for climate reporting?

We agree that alignment with international standards is critical to make the reporting relevant to global investors and to support foreign investment.

The UK, EU, US, New Zealand, Switzerland, Hong Kong and Japan have introduced or are contemplating mandatory climate disclosure requirements that broadly align with the TCFD. The ISSB's draft standards build on the framework provided by the TCFD to provide a more comprehensive baseline of climate-related disclosures. Derogation from this baseline would be contrary to Treasury's stated reform principles and impede Australia's integration into international markets.

The ISSB draft standards also offer much greater certainty for Australian entities regarding their climate-related disclosure obligations – under existing reporting requirements, those obligations are not standardised or clear. But we recognise that the comprehensive adoption of the new standards would represent a significant enhancement on current reporting practices with the corresponding challenges noted in our covering comments.

Question 2: Should Australia adopt a phased approach to climate disclosure, with the first report for initially covered entities being financial year 2024-25?

2.1 What considerations should apply to determining the cohorts covered in subsequent phases of mandatory disclosure, and the timing of future phases?

We agree that Australia should adopt a phased approach, and the proposed timing for its introduction seems appropriate. A carefully designed phase in approach must recognise the considerable uplift in practice and capability which will be required by some disclosing entities.

The timing of future phases should be clearly defined upfront to give smaller/lower risk companies time to build capacity and should include a timebound roadmap for implementation across the economy over a maximum period of, say, three years.

There should be consideration of thresholds relating to climate risk, not just the size of the reporting entity, so that companies within very high-risk sectors are required to report within the first phase. It is arguably more important for the new standards to apply to companies that are large emitters, rather than basing the consideration solely on capitalisation, as the disclosure will be more material for investors in those companies.

Question 3: To which entities should mandatory climate disclosures apply initially?

3.1 What size thresholds would be appropriate to determine a large, listed entity and a large financial institution, respectively?
3.2 Are there any other types of entities (that is, apart from large, listed entities and financial institutions) that should be included in the initial phase?

We consider that size is best measured by market capitalisation, rather than turnover or employee numbers. Market capitalisation is the best indicator of the ability of a company to absorb the additional cost of complying with new reporting standards. We suggest that the new standards should also apply to listed schemes of an equivalent size.

It is arguably not necessary to extend the scheme to all credit unions, super funds and similar financial institutions, as some may be too small to incur the expense of complying with the new reporting requirements.

The consultation paper emphasises coverage of listed companies in the first implementation phase. However, coverage of large, unlisted entities is important to institutional investors and these entities should be prioritised from the start of reporting requirements. This should specifically include large, unlisted companies with annual consolidated revenue of at least $100 million.

In relation to large private companies (and large subsidiaries of foreign corporations):

i. in so far as the purpose of these changes is to assist investors, then there is no need to extend the obligations to them; but
ii. in so far as the new regime has a secondary purpose of monitoring (and reducing) emissions, then it should extend to them.

Question 4: Should Australia seek to align our climate reporting requirements with the global baseline envisaged by the International Sustainability Boards?

4.1 Are there particular considerations that should apply in the Australian context regarding the ISSB implementation of disclosures relating to: governance, strategy, risk management and/or metrics and targets?

4.2 Are the climate disclosure standards being issued by the ISSB the most appropriate for entities in Australia, or should alternative standards be considered?

We consider that it is sensible for disclosure requirements to align with ISSB standards as a baseline with a phased approach to build out sophistication over time to ensure compatibility with fast evolving standards in the EU and UK.

Question 5: What are the key considerations that should inform the design of a new regulatory framework, in particular when setting overarching climate disclosure obligations (strategy, governance, risk management and targets)?

It is our view that the first regulatory framework proposal (overarching obligations in legislation; details in regulatory standards and guidance) best achieves the appropriate balance between covered entities' need for certainty, and flexibility to accommodate evolving market and regulatory expectations.

Question 6: Where should new climate reporting requirements be situated in relation to other periodic reporting requirements? For instance, should they continue to be included in an operating and financial review, or in an alternative separate report included as part of the annual report?

It makes sense for climate disclosures to take place within the existing periodic reporting requirements. If the primary purpose of this legislation is to assist investors, then it should be treated in the same manner as other information that is relevant to investors.

Where climate-related risks and opportunities are *material*, it is appropriate that they continue to be disclosed in operating and financial review reports, financial reports, and as part of continuous disclosure obligations, as would any other type of material information. To the extent disclosures above and beyond those existing requirements would be required, such as the disclosure of greenhouse gas emissions (GHGs) and transition plans, entities should be afforded flexibility in how they comply with those requirements (beyond baseline requirements such as disclosures occurring on an annual basis and being easily accessible for users).

Question 7: What considerations should apply to materiality judgements when undertaking climate reporting, and what should be the reference point for materiality (for instance, should it align with ISSB guidance on materiality and is enterprise value a useful consideration)?

We agree with the adoption of the ISSB definition of materiality to align with International Financial Reporting Standards Foundation accounting standards, with the following exception. The ISSB's definition of materiality should be used, *except* in relation to the inclusion of 'enterprise value'. That would create unnecessary inconsistencies with the definitions of materiality in the *Corporations Act 2001*, ASX Listing Rules, and the Australian Accounting Standards Board (AASB) Standard 101.

The EU concept of 'double materiality' may be helpful. While existing Australian materiality standards are directed to the impact of climate upon the company, 'double materiality' would also require them to disclose their material impact on the climate (except with regard to their emissions – these are disclosed regardless of materiality, as is contemplated by the ISSB draft standard). The assessment of materiality should by informed by existing materiality standards in Australia (*Corporations Act 2001*, ASX Listing Rules and AASB 101), which broadly align with the ISSB standards (except for the exclusion of 'enterprise value'). This is decision-useful information for investors and would minimise the risk of future regulatory lag and fragmentation and resulting administrative costs and burdens.

Question 8: What level of assurance should be required for climate disclosures, who should provide assurance (for instance, auditor of the financial report or other expert), and should assurance providers be subject to independence and quality management standards?

There may be a case for extending auditing requirements to covered entities' emissions disclosures, as will be the case in New Zealand, given concerns about significant under-reporting in some sectors. In that case, a phased approach and timeline to full verification and assurance should be provided. This will require the development of a robust assurance framework.

However, arguably, if disclosure is required because it is financially material, then there would be no need for a separate assurance. There is also the practical concern that this will significantly increase compliance costs.

Question 9: What considerations should apply to requirements to report emissions (Scope 1, 2 and 3) including use of any relevant Australian emissions reporting frameworks?

and

Question 10: Should a common baseline of metrics be defined so that there is a degree of consistency between disclosures, including industry-specific metrics?

We consider that Scope 3 reporting is critical to understanding underlying climate risk across capital markets and therefore should be scoped into the reporting requirements. A phased approach should be considered given the existing data challenges including requiring only certain Scope 3 categories to be reported on initially (Use of Sold Products and Purchased Goods and Services).

The ISSB draft standards provide helpful common baseline metrics for emissions disclosures. Our understanding is that the main principles and calculation methodologies of the *National Greenhouse and Energy Reporting Act 2007* and related regulations are broadly aligned with the GHG Protocol, which also underpins the ISSB draft standards. The key difference is the requirement to disclose Scope 3 emissions.

Question 11: What considerations should apply to ensure covered entities provide transparent information about how they are managing climate related risks, including what transition plans they have in place and any use of greenhouse gas emissions offsets to meet their published targets?

We consider that alignment with Australia's international and statutory climate-related commitment should be a central consideration for the reporting framework, that is, alignment with the 1.5C goal of the Paris Agreement and Australia's net zero emissions target. Entities would be required to disclose transition plans consistent with the Intergovernmental Panel on Climate Change and the International Energy Agency modelled pathways to limit warming to 1.5C. This would be consistent with the approach taken by the EU, what is required for Science Based Targets Initiative certification, and what was recommended by the United Nations expert working group.

Question 15: How suitable are the 'reasonable grounds' requirements and disclosures of uncertainties or assumptions in the context of climate reporting? Are there other tests or measures that could be considered to ensure liability is proportionate to inherent uncertainty within some required climate disclosures?

As noted in our earlier comments, some of our members have expressed concerns that, based on the subject matter of the disclosures proposed under the ISSB standards, establishing 'reasonable grounds' is likely to pose considerable difficulty for directors in a number of areas, given the inherent uncertainty of dependencies such as market dynamics, energy transition challenges and the development of new technologies.

Other members consider that there is no need for the adoption of other tests or measures, such as the US 'safe harbour' provisions, relying on the advice provided by Sebastian Hartford Davis to the IGCC & Australian Council of Superannuation Investors, to the effect that the 'reasonable grounds' requirements are sufficiently flexible to accommodate uncertainties or assumptions in the context of climate reporting.

Question 19: Which of the potential structures presented (or any other) would best improve the effectiveness and efficiency of the financial reporting system, including to support introduction of climate related risk reporting? Why?

In our view the first potential structure is best. It would allow leveraging of the AASB's existing expertise in relation to climate-related disclosures, as well as its relationships with international standard-setting bodies. We are concerned that the second structure would cause further regulatory fragmentation, and that the third would risk further delaying the implementation of a mandatory framework at a time when Australia is already experiencing regulatory lag.