

FCA Engagement Signals New Direction In ESG Disclosures

By **Ferdisha Snagg and Andreas Wildner** (October 30, 2023)

On May 4, the International Sustainability Standards Board, or ISSB, published a request for information to consult on its agenda priorities.[1]

On Sept. 7, the Financial Conduct Authority published a response to the consultation, recommending that the ISSB prioritize embedding its International Financial Reporting Standards, or IFRS, S1 and S2 standards.[2]

These standards deal, respectively, with general requirements for disclosure of sustainability-related financial information and, specifically, climate-related disclosures, as well as developing disclosure standards related to nature, human capital and human rights.

Together with the U.K. government, the FCA has made much of its support for the ISSB and the U.K.'s ambition to become the world's first net zero-aligned financial center.

The FCA's response to the consultation reiterates its backing of the standard-setter and illustrates the regulator's priorities for the U.K.'s green transition and broader environmental, social and governance agenda.

Both the FCA[3] and the U.K. government[4] strongly welcomed the launch of the ISSB's IFRS S1 and IFRS S2 standards in June and have expressed their intention to introduce disclosure requirements referencing the new standards.

By recommending that the ISSB develop additional guidance relating to transition planning, the consultation response also reflects the FCA's repeated commitment to the work of the Transition Plan Taskforce, the U.K.'s standard-setting body for private-sector climate transition plans, and the FCA's intention to consult, over the next year, on rules and guidance for companies to take into account the Transition Plan Taskforce's recommendations.

At the same time, the FCA's response is an important early indicator of where the regulator will turn its attention to next.

The consideration of nature-based disclosures has surfaced already in the FCA's updated ESG strategy,[5] as well as in its 2023 discussion paper on "Finance for positive sustainable change." [6]

In light of the publication by the Task Force on Nature-Related Financial Disclosures of its final recommendation in September,[7] it is to be expected that the FCA's focus will soon shift to nature.

On the other hand, the FCA appears to accept that standards relating to human capital and human rights, which it wants the ISSB to consider holistically, will likely take some time to



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develop.

What was the intention of the ISSB consultation?

The consultation was intended to inform of the ISSB's new work plan following completion of IFRS S1 general requirements for disclosure of sustainability-related financial information and IFRS S2 climate-related disclosures.[8]

Among other things, it sought views on the ISSB's overall strategic direction along with certain specific projects that the ISSB planned to pursue.

The consultation sought input on the ISSB's strategic direction.

Noting the range of activities that the ISSB undertakes, the consultation requested feedback on how these activities should be prioritized, and whether any other activities should be included in the scope of the ISSB's work.

Specifically, the ISSB asked how it should prioritize the following:

- New research on sustainability-related topics with a view to developing new standards for sustainability-related disclosures;
- Supporting the implementation of the IFRS S1 and IFRS S2 standards through the issuance of guidance and other initiatives;
- Research on target enhancements to the ISSB standards, especially IFRS S2, including guidance on the disclosure of climate-adjacent risks and opportunities, e.g., risks and opportunities related to nature or just transition, with a view to enabling a more holistic approach to climate-related disclosures; and
- Enhancing the Sustainability Accounting Standards Board, or SASB, standards, which play an important role in both IFRS S1 and IFRS S2.

The consultation presented three new projects.

In addition, the consultation sketched the broad outlines of three specific research and standard-setting projects that the ISSB identified as priority sustainability-reporting matters.

1. Biodiversity, Ecosystems and Ecosystem Services

Biodiversity is a foundational characteristic of functional, productive and resilient ecosystems.

Ecosystems provide ecosystem services — such as climate regulation, provision of raw

materials, pollination, pest and flood control — that are indispensable for life on earth.

Changes in biodiversity, ecosystems and ecosystem services are likely to contribute to entities' sustainability-related risks and opportunities, both from the perspective of individual business operations and from a broader financial-stability perspective.

Investors are showing increasing interest in biodiversity, ecosystems and ecosystem services, given that it ultimately underpins all business activities, and the fact that ecosystem and biodiversity indicators are already in decline increases the pressure to provide meaningful information to investors.

2. Human Capital

There are various ways in which human-capital-related issues — including topics such as worker wellbeing, diversity, equity and inclusion, workforce investment, labor conditions in the value chain, etc — drive value and, correspondingly, are of interest to investors.

However, there are various challenges in meeting investors' information needs — including the multifaceted nature of human-capital-related issues and inherent difficulties in measuring relevant aspects — or regulatory hurdles in collecting data.

3. Human Rights

A range of human-rights issues may contribute to entities' sustainability-related risks and opportunities.

In particular, challenges to managing human-rights-related issues create increasing risks for businesses, e.g., in the form of protests, boycotts, suspension of permits, or fine or compensation claims following human-rights violations.

What will the ISSB's work with the strategic projects look like?

These considerations may inform investment decisions, but investors face various challenges in obtaining decision-relevant information.

The ISSB's work on each of these projects would involve developing a framework of categories and definitions, understanding sustainability-related risks and opportunities, and understanding existing topic-specific practices, tools and metrics used to measure and disclose material information.

The consultation also identified integration in reporting as a priority concern and outlined a research project to consider connections, interdependencies, synergies and trade-offs between an entity's financial performance and general-purpose financial reports, and its sustainability performance and sustainability-related disclosures.

This would be underpinned by a vision of creating an integrated, coherent and comprehensive system of corporate reporting that provides a holistic and transparent view of how an entity creates value over time.

The ISSB's work could involve developing guidance on how entities might bring sustainability-related financial information together with other qualitative and quantitative financial information, or establishing a corporate reporting framework that integrates disclosure.

How did the FCA respond?

Unsurprisingly, the FCA's response recommended prioritizing the embedding of IFRS S1 and IFRS S2.

The ISSB's standards are expected to form a core component of the U.K. sustainability disclosure requirements framework and be the backbone of its corporate reporting element.

The FCA previously set out plans to consult in the first half of 2024 on proposals to implement disclosure rules referencing U.K.-endorsed IFRS S1 and IFRS S2 for listed companies.

It welcomed the ISSB's commitment to establishing a transition implementation group, and developing adoption guidance and parameters for "jurisdictional scaling and phasing-in."

The FCA also recommended clarifying the architecture of the standards, including the interaction between thematic and industry-based standards.

However, the FCA also called on the ISSB to launch a comprehensive work programme to build out a suite of investor-material sustainability-related disclosure standards beyond climate.

In particular, in the short term, the ISSB should swiftly start work on developing a thematic standard on nature.

A thematic standard on nature should be prioritized because climate and nature are interdependent, and governments and policymakers globally have acknowledged the urgent need for action in this respect.

It should be informed by the final recommendations of the Task Force on Nature-Related Financial Disclosures, which were themselves based on the work of the Task Force on Climate-Related Financial Disclosures and the IFRS foundation, and subject to extensive outreach, testing and engagement.

The FCA also called for a more holistic approach beyond biodiversity, ecosystems and ecosystem services that would capture the full implications of nature-related disclosures.

Joint standards on human capital and human rights should be developed in the medium-term, recognizing the interdependencies and areas of overlap between these issues.

Again, the ISSB could draw on existing work to develop research in this area, for example the literature and thought leadership produced by the International Integrated Reporting Council or the SASB's human capital management research project.

Regarding targeted enhancements to the ISSB standards, the FCA considered that such enhancements, which may involve guidance on nature and just-transition disclosures and support of the implementation of such enhancements through the development of educational materials, may usefully complement the development of nature- and human capital- and human-rights-related standards.

The FCA also encouraged the ISSB to develop additional guidance relating to transition planning and, in doing so, to draw on the disclosure recommendations published by the

Transition Plan Taskforce.[9]

The FCA supported the consolidation of industry-based disclosure requirements in the SASB standards.

However, if the ISSB were to consider making reporting against the SASB standards an integral requirement under its own standards, the full content of the SASB standards should be subject to stakeholder feedback and rigorous IFRS foundation due process.

The FCA welcomed the ISSB's proposed work on reporting integration. It recommended undertaking this project jointly with the International Accounting Standards Board, to ensure that the ISSB's new requirements can be applied effectively alongside existing financial reporting requirements.

What is next for sustainability disclosure requirements?

Both the consultation and the FCA's response to it are highly informative indicators of the direction in which sustainability-related disclosures, and sustainable finance more generally, are developing.

One aspect of these developments is the expansion from a focus on climate change specifically to other environmental factors, especially nature and biodiversity.

Key recent developments in this respect include the publication of the Task Force on Nature-Related Financial Disclosures recommendations, as well as the rise of biodiversity credits and offsets.

Reporting companies may want to consider carefully how best to prepare for increasingly integrated environment-related disclosures.

Another aspect, highlighted especially by the FCA response, is the conceptual challenges that creating a coherent framework for human capital- and human rights-related disclosures may entail.

In fact, the experience of the European Union in this regard is instructive.

In February 2022, the EU's platform on sustainable finance — an independent expert body advising the European Commission on the development of sustainable finance policies and, in particular, the EU taxonomy — published a report on extending the EU's taxonomy for sustainable activities to include criteria also for the sustainability of economic activities from a social and governance perspective.[10]

However, that report was shelved, and the project of extending the taxonomy put on hold, due to disagreement over what exactly a social taxonomy should look like.

That being said, under the EU's emerging sustainability reporting framework, four of the already published European sustainability reporting standards deal with social dimensions — specifically, own workforce, workers in the value chain, affected communities, and consumers and end users — and the EU's proposed Corporate Sustainability Due Diligence Directive will further increase the focus on the human rights-related impact of companies' operations and disclosures relating to the same.

Navigating this emerging disclosure landscape will, especially for companies operating

across multiple jurisdictions with different disclosure and reporting frameworks, require careful planning to achieve compliance without undue inefficiencies.

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[1] The Consultation is accessible here: <https://www.ifrs.org/content/dam/ifrs/project/issb-consultation-on-agenda-priorities/issb-rfi-2023-1.pdf>.

[2] The FCA's response to the Consultation is accessible here: <https://www.fca.org.uk/publication/corporate/issb-request-information-response.pdf>.

[3] See the FCA's Primary Market Bulletin 45, accessible here: <https://www.fca.org.uk/publications/newsletters/primary-market-bulletin-45>.

[4] See the UK Governments 2023 Green Finance Strategy, accessible here: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1149690/mobilising-green-investment-2023-green-finance-strategy.pdf.

[5] The FCA's ESG Strategy is accessible here: <https://www.fca.org.uk/publications/corporate-documents/strategy-positive-change-our-esg-priorities>.

[6] The FCA's Discussion Paper 23/1 on "Finance for positive sustainable change: governance, incentives and competence in regulated firms" is accessible here: https://www.fca.org.uk/publication/discussion/dp23-1_updated.pdf.

[7] The Recommendations of the TNFD are accessible here: https://tnfd.global/wp-content/uploads/2023/08/Recommendations_of_the_Taskforce_on_Nature-related_Financial_Disclosures_September_2023.pdf?v=1695118661.

[8] For an analysis of the ISSB's IFRS S1 and IFRS S2 disclosure standards, please see here: <https://www.clearygottlieb.com/-/media/files/alert-memos-2023/ifrs-releases-new-global-sustainability-disclosure-standards.pdf>.

[9] The TPT's Disclosure Framework is accessible here: https://transitiontaskforce.net/wp-content/uploads/2023/10/TPT_Disclosure-framework-2023.pdf.

[10] For an analysis of the Platform's Social Taxonomy Report, please see here: <https://www.clearygottlieb.com/-/media/files/alert-memos-2022/a-social-taxonomy-for-europe-extending-the-eu-esg-framework-to-socially-sustainable-activities-and-companies-corporate-governance.pdf>.