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ISS Proposed Policy Changes for 2021

ClientEarth Comments on Director Accountability for Material E&S Risk Oversight Failures

1. Introduction

ClientEarth is a non-profit environmental law organisation based in London, Brussels, Berlin, Warsaw, Madrid, New York and Beijing. ClientEarth's Climate Programme conducts research and advocacy in relation to the legal implications of climate change-related financial risks for a range of market participants, including companies, investors, company directors, professional advisers and regulators.

This response provides our comments solely on the ISS's proposal concerning changes to all ISS policies to improve director accountability for governance failures in the context of significant risk oversight failures related to material environmental and social concerns (including climate change), by triggering vote recommendations against board members on a case-by-case basis (Director Accountability (All Global Policies)) **("Proposed Change to Director Accountability").**

Headline Comments:

- ClientEarth fully supports the Proposed Change to Director Accountability.
- The Proposed Change to Director Accountability is consistent with and required under law, which requires directors, investors, asset managers and trustees to identify, manage and disclose material climate risks.

- In terms of indicators of adequate risk oversight of climate-related risk and issues, companies should be reporting in line with the TCFD Recommendations and have Paris Agreement aligned business strategies in place.
- ClientEarth fully supports ISS's proposal to establish criteria that would allow ISS benchmark policies to proactively identify boards that fail to prepare for foreseeable future risks.

2. Director Accountability (All Benchmark Policies) Director Elections: Material E&S Risk Oversight Failures

A. General Comments:

1. ClientEarth fully supports the Proposed Change to Director Accountability. The proposal is consistent with and required by law, which obliges directors, investors, asset managers and trustees to manage and mitigate financial risks, including those posed by environmental risks such as climate change. We have provided a summary of legal principles relevant to the policy change proposal below. This response focusses on climate change, however other environmental risks may also be material and trigger fiduciary duties of risk oversight.

Fiduciary Duties

2. Company directors have a fiduciary duty towards the company and/or its shareholders.[1] The concept of fiduciary duty is broadly similar in corporate law around the world, imposing duties of trust and loyalty, and due care, skill and diligence. In the context of climate change, fiduciary duties may be breached if a director consciously disregards, or wilfully ignores, material risks associated with climate change and their potential impacts on corporate operations, risk management and strategy. [2] This duty may also be breached in some circumstances if the director adopts a course of action that was not in the best interests of the company.[3]

3. Pension fund trustees may breach their fiduciary duty for similar reasons. More generally, investment institutions may also be in breach of national laws or regulations if they fail to identify and manage climate risks. For instance, UK investment institutions must comply with the UK Stewardship Code on a "comply or explain" basis. The Stewardship Code states that, "Environmental [issues], particularly climate change, […] have become material […] for investors to consider when making investment decisions and undertaking stewardship […]."[4] The Stewardship Code also makes clear that service providers, including proxy advisers, must consider systemic risks such as climate change.[5] Investors and asset owners should be actively managing their shareholdings and engaging with investee companies, including by voting against directors where necessary, in order to discharge their fiduciary duties.

[1] While the concept of fiduciary duty is most well recognised in common law jurisdictions, it is also present in civil law jurisdictions. For instance, the concept of fiduciary duty is present in the legislation of every EU member state and specific provisions are codified in law. See: EU, "Resource Efficiency and Fiduciary Duties of Investors", available here; UN PRI, United Nations Global Compact, UNEP Finance Initiative and Inquiry, "Fiduciary Duty in the 21st Century", available here;
[2] Commonwealth Climate Law Initiative, "Director's Liability and Climate Risk: Comparative Paper – Australia, Canada, South Africa and the United Kingdom", available here.
[3] Ibid
[4] Financial Reporting Council, "UK Stewardship Code", available at: https://www.frc.org.uk/investors/uk-stewardship-code
[5] Ibid, see Principle 4

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Duty of Care & Diligence

4. Company directors typically have a duty of competence and attentiveness, requiring due care and diligence. A director may breach this duty if they fail to, or inadequately, consider and manage foreseeable and "material"[6] climate risks. Directors should also have a robust corporate risk and reporting system in place that identifies and manages climate risks. The greater the materiality of an issue, the more time and resources that will be needed to discharge duties in relation to risk management oversight of that risk.[7]

5. In addition to companies directly impacted by physical and transition risks, passive and active investors will also be impacted. The most significant climate-related financial risks that financial institutions face over the long term may not be idiosyncratic to particular companies, sectors or geographies. Arguably, the most significant risks for overall investment returns will come from 'system level' macro-economic and financial stability risks, caused by the negative physical impacts of climate change and/or a disorderly transition that harms the entire global economy. As the Covid-19 crisis has illustrated, system-level risks can have severe negative impacts for the performance of financial institutions and are largely unhedgeable through traditional asset allocation and stewardship strategies.

Duty to Disclose

6. Directors normally have obligations to provide a true and fair view of corporate performance and prospects, including with respect to material risks. In some jurisdictions, directors may be held personally liable for breach of this duty. A failure to disclose the material economic transition risks or physical risks to a company's financial position, performance or prospects could constitute a breach of this duty. Directors may also be liable for a denial or material understatement of risk exposure, or a material overstatement of strategic preparedness or risk management. Both of these examples are highly relevant in the context of climate change risks. Recently, the UK Financial Conduct Authority has highlighted that, in the context of disclosure, "[c]limate change is a relevant consideration for all companies and likely to be material for most."[8]

Conclusion

7. Investors have made clear that consistent, comparable and high quality climate-related information is highly material to their decision-making.[9] Failure by companies to meet investors' disclosure expectations impedes investors from integrating climate-related information into their investment and stewardship decision-making.[10] This undermines the ability of investors to meet their fiduciary duties and increases financial stability risks.

8. The clear materiality signals from investors also indicate that many directors may be in breach of their fiduciary duties, care and diligence duties and disclosure duties with respect to the identification, management and disclosure of material risks.[11]

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[6] This is defined differently in different jurisdictions. Broadly, material risks are those which are required for, or would influence, investor decision making.
[7] Commonwealth Climate Law Initiative, "Director's Liability and Climate Risk: Comparative Paper – Australia, Canada, South Africa and the United Kingdom"
[8] FCA, "Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations", available at: https://www.fca.org.uk/publication/consultation/cp20-3.pdf
[9] See, eg, IIGCC (2012), "Institutional investors' expectations of corporate climate risk management", available at: https://www.iigcc.org/resource/institutional-investors-expectations-of-corporate-climate-risk-management/
[10] See Bank of England, "Climate change: why it matters to the Bank of England", available at: https://www.bankofengland.co.uk/knowledgebank/climate-change-why-it-matters-to-the-bank-of-england#:~:text=Severe%20climatic%20changes%20could%20impact,stability%20of%20the%20financial%20system.
[11] See further, ClientEarth, "UK financial regulators are missing in action on company disclosure failures", available at: https://www.clientearth.org/press/financial-regulators-are-missing-in-action-on-climate-risk-clientearth-

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9. Proper oversight of environmental issues, including climate change, is a fundamental requirement for directors, asset managers, investors and trustees to fulfil their legal obligations. ISS's proposal clarifies the benchmark policy and aligns it more closely with the prevailing requirements of law around the world. It would also be a strong complementary mechanism that would help investors actively use their shareholder powers to ensure investee companies and their directors engage with and fulfil their legal obligations. This would, in turn, ensure that investors are meeting their own legal obligations.

B. Proposal Specific Questions:

Question 1: What factors would your organization consider as evidence that the board has demonstrated poor risk oversight of environmental and social concerns?

TCFD Recommendations - Disclosure and Risk Management

10. The Financial Stability Board's Taskforce on Climate-related Financial Disclosures released their Final Recommendations in 2017 (the "**TCFD Recommendations**").[12] The TCFD Recommendations are now the base-line industry standard for disclosing material climate-related information in a useful and consistent format. Recently, several governments have been seeking to formalise the use of the TCFD Recommendations in company regulation. For instance, New Zealand became the first country to make company reporting in line with the TCFD Recommendations mandatory, where companies must start reporting by 2023.[13] In the UK, the Financial Conduct Authority is currently undertaking a consultation to make the TCFD Recommendations mandatory for premium listed companies.[14]

11. The TCFD Recommendations are a principles-based framework, which provide flexibility for issuers to disclose in a proportionate way, and are therefore unlikely to be overly burdensome to the vast majority of companies. Hundreds of firms across a wide range of sectors are now using the TCFD Recommendations as a framework for making their disclosures. Additionally, consulting firms and service providers have significantly scaled up their expertise and capabilities to provide comprehensive advisory services relating to TCFD-aligned disclosures. Recently, Mark Carney, the Secretary-General's Special Envoy on Climate Action and Finance and formerly the Governor of the Bank of England, made clear in his speech to the UN Climate Change Round Table that disclosure is "essential" and that it is "unacceptable" for companies not to disclose the impact of their decisions of the climate.[15]

12. Our position is that all companies should be reporting in line with the TCFD Recommendations to ensure that they are adequately reporting on climate risks. We believe that TCFD Recommendations aligned disclosure is one of the few ways to ensure that a company is properly assessing and disclosing risk, and that companies should be doing so already in order to comply with their existing legal obligations with respect to material risk disclosure. **As such, we believe that failure to report**

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lawyers/#:~:text=ClientEarth%20has%20called%20out%20the,a%20new%20briefing%20released%20today.&text=Under%20UK%20law%2C%20companies%20must,still%20failing%20to%20do%20so.

[12] TCFD, "Final Recommendations", available at: https://www.fsb-tcfd.org/publications/tcfd-recommendations-report-translations/

[13] Responsible Investor, "New Zealand becomes world's first country to introduce mandatory TCFD disclosure", available at: https://www.responsible-investor.com/articles/new-zealand-becomes-world-s-first-country-to-introduce-mandatory-tcfd-disclosure#:~:text=Around%2090%25%20of%20New%20Zealand's,to%20make%20the%20framework%20mandatory.

[14] FCA, "Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations", available at: https://www.fca.org.uk/publications/consultation-papers/cp20-3-proposals-enhance-climate-related-disclosures-listed-issuers-and-clarification-existing

[15] UN News, "UN Climate Change Roundtable", available at: https://news.un.org/en/story/2020/09/1073422

in line with the TCFD Recommendations is a clear indication that a company is demonstrating poor oversight and management of climate issues.

Paris Agreement Aligned Strategies and Long-term Planning

13. There is a reasonably foreseeable risk that the physical risks of climate change will expose companies to issues such as: increased operational and capital expenditure costs; loss of revenues; increased exposure to health and safety risks for employees and/or sub-contractors; increased disruption to sourcing of raw materials, supply chain and logistics (e.g. supply of water, energy and materials, resilience on vulnerable transport networks); increased costs of capital and more restricted access to credit markets; and increased insurance premiums and potential for reduced availability of insurance on assets in 'high-risk' locations.[16]

14. Transition risks, generally, refer to risks arising from the transition to a low-carbon economy. Extensive policy, legal, technology, and market changes to address mitigation and adaptation requirements related to climate change are well underway. These changes are widely projected to accelerate, as the urgency of meeting the objectives of the Paris Agreement and addressing physical impacts increases.[17]

15. Companies need to make forward-looking strategies that consider how to transition their businesses to be resilient to both physical and transition risks in the long term, in a future that is consistent with the objectives of the Paris Agreement.[18] As financial institutions become increasingly aware of systemic risks, they are becoming incentivised to find both advocacy routes and legally binding methods of ensuring that investee companies are properly managing long-term risks. For example, three shareholder resolutions were recently proposed at Aena[19] by TCI Fund Management. If passed, these would require the company to produce and update a Climate Action Plan every year, hold an annual advisory shareholder vote on the plan and amend the company byelaws to reflect these requirements.[20] We note that ISS called on investors to support these proposals, arguing it would "improve Aena's transparency on its environmental actions" and that it was "not overly burdensome for the company".[21]

16. In order to remain viable and resilient in the short-, medium- and long-term, companies must adopt credible strategies that are aligned with the goals of the Paris Agreement ("**Paris Alignment Strategy**"). **Our position is that failure to have adequate Paris Alignment Strategies in place is a strong indicator that companies are demonstrating poor risk oversight with respect to managing climate change risks.**

Question 2: In the past, ISS has generally applied the material governance failures policy in a retrospective fashion. Would your organization support establishment of criteria that would allow ISS benchmark policies to proactively identify boards that fail to prepare for foreseeable future risks?

17. ClientEarth strongly supports the proposal that the ISS benchmark policy should proactively identify boards that fail to prepare for foreseeable future risks. Strong forward-looking policies and strategies

[16] 3 See further examples, EBRD and Global Centre for Climate Excellence (2018), "Advancing TCFD Guidance on Physical Climate Risks and Opportunities".
[17] See, eg, Mark Carney, Governor of the Bank of England (2016), "Resolving the Climate Paradox", Speech given at the Arthur Burns Memorial Lecture, 22 September 2016.
[18] Article 2(a) of the Paris Agreement sets out the goals of, "well below 2 °C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5 °C above pre-industrial levels"
[19] AENA, "Proposed resolutions for the ordinary general meeting of Aena", available here
[20] Since the resolutions were filed, Aena voluntarily agreed to develop a Climate Action Plan and hold an annual vote on the plan.
[21] Financial Times, "Billionaire Chris Hohn forces first annual investor vote on climate policy", available at: https://www.ft.com/content/07e4aa70-a99e-40ea-9b66-2eac47ade0d6

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are critical to secure companies' long-term performance and viability. We have provided background on the need for Paris Alignment Strategies in our response to question 1, above. ISS should be able to identify key risk oversights associated with forward looking planning by considering the credibility of proposed Paris Alignment Strategies and whether they adequately address foreseeable future risks associated with climate change. ClientEarth has recently published a position paper containing Principles for Paris-alignment.[22] These Principles set out minimum standards that we believe a Paris Alignment Strategy must meet in order to be considered credible.

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[22] ClientEarth, "Principles for Paris Alignment", available at: https://www.documents.clientearth.org/wp-content/uploads/library/2020-10-16-principles-for-paris-alignment-position-paper-ce-en.pdf