ALERT MEMORANDUM

Corporate **Net Zero Transition Plans – *A "how to"***

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Transition plans describe how, as the wider economy transitions towards net zero, a company positions itself within a more sustainable economy.

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Transition plans, and companies' disclosures of the same, have been receiving increased attention from regulators: UK Financial Conduct Authority ("**FCA**") rules for certain economic sectors already entail certain transition-plan related requirements, which the UK Government intends to further enhance. Recent regulatory and legislative proposals in the US and the EU also feature transition plan disclosures, in some cases prominently. Further, recent lawsuits illustrate that, leaving aside regulatory requirements, transition plans may expose companies to significant litigation risk. Also, investors with transition strategies of their own increasingly demand such disclosures from their investment targets.

In this environment, guidance on how to design transition plan disclosures may be a valuable tool for companies to navigate a landscape that is full of complexity and risk. Indeed, several initiatives have developed guidance to support the effective disclosure of real-economy transition plans. While much commonality exists in the published guidance, there are also some important differences. A recent report by the Glasgow Financial Alliance for Net Zero ("**GFANZ**")[1] on "Expectations for Real-economy Transition Plans" (the "**GFANZ Report**")[2] seeks to help companies navigate existing guidance by demonstrating how companies can leverage such guidance.

The GFANZ Report is of particular interest given that through no fewer than seven financial sector-specific net zero alliances under the UN Race to Zero, financial institutions, including asset managers, asset owners, banks, data providers, exchanges, insurers, and rating agencies have committed to setting net zero targets[3] and are developing transition plans to reach their commitments. However, to implement these plans, they need reliable information from current and potential clients and portfolio companies about their approach to the transition and their level of ambition.

This memorandum outlines evolving regulatory requirements relating to transition plan disclosures in the UK, EU and US, and the investor pressure to which transition plan disclosures may be subject. It also provides an overview of GFANZ's recommendations.

[1] GFANZ is an international coalition of financial institutions coordinating the transition of all sectors towards a net zero global economy.
[2] The Report is accessible here.
[3] The alliances are the Net Zero Asset Managers Initiative (NZAM), the Net-Zero Asset Owner Alliance (NZAOA), the Net-Zero Banking Alliance (NZBA), the Net Zero Financial Service Providers Alliance (NZFSPA), the Net-Zero Insurance Alliance (NZIA), the Net Zero Investment Consultants Initiative (NZICI), and the Paris Aligned Asset Owners (PAAO).

I. Regulatory Landscape

Upcoming global regulatory requirements are one factor behind the rise of corporate net zero transition plans.

a. *United Kingdom*

The UK Government's intentions regarding transition plans surfaced in the October 2021 "Greening Finance Roadmap".[4]

A centrepiece[5] of the UK strategy is a new disclosure regime (the "**Sustainability Disclosure Requirements**" or "**SDRs**"), which also envisages transition plan disclosures. These intentions were confirmed at the 2021 United Nations Climate Change Conference in Glasgow (the "**COP26**"), where the UK Government pledged to become the world's first Net Zero-aligned Financial Centre. Transition plans being an important tool to achieve this goal, Rishi Sunak announced the Government's intention to make it mandatory for certain firms to publish clear, deliverable decarbonisation plans.

i. FCA climate disclosures

UK adopted International Sustainability Standards Board ("**ISSB**") standards will eventually form the central component of the SDRs. In March 2022, the ISSB produced an "exposure draft" on climate-related disclosures that sets out proposed requirements to identify, measure and disclose climate-related risks and opportunities (the "**Exposure Draft**").[6] The Exposure Draft proposes a range of disclosures about an entity's transition plans, including information about how the entity plans to achieve any climate-related targets that it has set (which includes information about the use of carbon offsets); its plans and critical assumptions for legacy assets; and quantitative and qualitative information about the progress of plans previously disclosed by the entity.

Pending the finalisation and UK adoption of the ISSB standards, transition plan reporting is effectively already required for certain companies in the UK. In December 2020, the FCA introduced a rule for commercial companies with a UK premium listing to disclose, on a comply-or-explain basis, in accordance with the recommendations of the Task Force on Climate-Related Financial Disclosures ("**TCFD**" - a body created in 2015 by the Financial Stability Board).[7] In December 2021, the FCA extended the rule to issuers of standard listed shares and standard listed global depositary receipts representing equity shares (excluding standard listed investment entities and shell companies).[8] The rule for premium listed companies came into effect for accounting periods beginning on or after 1 January 2021. The rule for standard listed companies applies for accounting periods beginning on or after 1 January 2022.

If an issuer falls within the scope of the disclosure requirements, it must include a statement in its annual financial report setting out, as applicable:

- whether the issuer has made disclosures consistent with the TCFD's recommendations and recommended disclosures in its annual financial report;
- where the issuer has included some, or all, of its disclosures in a document other than its annual financial report, an explanation of why and a reference to where the disclosures can be found; and
- where the issuer has not made disclosures, an explanation of why, and a description of any steps it is taking or plans to take to be able to make consistent disclosures in the future – including relevant time frames.

Also in December 2021, the FCA introduced rules for certain FCA-regulated asset managers and "asset owners" in respect of their assets managed or administered from an establishment in the UK, subject

[4] The Greening Finance Roadmap is accessible here.

[5] Another key element of the Greening Finance Roadmap is the Government's intention to introduce a UK Green Taxonomy, which would set out the criteria which specific economic activities must meet to be considered environmentally sustainable.

[6] "IFRS S2 Climate-related Disclosures", accessible here.

[7] FCA Handbook, Listing Rules ("**LRs**") 9.8.6R(8) and related or consequential rules and guidance. These requirements were introduced by Policy Statement PS20/17 on "Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations", which is accessible here.

[8] LR 14.3.27R and related or consequential rules and guidance, introduced by Policy Statement PS21/23 on "Enhancing climate-related disclosures by standard listed companies", which is accessible here.

to an exemption for firms with less than £5 billion in AUM or administration,[9] to make disclosures consistent with the TCFD's recommendations.[10] In-scope firms must make mandatory disclosures on an annual basis at entity- and product-level:

- *entity-level*: the firm must publish an annual "TCFD entity report" in a prominent place on its main business website. This must set out how the firm takes climate-related matters into account in managing or administering investments on behalf of clients and consumers; and
- *product-level*: the firm must make disclosures (including a core set of climate-related metrics) on its products and portfolios. These should be made in a prominent place on the firm's main business website and be included or cross-referenced in an appropriate client communication, or made upon request to certain eligible institutional clients.

The rules came into effect for the largest firms on 1 January 2022 and will come into effect on 1 January 2023 for smaller firms.

The TCFD issued a 2017 report with recommendations on companies' climate-related financial disclosures (the "**TCFD Final Report**"), which have become the leading framework for climate-related financial disclosures.[11] The TCFD Final Report recommended that these be built around four core elements:

GOVERNANCE	**STRATEGY**
RISK MANAGEMENT	**METRICS & TARGETS**

It also included seven principles for effective disclosure that should underpin companies' climate-related financial reporting, including that disclosures should be "specific and complete", "consistent over time" and "comparable among companies within a sector, industry or portfolio".

In determining whether disclosures are consistent with the TCFD recommendations, certain additional TCFD documents should be taken into account.[12] These include relevant sections of the revised Annex to the TCFD Final Report, titled "Implementing the Recommendations of the TCFD" (the "**TCFD Annex**"),[13] and the TCFD's "Guidance on Metrics, Targets and Transition Plans",[14] both published in October 2021. Notably, the TCFD observes in the latter that while its strategy recommendation asks for disclosure of the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning, reporting on transition plans has emerged more recently as important to users. As a result, the document, among other things, describes how organisations might include information on their transition plans in their disclosures. It states that a climate transition plan should be:

- aligned with strategy;
- anchored in quantitative elements, including climate-related metrics and targets;
- subject to effective governance processes;
- actionable with specific initiatives;
- credible;
- periodically reviewed and updated; and
- reported annually to stakeholders.

It sets out "transition plan elements" centred around governance, strategy, risk management, metrics and targets.

Where companies disclose transition plans, the FCA encourages them to consider any net zero commitments of the country in which such company operates – such as the UK's commitment under the Climate Change Act 2008 (2050 Target Amendment) Order 2019. Where the entity has not considered this commitment in developing and disclosing its transition plan, it should explain why it has not done so.[15]

[9] Calculated on a 3-year rolling average basis with respect to specified "TCFD in-scope business".
[10] FCA Handbook, Environmental, Social and Governance sourcebook ("**ESG**"), chapter 2. These requirements were introduced as part of the FCA's Policy Statement PS21/24 on "Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers", which is accessible here.
[11] The TCFD Final Report is accessible here.
[12] LRs 9.8.6BG, 9.8.6CG, 14.3.28G; ESG 2.1.7G.
[13] The TCFD Annex is accessible here.
[14] The TCFD's Guidance on Metrics, Targets and Transition Plans is accessible here.
[15] LRs 9.8.6FG, 14.3.32G; ESG 2.2.3R.

These requirements represent the FCA's first step towards more detailed provisions on transition plans. The regulator has committed to doing further work to promote well-designed, well-governed, credible and effective net zero transition plans by listed companies and regulated firms.[16]

ii. Further developments in the UK

In its Fact Sheet on the Net Zero-aligned Financial Centre (the "**Fact Sheet**"),[17] the UK Government stated that the "UK will move towards making publication of transition plans mandatory". As standards for transition plans emerge, the UK Government and regulators would take steps to incorporate these into the SDRs and strengthen requirements to encourage consistency in published plans and increased adoption by 2023. The UK Government's aim here is to "*increase transparency and accountability about the actions firms are planning to take to align with the UK's economy-wide transition to net zero*".[18] It is anticipated that existing TCFD-aligned disclosure rules in the UK will be replaced by a requirement for certain companies to disclose in accordance with ISSB standards as adopted and endorsed for use in the UK.

In April 2022, the UK Government launched the Transition Plan Taskforce (the "**TPT**") with a mandate to develop a "gold standard" for transition plans.

The TPT is working, amongst other things, on *(i)* a sector-neutral framework for private-sector transition plans, *(ii)* sectoral transition plan templates, and *(iii)* guidance on how to simplify assessment, comparison and interpretation of transition plans by users. Having published in May a "Call for Evidence" to consult on a sector-neutral framework for private-sector transition plans,[19] on 8 November 2022, the TPT published a consultation on a sector-neutral disclosure framework and accompanying implementation guidance (the "**TPT Consultation**").[20]

The TPT Consultation proposes three guiding principles for transition plans with associated categories of disclosures:

1. "**Ambition**", including disclosures on foundational information such as transition-related objectives, priorities and business model implications;
2. "**Action**", including disclosures on companies' implementation strategies (including business, operational and financial planning) and engagement strategies (including in respect of engagement with value chain, industry and the public sector); and
3. "**Accountability**", including disclosures on metrics & targets (e.g., financial metrics, greenhouse gas emissions, use of carbon credits) and governance (e.g., board oversight, incentives, and skills).

The TPT recommends that entities publish standalone transition plans at least every three years, and sooner when there are significant changes to the plan. Progress against the plan and material updates should be reported annually as part of TCFD- or ISSB-aligned disclosures in general purpose financial reporting (e.g., annual financial reports). To maximise alignment, entities should apply the same corporate reporting norms to their transition plan disclosures as they would to their general purpose financial reporting. For example, entities should approach materiality in the same way as they do in their general purpose financial reporting. This means that they should disclose any information that, if omitted, misstated, or obscured, could reasonably be expected to influence decisions that the primary users of general purpose financial reporting make on the basis of that reporting, which provides information about a specific reporting entity.

A good practice transition plan should cover:

- an entity's high-level ambitions to mitigate, manage and respond to the changing climate and to leverage opportunities of the transition to a low GHG and climate resilient economy. This includes interim and long-term targets to reduce GHG emissions over time across emissions Scopes 1, 2, and 3[21] (e.g., a net zero

[16] See FCA, "A strategy for positive change: our ESG priorities", accessible here.
[17] The Fact Sheet is accessible here.
[18] Fact Sheet, section 5.
[19] The TPT's Call for Evidence is accessible here.
[20] The TPT's consultation on the sector-neutral disclosure framework is accessible here, and the consultation on the implementation guidance is accessible here.
[21] If the entity excludes categories of Scope 3 emissions from its metrics and targets, it should state the reason for omitting them,

commitment);

- short, medium and long-term actions the entity plans to take to achieve its strategic ambition, alongside details on how those steps will be financed;
- governance and accountability mechanisms that support delivery of the plan and robust periodic reporting; and
- measures to address material risks and leverage opportunities.

Notably, the TPT recommends disclosing and explaining the entity's intended use of carbon credits in achieving its objectives and priorities.

The TPT Consultation is open until 28 February 2023 and the TPT aims to finalise its framework in the course of 2023.

The TPT has also launched a sandbox[22] in which it intends to work with preparers (starting in October 2022) and users (starting in spring 2023) of transition plans to road test the TPT's outputs and gather practical feedback from the market. The findings from this exercise are expected to inform the final iteration of the TPT disclosure framework, implementation guidance and sector guidance.

b. European Union

In the European Union, transition plan requirements will be imposed on all "large" companies, under the proposed Corporate Sustainability Reporting Directive (the "**CSRD**").[23]

This will affect all EU-headquartered companies that cross (whether on a solo or a consolidated basis) at least 2 of 3 thresholds in any given year:

i. 250 employees;

ii. 40 million Euro net turnover; and

iii. 20 million Euro assets.

The CSRD will also apply to all companies (including SMEs) with listed securities trading on an EU regulated market.

The CSRD will require in-scope companies to disclose transition plans, including implementing actions and related financial and investment plans. These plans must be designed so as "*to ensure that its business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement and the objective of achieving climate neutrality by 2050*".[24] As such, under the proposed EU rules, not only would transition plan disclosure be mandatory, but companies' transition plan would need to set specific, ambitious targets.

The CSRD will be phased-in from 2024, starting with entities already within the scope of the Non-Financial Reporting Directive.[25] From 2028, the CSRD might impose consolidated ESG-reporting requirements even on *non-EU* ultimate parent entities that generate a relevant group turnover within the EU.

c. United States

In the US, transition plan disclosure requirements may be introduced as early as 2024, under the Securities and Exchange Commission's proposed rules to enhance and standardise climate-related disclosures for investors (the "**SEC Proposal**"),[26] released in March 2022. If adopted, these would apply to all issuers of US-listed securities, with certain limited exceptions.

Whilst the SEC Proposal would not require companies to adopt transition plans, it would require a company that has adopted a transition plan to provide a description of it in its public disclosure.[27] This disclosure would need to include relevant metrics and targets used to identify and manage physical and transition risks, and how the company plans to mitigate,

and any steps it is taking to improve monitoring and reporting systems and enable target setting for relevant Scope 3 emission categories.

[22] More information on the TPT sandbox is available here.

[23] A copy of the CSRD draft on which the European Parliament and the Council have reached provisional agreement, released on 30 June 2022, is accessible here. Cleary Gottlieb's alert memorandum, providing a background overview of the requirements of an earlier draft of the CSRD, is accessible here.

[24] See e.g., proposed new Article 19a(2)(a)(iii) of Directive 2013/34/EU, proposed to be inserted by CSRD, Article 1(3).

[25] I.e., large listed companies, large banks, large insurers and other entities designated as "public interest entities" by individual Member States. Directive 2014/95/EU, the Non-Financial Reporting Directive, is accessible here.

[26] The SEC Fact Sheet regarding the disclosures is accessible here. The Cleary Gottlieb alert memorandum, explaining the proposed rules, is accessible here.

[27] SEC Proposal, Item 1503(c)(1).

or adapt to, such risks. The transition plan disclosure would also need to be updated annually by describing the actions taken during the year to achieve the plan's targets or goals.

II. What makes a good plan?

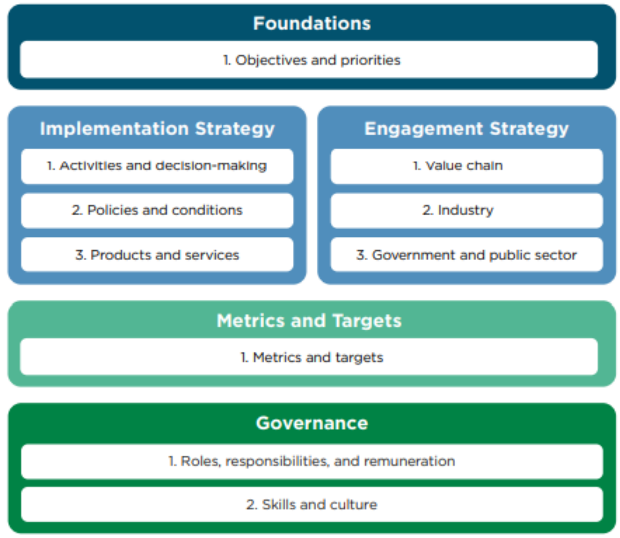
In addition to regulatory pressure, investors have been demanding detailed transition plan disclosures from corporates. Indeed, investor demand was described by a TCFD 2022 report as a "key driving factor" for the recent – and continuing – increase in climate-related financial disclosures.[28] There is also an increasing trend of investor-led initiatives such as Climate Action 100+[29] utilising shareholder proposals and votes as an engagement tool, pushing, among other things, for *(i)* strong governance frameworks with clear accountability for, and oversight of, climate change risk; *(ii)* tangible reductions in greenhouse gas emission; and *(iii)* enhanced corporate disclosure on transition plans.

Given the clear direction of travel, companies will need to think carefully about their transition plans and what exactly their disclosures should look like.

There are quite a few different sources of guidance and recommendations on how to design transition plan disclosures (including the TCFD and ISSB and TPT draft standards), and much of the work that has been done recently consists of consolidating the insights emerging from these different sources. The GFANZ Report is a good example of such a resource.[30]

The GFANZ Report outlines certain components that real-economy transition plans should include. Financial institutions will be examining these components to inform their allocation of capital and services, and how they engage. Resonant with the key pillars of the TCFD guidance and ISSB and TPT drafts, GFANZ has identified five transition plan themes, with ten components in total.

1. <u>**Foundations**</u>: Transition plans should state the company's ultimate goal with respect to climate change and its strategy for achieving that goal. This would mean articulating its **objectives**, **priorities**, and the principles governing its actions (e.g., 'just transition' and 'nature-positive economy' principles), concrete (short- and long-term) targets, as well as timeline and methods for achieving those targets.



2. <u>**Implementation Strategy**</u>: Transition plans should also demonstrate how the company will align business activities and operations with its climate objectives and priorities, to give investors confidence that the transition plans translate into concrete actions. This may entail demonstrating how the company's actions contribute to achieving emissions reductions, such as through the managed phaseout of high-emitting assets. Disclosure of **policies and conditions** may give insight into the company's priority issues and actions, for example in relation to (i) business, financial, and operational planning (e.g., climate-related requirements for suppliers), or (ii) mitigation of impact on natural eco-systems (e.g., deforestation, pollution). Disclosures related to **products and services** will help financial institutions understand and evaluate how a company is positioning itself commercially to meet its transition plan ambitions and GHG targets.

3. <u>**Engagement Strategy**</u>: Transition plans should outline how the company will influence others to support its transition objectives/strategy and accelerate the transition of the whole economy. For example, disclosure by a real-economy company of

[28] The TCFD's 2022 report is accessible here.
[29] Climate Action 100+'s website is accessible here.
[30] The Report sets out expectations for *real-economy* transition plans. In November 2022, GFANZ further published recommendations and guidance on financial institution net zero plans, accessible here.

its engagement with its **value chain** may encourage suppliers to match (or exceed) the company's own decarbonization targets and drive increased demand for low-carbon products and services. Disclosure on engagement and leadership in **industry** initiatives, trade organizations, and/or direct engagement with peers may provide assurance that a company is appropriately collaborating with the industry to identify and promote solutions that will have positive impacts across its peers and value chain (i.e., how the company is helping to enable economy-wide transition). Disclosure on **government and public sector** is expected to provide insight into a company's role in promoting climate-related policies (e.g., direct and indirect lobbying for policies that support the net zero transition) and into how the company's transition plan strategy and objectives are aligned with the Government's policy activities.

4. **Metrics and Targets**: Transition plans should set out quantitative goals against which investors can measure the progress and success of the implementation of a company's transition plan over time. Relevant metrics and targets may include, for example, GHG emissions metrics, selection and details of sectoral pathways, use of carbon offsets, business and operational metrics (e.g., % in high-carbon assets), financial metrics (e.g., low-carbon CapEx), nature-based targets and progress against those targets (e.g., acres of reforestation), governance targets and progress against those targets (e.g., employee remuneration linked to progress against GHG emissions targets). Notably, GHG emissions targets for Scope 3 GHG emissions should be disclosed if Scope 3 emissions are material (if Scope 3 emissions are omitted, this should be justified). Carbon credits, offsets, and avoided emissions (i.e., also known as Scope 4 emissions) should be disclosed separately from GHG reduction targets and metrics; carbon credits should not be incorporated into reaching transition plan's target GHG emissions.

5. **Governance**: Finally, Transition Plans should outline how a company's governance structure provides oversight, incentivises, and supports the implementation of its transition plan. Disclosure on **roles and responsibilities** of the company board and management in respect of transition plan strategy and execution, and on the extent of alignment of **remuneration** to the company's transition-plan objectives, will provide insight regarding the level of a company's commitment to its transition plan. Disclosure on **skills** (e.g., management's climate expertise) and **culture** (e.g., stakeholder communication mechanisms, sustainability-related performance objectives) may show that the company embeds the importance of climate change within its core values and invests to develop its teams' knowledge and skills to attain transition-plan goals.

III. Conclusion

Transition plans, and their disclosure, are an area of significant potential litigation and enforcement risk for companies. It will be increasingly difficult for companies to avoid disclosing transition plans, and such disclosure will be scrutinised for its completeness, its credibility and its consistency with other disclosures and activities of the company. Moreover, recent litigation highlights that not only the quality of disclosures, but companies' transition strategies themselves, may become subject to criticism.

Further, in terms of reporting obligations, the regulatory landscape is filled with complexity, especially where companies operate across different jurisdictions. This is partly because requirements across jurisdictions will be phased-in for different entities at different times. It is also, in part, because regulatory requirements in one jurisdiction may have unforeseen implications for other jurisdictions: for example, whilst the SEC Proposal would require transition plan disclosures only where companies actually adopt transition plans, this voluntariness will be illusory for companies that also operate in the UK and EU where transition plans will become mandatory for companies.

In this environment, companies will need to think carefully about an effective, efficient and credible way to provide disclosures on their net zero plans, that does not risk falling short of regulatory requirements and provides to shareholders and other investors the information they seek. Guidance such as the GFANZ Report may prove a valuable starting point for such considerations.

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