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Insights

Alternative Investments Practice

TCFD Reporting and Implications for CLO Managers

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1. Introduction

The Task Force on Climate-related Financial Disclosures ("**TCFD**") was established by the Financial Stability Board to develop consistent climate-related financial disclosures for use by companies, banks and investors in providing information to stakeholders.[1] The TCFD published a final report in June 2017 that contained 11 recommended disclosures under four overarching recommendations covering governance, strategy, risk management, and metrics and targets (the "**TCFD Recommendations**").[2] Almost four years later, the Financial Conduct Authority's ("**FCA**") Policy Statement (PS21/24) provided that, among others, certain asset managers would need to make climate-related disclosures consistent with the TCFD Recommendations on an annual basis at entity and product level.[3] By introducing disclosures consistent with the TCFD Recommendations, the FCA aims to increase transparency on climate-related risks and opportunities and enable clients and consumers to make considered choices in matters relating to environmental, social and governance ("**ESG**"), and to further the Government's commitment to mandatory TCFD-aligned disclosures across the UK economy by 2025 and a net zero economy by 2050.[4] The rules and guidance for certain asset managers to make disclosures consistent with the TCFD Recommendations can be found in the FCA's ESG Sourcebook (the "**FCA ESG/TCFD Rules**").[5]

The FCA ESG/TCFD Rules either apply, or will apply, to FCA-authorised asset managers (including, for the purpose of this Client Alert, FCA-authorised CLO managers) with assets under management ("**AUM**")

[1] 'TCFD – Task Force On Climate-Related Financial Disclosures' (*Unepfi.org*) <https://www.unepfi.org/climate-change/tcfd/>

[2] Task Force on Climate-related Financial Disclosures, 'Recommendations Of The Task Force On Climate-Related Financial Disclosures' (2017) <https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf>

[3] FCA, 'Enhancing Climate-Related Disclosures By Asset Managers, Life Insurers And FCA-Regulated Pension Providers' (2021) <https://www.fca.org.uk/publications/policy-statements/ps-21-24-climate-related-disclosures-asset-managers-life-insurers-regulated-pensions> ("**PS21/24**"), 1.9

[4] PS21/24*,* 1.6 and 1.7

[5] Financial Conduct Authority, 'Environmental, Social And Governance Sourcebook' <https://www.handbook.fca.org.uk/handbook/ESG.pdf> ("**ESG Sourcebook**")

above certain prescribed thresholds.[6] In addition, we understand that certain CLO investors are considering TCFD reporting as a pre-condition for investment in European CLOs (regardless of whether the FCA ESG/TCFD Rules are directly applicable to the relevant CLO manager), either to allow such CLO investors to comply with their own TCFD reporting obligations or because they regard TCFD reporting as an important ESG metric.

This Client Alert sets out a short synopsis of the reporting requirements and the scope of TCFD reporting as it applies to FCA-authorised CLO managers (which may also be relevant for out-of-scope CLO managers to the extent TCFD reporting is requested by CLO investors on their managed transactions).

2. Framework

The FCA ESG/TCFD Rules relate to either (i) the assets that an in-scope entity manages or administers[7] (disclosed in an entity-level report (an "**Entity-Level Report**")); or (ii) the assets relating or corresponding to a particular financial product or service (disclosed in a product-level report (a "**Product-Level Report**"))[8], and are distinct from ESG reporting pursuant to the Sustainable Finance Disclosure Regulation[9] (Regulation (EU) 2019/2088).[10] For more information on the requirements of Entity-Level Reports and Product-Level Reports, see section 5 of this Client Alert.

3. Scope of Obligations

The FCA ESG/TCFD Rules apply to, among others, FCA-authorised (i) alternative investment fund managers, (ii) UCITS managers and (iii) portfolio managers, which will include FCA-authorised UK CLO manager entities.[11] The FCA ESG/TCFD Rules came into effect on 1 January 2022 for FCA-authorised asset managers with more than £50 billion AUM (calculated on a three-year rolling average basis, assessed annually).[12] The first set of Entity-Level Reports and Product-Level Reports for these firms are due by 30 June 2023.[13] For asset managers with less than £50 billion AUM, the implementation is deferred until 1 January 2023[14] and the first set of reports for these firms are due by 30 June 2024.[15]

4. Exemptions

The FCA ESG/TCFD Rules do not apply to UK asset managers with less than £5 billion AUM in relation to the firm's "TCFD in-scope business"[16] (which includes portfolio management) on a three-year rolling average basis, assessed annually.[17] The £5 billion AUM threshold is applied at an individual, rather than

[6] For more details on the applicable thresholds and exemptions that apply under the FCA ESG/TCFD Rules, see sections 3 and 4 of this Client Alert.
[7] ESG Sourcebook, 1.1.3G
[8] ESG Sourcebook, 1.1.3G
[9] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02019R2088-20200712> ("**SFDR**")
[10] For further information on the application of SFDR to Euro CLOs, see Milbank's Client Alert "ESG and Euro CLOs: The Past, Present and Future", available at <https://www.milbank.com/images/content/1/6/v4/167053/Updated-ESG-and-Euro-CLOs-The-Past-Present-and-Future.pdf>
[11] ESG Sourcebook, 1.2.1R
[12] ESG Sourcebook, Transitional Provisions ("**TP**") 1.1
[13] ESG Sourcebook, TP 1.3(2)
[14] ESG Sourcebook, TP 1.4
[15] ESG Sourcebook, TP 1.3(1)
[16] "TCFD in scope business" includes the following activities: (1) portfolio management; (2) managing a UK UCITS; (3) managing an AIF; (4) providing insurance-based investment products; (5) operating a personal pension scheme (excluding a SIPP) or stakeholder pension scheme; and (6) operating a SIPP in certain circumstances.
[17] ESG Sourcebook, 1.2.2R

group consolidated basis, and was included by the FCA to ensure a proportionate response to climate disclosures.[18] However, firms below this threshold are encouraged to make disclosures voluntarily where possible, or start building the capabilities to do so.[19] The FCA has further advised that the £5 billion AUM threshold will be reviewed as part of its post-implementation review after three years of disclosures.[20]

For in-scope UK CLO managers, there is no difference in treatment for (i) products only marketed outside the UK, (ii) portfolio management arrangements with clients outside the UK, or (iii) portfolios of assets located outside the UK.[21] The FCA ESG/TCFD Rules also do not directly apply to non-UK CLO managers[22] (but such CLO managers may be caught indirectly by TCFD reporting to the extent that such reporting is requested by CLO investors at a contractual level – see section 5B(ii) below).

5. Reporting Requirements

The FCA ESG/TCFD Rules require in-scope asset managers to prepare Entity-Level Reports and Product-Level Reports on an annual basis (and by 30 June of each year).[23] Both forms of disclosure must be published in a prominent place on the main website of the firm.[24] In-scope asset managers must ensure that any climate-related financial disclosures in its Entity-Level Reports and Product-Level Reports are consistent with the TCFD Recommendations unless otherwise permitted by the FCA ESG/TCFD Rules (including, part 4, section D of the TCFD Annex included in the TCFD Recommendations).[25]

A. Entity-Level Reports

Entity-Level Reports should cover how the firm takes climate-related matters into account by including, with respect to its "TCFD in-scope business":[26]

- climate-related financial disclosures, consistent with the TCFD Recommendations, regarding the overall assets managed or administered by it in relation to its TCFD in-scope business;[27]
- how the firm's approach to a particular investment strategy, asset class or product is materially different to its overall approach to the TCFD Recommendations;[28]
- how the TCFD Recommendations have influenced the firm's approach to its delegates and third parties;[29]
- where the firm is headquartered in, or operates in, a country that has made a commitment to a net zero economy, the firm's consideration of that commitment in developing and disclosing its transition plan;[30]
- the firm's application of climate-related scenario analysis in its investment and risk decision-making process;[31]

[18] PS21/24, 3.42
[19] PS21/24, 3.52
[20] PS21/24, 3.52
[21] PS21/24, 3.52
[22] ESG Sourcebook, 1.2.1R
[23] ESG Sourcebook, 2.1.1R(1)
[24] ESG Sourcebook, 2.1.3R
[25] ESG Sourcebook, 2.1.5R
[26] For the definition of "TCFD in-scope business", see footnote 16.
[27] ESG Sourcebook, 2.2.1R(1)
[28] ESG Sourcebook, 2.2.1R(2)
[29] ESG Sourcebook, 2.2.1R(3)
[30] ESG Sourcebook, 2.2.2G
[31] ESG Sourcebook, 2.2.3R(1)

- where reasonably practicable, quantitative examples to demonstrate the firm's approach to climate-related scenario analysis;[32] and
- a description of any targets set to manage climate-related risks and opportunities, including any key performance indicators used to measure progress (and, where a firm has not yet set such targets, it must explain why).[33]

Firms can cross-refer to disclosures made by other members of their group,[34] so long as the firm clearly signposts the relevant climate-related disclosures[35] and sets out its rationale for doing so.[36] An Entity-Level Report must be signed by a member of the firm's senior management to confirm that it complies with the FCA's requirements.[37]

B. Product-Level Reports

In addition to Entity Level Reports, in-scope asset managers are required to prepare Product-Level Reports, which are bifurcated in the FCA ESG/TCFD Rules between "public TCFD product reports" and "on-demand TCFD product reports":

i. **Public** – A public TCFD product report must be prepared in respect of certain authorised funds and funds listed on recognised stock exchanges, but is not required with respect to CLO portfolio management. Accordingly, a "public TCFD product report" will not be required by law to be produced by UK managers with respect to CLO transactions.

ii. **On-demand** – A client who requires TCFD information in order to satisfy its own climate related financial disclosure obligations will be entitled to request "on-demand information" (which includes an on-demand TCFD product report or underlying asset data)[38] in respect of the investments that the firm manages for that client (although such requests may only occur from, at the earliest, 1 July 2023).[39] Upon receipt of such request, the firm must give the information to the client within a reasonable time period and in a format that it considers appropriate to meet the needs of that client.[40] However, for European CLOs, we note that an issuer, who is in practice, effectively controlled by the collateral manager, is unlikely to request on-demand product reports from the collateral manager.

For the reasons set out above, CLO managers exercising portfolio management with respect to CLO issuers are unlikely to be required to prepare Product-Level Reports. However, we note that the FCA encourages in-scope firms to consider, where practicable, making available to clients disclosures broadly equivalent to an "on-demand TCFD product report" irrespective of the client's eligibility to request such a report.[41]

Product-Level Reports must cover a core set of climate-related metrics on, as relevant, scope 1 and 2 greenhouse gas emissions; scope 3 greenhouse gas emissions; total carbon emissions; total carbon footprint; and weighted average carbon intensity,[42] in each case, using the calculations contained in the TCFD Recommendations and having regard to the "TCFD Guidance on Metrics, Targets and Transition Plans". Product-Level Reports must also include:

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[32] ESG Sourcebook, 2.2.3R(2)
[33] ESG Sourcebook, 2.2.4R
[34] ESG Sourcebook, 2.2.5R(1)
[35] ESG Sourcebook, 2.2.5R(2)(a)
[36] ESG Sourcebook, 2.2.5R(2)(b)
[37] ESG Sourcebook, 2.2.7R
[38] ESG Sourcebook, 2.3.5R
[39] ESG Sourcebook, 2.3.5R
[40] ESG Sourcebook, 2.1.1R(2)
[41] ESG Sourcebook, 2.3.7G
[42] ESG Sourcebook, 2.3.9R(1)

- relevant contextual information such as how the metrics should be interpreted, their associated limitations, and annual calculations after the first year of the Product-Level Report;[43]
- how the firm's approach to a TCFD product[44] is materially different to its overarching approach disclosed in its Entity-Level Report;[45]
- a qualitative summary of how climate change is likely to impact the assets underlying the relevant TCFD product under 'orderly transition', 'disorderly transition' and 'hothouse world' situations (as defined in 2.3.11R(3) of the FCA ESG Sourcebook) and a description of the most significant drivers of such impact;[46]
- where a TCFD product has concentrated exposures or high exposures to carbon intensive sectors, a quantitative analysis of orderly transition', 'disorderly transition' and 'hothouse world' situations;[47]
- any other metrics that the firm considers an investor will find useful when deciding whether to select a particular TCFD product, together with an explanation of the methodology used in providing each metric;[48] and
- as far as reasonably practicable, a calculation of (i) climate value-at-risk and (ii) metrics that show the climate warming scenario with which a TCFD product is aligned for each TCFD product.[49] The latter may include using an implied temperature rise metric.[50]

6. Contractual TCFD Reporting

Sections 2 to 5 of this Client Alert discuss how the FCA ESG/TCFD Rules will apply to in-scope FCA-authorised CLO managers. Importantly, whilst in-scope FCA-authorised CLO managers are required by law to prepare Entity-Level Reports, they are unlikely to be required to prepare Product-Level Reports (for the reasons discussed above).

We note, however, that in-scope UK CLO managers and out-of-scope UK CLO managers (i.e. those CLO managers that are below the £5 billion AUM threshold or are non-UK based) may be requested by CLO investors to prepare, at a contractual level, Entity-Level Reports and/or Product-Level Reports with respect to their CLO business and transactions. This raises the prospect of "TCFD aligned" CLOs that satisfy the reporting requirements set out in the TCFD Recommendations and the FCA ESG/TCFD Rules without being legally required to do so by applicable law. To the extent required, CLO managers may want to prepare the relevant reports in-house, or engage a third party to assist with such reporting.

7. Forthcoming Disclosures

We will continue to monitor the impact of TCFD and ESG reporting on CLO managers as the UK framework governing ESG disclosures is set to expand. In particular, the coming years will see UK authorised managers having to comply with the new Sustainability Disclosure Requirements (which will build on the FCA ESG/TCFD Rules, and include requirements for asset managers and asset owners to disclose how they take sustainability into account and the sustainability of products managed by them) and the UK Green Taxonomy (which will set out criteria which specific economic activities must meet to be considered

[43] ESG Sourcebook, 2.3.9R(2)(a) and (b)
[44] PS21/24, Appendix 1, Annex A
[45] ESG Sourcebook, 2.3.9R(2)(c)
[46] ESG Sourcebook, 2.3.11(1)(a) and (b)
[47] ESG Sourcebook, 2.3.11(1)(c)
[48] ESG Sourcebook, 2.3.14G
[49] ESG Sourcebook, 2.3.13R
[50] ESG Sourcebook, 2.3.13R(2)

environmentally sustainable).[51] Such initiatives are outside of the scope of this Client Alert, but will be watched with interest by market participants.

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[51] 'New Independent Group To Help Tackle 'Greenwashing'' (*GOV.UK*, 2021) <https://www.gov.uk/government/news/new-independent-group-to-help-tackle-greenwashing>