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Securities Update

Climate Change Disclosure Issues and Securities Law

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This memorandum is intended for lawyers, bankers, traders and company officials who are responsible for, or concerned with, disclosure matters related to climate change. Corporate disclosures related to climate change arise out of existing SEC requirements and from growing pressure from investors and regulators to provide more detailed information regarding the climate change risks faced by companies.

As federal, state and foreign legislatures and regulators adopt new emission reduction requirements, companies must examine what constitutes fair disclosure of their financial exposure under the new laws and regulations, and the potential liabilities for their businesses. As a result of such legislative and regulatory developments, publicly held companies may need to inform investors of possible climate change liabilities impacting their financial condition. In addition, a growing number of socially conscious investors are seeking to include shareholder proposals in annual proxy statements, calling on companies to adopt emissions goals and report to shareholders annually on plans to achieve these goals. These investors, who increasingly draw support from mainstream investors with significant capital under management, highlight the growing awareness that exists about, and the importance that companies are attributing to, disclosing meaningful data about their climate change initiatives.[1] Most significantly, individual states are at the forefront of new legal and regulatory developments of climate change in implementing mandatory emission targets. One state recently issued subpoenas to companies alleging that they failed to disclose climate change risks to their investors. As a result of these developments, climate change disclosure is perceived as offering both business and legal benefits.

The burden of disclosure is most onerous for companies in industries with energy-intensive operations, those with significant greenhouse gas (GHG) emissions (such as, energy, airlines, trucking and shipping) and those directly tied to weather patterns (such as, insurance, agriculture and ski resorts). However, companies across every sector should consider whether disclosing climate change risks is required or appropriate in their public securities filings.

Threat of Sanctions for Non-Disclosure Grows

In September 2007, New York State Attorney General Andrew Cuomo invoked his investigatory powers under the Martin Act, a 1921 New York State securities law, to issue subpoenas to five energy companies requiring them to turn over information and documentation relating to internal analyses of their climate change risks. In the letters accompanying the subpoenas, the Attorney General questions whether these companies' disclosures to investors were incomplete and misleading in that they failed to account for the significant costs that would

1. According to a study by Ceres, a coalition of investors and environmentalists, mutual funds last year voted against climate-related shareholder initiatives 65.1 percent of the time, down from 77.8 percent of the time in 2004. *See* "Fewer US mutual funds nix climate proposals: study," Reuters, Wednesday, April 16, 2008, available at http://www.reuters.com/article/environmentNews/idUSN1546732220080416.

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result from “new or likely regulatory initiatives” from state carbon emission controls, potential EPA regulations and federal global warming legislation. In his letter to one utility company, the Attorney General stated:

> “In its 2006 Form 10-K, [the company] made no disclosure of projected CO_2 emissions from the proposed plant or its current plants. Further, [the company] did not attempt to evaluate or quantify the possible effects of future greenhouse gas regulations, or discuss their impact on the company…
>
> Selective disclosure of favorable information or omission of unfavorable information concerning climate change is misleading. [The company] cannot excuse its failure to provide disclosure and analysis by claiming there is insufficient information concerning known climate change trends and uncertainties.”

The New York State Attorney General may prosecute a company for fraudulent practices under the Martin Act if the company’s disclosures contained a “material misrepresentation” or “material omission.” The Martin Act is far-reaching and the Attorney General does not need to prove the traditional elements of a fraud action, such as intent and reliance, but only needs to show misrepresentation of a material fact.[2] Information is considered “material” based on the same test for materiality used by the Federal courts (e.g., there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available).[3]

Private Investor Groups Press for Better Disclosure

There is also growing pressure from investors for public companies to include climate change disclosure in their public documents. Specifically, shareholders have called for companies to report on their energy efficiency initiatives and their achievement of GHG reduction targets. While these calls were focused initially on the auto, energy and extractive industries, they have grown to encompass a broader range of industries. In its December 2007 policy guidelines, ISS, the largest proxy advisor in the country, stated that it would be generally supportive of disclosure-based shareholder proposals, although it would still recommend against prescriptive proposals for companies to achieve energy efficiency goals within prescribed timelines.

In October 2006, a group of fourteen leading institutional investors and other organizations released the Global Framework for Climate Risk Disclosure (“Global Framework”), a statement outlining necessary aspects of disclosure for assessment of corporate climate risk and opportunities.[4] The Global Framework provides four primary issues to be disclosed by companies:

(i) A complete account of a company’s GHG emissions data, including total historical, current and projected data.

(ii) The company’s position on climate change, explanation of any company policies on GHG emission reduction and any governance structures that are in place that relate to climate change.

(iii) An assessment of the physical risks a company faces to its corporate facilities or operations, including its supply chain, as a result of climate change.

(iv) An analysis of the expected impact of GHG legislation, a list of GHG regulations currently imposed and the company’s expectations regarding the future cost of reducing GHG emissions.[5]

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2 *See People v. Federated Radio,* 244 N.Y. 33, 38-39 (1926).

3 *See State v. Rachmani,* 71 N.Y.2d 718, 725-26 (1988).

4 *See* “Global Framework for Climate Risk Disclosure Report,” dated October 2006, available at http://www.calpers-governance.org/alert/initiatives/docs/global-framework-report.pdf. The Global Framework for Climate Risk Disclosure was drafted by a steering committee which included representatives from the California Public Employees’ Retirement System, Carbon Disclosure Project, Institutional Investors Group on Climate Change, and the United Nations Foundation. *Id.* at 3.

5 To assist companies, a guide was created to provide specific information about how to disclose the four elements of disclosure detailed in the Framework as well as examples of such disclosure. *See* “Using the Global Framework for Climate Risk Disclosure,” dated October 2006, available at http://www.calpers-governance.org/alert/initiatives/docs/using-the-framework-guide.pdf.

In addition, in September 2007, a coalition of state officials, environmental advocates and investors managing over US$1.5 trillion in assets (the "Coalition") petitioned the SEC for an interpretive release to clarify climate risk disclosure under existing securities regulations.[6] At the same time, the Coalition wrote to the Director of the SEC's Division of Corporation Finance requesting that the SEC devote particular attention to the adequacy of companies' disclosure in climate risk. The Coalition's proposals broadly mirror those in the Global Framework and stress financial risks and opportunities arising from enacted or imminent greenhouse gas regulation and climate-related litigation as important disclosure points. On June 12, 2008, the Coalition supplemented their original petition with evidence of developments regarding climate change and further stressed the necessity and urgency of SEC guidance.[7] The chief investment officer of the California Public Employees' Retirement System ("CalPERS"), the largest public pension fund in the country and a member of the Coalition, urged: "SEC guidance for all publicly traded companies is needed to protect investors." CalPERS has also adopted a set of corporate governance standards that require companies it invests in to disclose their financial risks from global warming. Although the SEC has yet to formally respond, the petition has attracted significant public attention and has been the subject of support and comments from investor groups.[8]

On October 22, 2008, a group of fourteen large institutional investors and asset managers (the "Investors")[9] called on the SEC to improve and provide specific guidance on climate risk disclosure in SEC filings.[10] The Investors sent the letter to the SEC in response to its 21st Century Disclosure Initiative, which proposes to modernize the disclosure system so that the information is more useful and transparent to investors. The Investors noted that the lack of SEC guidance on climate risk disclosure has resulted in voluntary corporate reports that are not consistent enough to support comparisons amongst companies and often fail to address the needs of reasonable investors for information on climate change risks. The Investors asserted that "reporting on climate risks is no longer a mere virtue, but a legal obligation and a necessity for investors." The letter also urged the SEC to address a broader range of environmental, social and governance (ESG) issues in disclosure requirements, following the model of many other countries. In addition, the letter recommended that the SEC appoint an investment professional as a member of the Federal Advisory Committee to ensure that investor views on climate risks are represented.

A study conducted in January 2007 by the Coalition for Environmentally Responsible Economies (CERES) suggests that, although many companies provided limited climate change disclosure, the disclosure is often inconsistent and inadequate—particularly within industries that are known to be at high risk for climate change or from regulation of GHGs.[11] The study states that, on average, companies in the S&P 500 provided only 25 percent of the information that is stated as being necessary in the Global Framework. In many cases, companies provided no climate risk information in their periodic reports on Forms 10-K and 10-Q.

Proposed Disclosure Legislation and Regulation

Legislation addressing climate change issues and GHG emissions has been heavily debated. In the landmark decision, *Massachusetts v. Environmental Protection Agency,* No. 05-1120 (April 2, 2007), the US Supreme Court held that the Clean Air Act authorizes and *requires* the Environmental Protection

6 *See* "Petition for Guidance on Climate Risk Disclosure," dated September 18, 2007, available at http://www.sec.gov/rules/petitions/2007/petn4-547.pdf.

7 *See* "File No. 4-547: Request for Interpretive Guidance on Climate Risk Disclosure," dated June 12, 2008, available at http://www.sec.gov/rules/petitions/2008/petn4-547-supp.pdf.

8 Since the petition was filed in September 2007, the SEC has received numerous supportive comments from more than 50 additional investors representing over US$5.5 trillion. Key Senate Banking Committee leaders, Senator Christopher Dodd and Senator Jack Reed, also supported the petition in a letter sent to the SEC last December. *See* "Comments on Rulemaking Petition: Request for Interpretive Guidance on Climate Risk Disclosure," SEC Docket No. 04-547, available at http://www.sec.gov/comments/4-547/4-547.shtml.

9 The Investors included most of those involved in the above-mentioned Coalition petitioning the SEC for an interpretive release on climate risk disclosure.

10 *See* "Comments on Roundtable on Modernizing the SEC's Disclosure System – File No. 4-567," dated October 22, 2008, available at http://www.sec.gov/comments/4-567/4567-20.pdf.

11 "Climate Risk Disclosure by the S&P 500," January 2007, available at http://www.calvert.com/pdf/Ceres_Calvert_SandP_500.pdf.

Agency to regulate carbon dioxide and other greenhouse gas emissions from motor vehicles. The EPA has recently issued an advanced notice of proposed rulemaking. The Bali Action Plan, launched at the United Nations Climate Change Conference in December 2007, established a timeline for negotiation of a new global climate change protocol by the end of 2009. The United States joined 187 countries that committed to the Bali Action Plan. There are also a number of climate change-related proposals currently before the 110th Congress. Although the Senate stopped further discussion of the Lieberman-Warner climate bill (S.2191), which proposed setting an annual limit or cap on the volume of certain GHGs emitted from electricity-generating facilities and from other activities involving industrial production and transportation, there may be other federal legislation forthcoming in the near future.

In addition to climate change-related regulations, efforts are under way pertaining to disclosure legislation. On a federal level, three climate change bills that are before the 110th Congress also address disclosure issues for public companies. The Global Warming Pollution Act (S.309)[12] and the Global Warming Reduction Act of 2007 (S.485)[13] would require the SEC to direct issuers to inform investors of the issuer's financial exposure due to the issuer's net pollution emissions. The Greenhouse Gas Accountability Act of 2007 (H.R.2651)[14] would require specified companies, including publicly listed companies with annual revenues of over US$10 million, to disclose in their annual reports their GHG emissions, a statement as to whether the emissions report was independently verified, the estimated financial exposure of the issuer and the potential economic impacts of climate change on the issuer's interests. The Act would also require the SEC to issue an interpretive release clarifying that, for purposes of Item 303 of Regulation S-K, US commitments to reduce emissions under the United Nations Convention on Climate Change amount to a "material effect" and that global warming is a known trend.

The most significant participants in climate change legislation have turned out to be individual states in the United States. Over 36 states have adopted direct-action plans relating to climate change. Over 17 states have established mandatory reduction targets. California has been a national leader in state climate legislation initiatives and, on June 26, 2008, the California Air Resources Board outlined a plan to implement its 2006 commitment to cut GHG emissions and establish a joint carbon trading program. Some of the measures will become law as soon as 2009. A number of other states who have also adopted climate change action plans are expected to release their plans by 2009. The Regional Greenhouse Gas Initiative, which counts ten northeastern states among its partners, is a multistate accord to establish a cap-and-trade program for GHG emissions by 2009. The Western Climate Initiative and the Midwestern Greenhouse Gas Reduction Accord also aim to establish cap-and-trade programs, with the Western Climate Initiative launching a joint cap-and-trade program with California and three Canadian provinces.

California Senate Bill 1550, titled "Corporations: Climate Risk Disclosure," was approved by the California Senate and is currently before the California State Assembly.[15] The Bill would instruct the California Controller, in consultation with the investment community, to set climate change disclosure standards for listed companies doing business in California.

12 "Global Warming Pollution Reduction Act," S.309, January 16, 2007, available at http://thomas.loc.gov/cgi-bin/query/z?c110:S.309:.

13 "Global Warming Reduction Act of 2007," S.485, February 1, 2007, available at http://www.govtrack.us/congress/billtext.xpd?bill=s110-485.

14 "Greenhouse Gas Accountability Act of 2007," H.R. 2651, June 11, 2007, available at http://thomas.loc.gov/cgi-bin/query/z?c110:H.R.2651:.

15 "Corporations: Climate Risk Disclosure," California Senate Bill 1550, February 22, 2008, available at http://info.sen.ca.gov/pub/07-08/bill/sen/sb_1501-1550/sb_1550_bill_20080702 _amended_asm_v96.pdf (as of August 1, 2008). "The Controller, in consultation with the investment community, shall develop an investor-based climate change disclosure standard in accordance with subdivision (e) for use by listed *corporations, as defined in subdivision (d) of Section 301.5,* doing business in California. The standard shall provide guidance on disclosure of climate change risks and opportunities for listed corporations. No listed corporation is required to meet the standard." [emphasis added] *Id.* at sec. 24 – 32.

Obligations Under Existing SEC Disclosure Requirements

SEC disclosure rules are not specifically tailored to climate change disclosure. Pursuant to Regulation S-K, which sets forth the disclosure requirements for offering documents under the Securities Act of 1933 and periodic reports under the Securities Exchange Act of 1934, companies are required to disclose material information that is necessary for investors to make informed decisions. Item 101 (Description of Business), Item 103 (Legal Proceedings) and Item 303 (Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)) are most pertinent in disclosing the material impact of climate change on companies.

Item 101—Description of Business—Compliance with Environmental Provisions

Item 101 requires companies to disclose the material "Effect of existing or probable governmental regulations on the business." This includes the effects that compliance with federal, state and local environmental provisions, which have already been enacted or adopted, may have on capital expenditures, earnings and competitive position. Companies must disclose these material effects for the current year, one year in the future and, if a failure to disclosure would make existing disclosure misleading, for subsequent periods.

Companies with operations in jurisdictions that implement, or are proposing to implement, environmental legislation and initiatives should pay close attention to their disclosure obligations under Item 101 if their actual or anticipated compliance costs with the aforementioned provisions are material.

Item 103—Legal Proceedings

Item 103 requires disclosure of pending or contemplated material legal proceedings to which the registrant or any of its subsidiaries is a party or to which its property is subject. This also includes proceedings contemplated by government authorities.

It is yet unclear what role this disclosure item will have in expanding companies' obligations since there are no successful suits to date pertaining to climate change. The United States District Court for the Southern District of New York dismissed a public nuisance claim by eight states against top GHG-emitting electric companies and held that the suit "presented non-justifiable political questions that are consigned to the political branches, not the judiciary."[16] A California action against automakers was also dismissed on the basis that it was a political issue.[17] More recently, the US District Court for the Southern District of Mississippi dismissed a public nuisance claim against petrochemical companies for aggravating the effects of Hurricane Katrina by way of GHG emissions.[18] All three suits are currently pending on appeal.

Item 303—MD&A—Known Trends Expected to Have Material Impact

Item 303 requires discussion in the MD&A section of currently known trends, events or uncertainties that are reasonably expected to have a material impact on liquidity, capital resources, revenues or net income. An impact is material if there is a substantial likelihood that a reasonable investor would attach importance to it in deciding whether

16 *Connecticut et al. v. American Electric Power Co. et al.,* No. 04-cv-05669, (S.D.N.Y. Sept. 15, 2005), available at http://ag.ca.gov/globalwarming.

17 *California v. General Motors Corp., et al.,* No. 06-cv-05755 MJJ, (N.D.D.C. Sept. 17, 2007), available at http://ag.ca.gov/globalwarming.

18 *See Comer v. Murphy Oil, et al.,* CV 05-0436, (S.D. Miss. Aug. 30, 2007).

to buy or sell a security. The impact of Item 303 disclosure is two-fold, since "currently known trends" refers both to the trend of climate change regulations, as well as the actual impact of climate change. Companies who expect to be affected materially by actual regulations or by probable regulatory initiatives need to include these discussions in their MD&A disclosure. At the same time, companies that expect to be affected materially by the physical effects of climate change, whether through loss of assets, decreased business demand or liabilities, should also make this part of their public disclosure.

FAS 5

Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (FAS 5), requires a company to accrue a charge against current income for the entire amount of a material liability that is probable and reasonably estimable. It allows a contingent liability to be expressed as a range of estimable liabilities. If a material contingent liability is "reasonably possible" but cannot be estimated, FAS 5 requires that liability be disclosed in the footnotes to the financial statements.

In September 2007, the Coalition stated that "examples of companies that have likely crossed the FAS 5 threshold for accruing actual dollar values for climate-related contingent liabilities include companies that emit significant levels of greenhouse gases and are already subject to direct regulation of those emissions here or abroad, companies considering major capital investments that are affected by new and evolving regulatory treatment of greenhouse gas emissions and companies whose physical operations are at hazard due to developments, such as melting permafrost or storm damage."[19]

Conclusion

Recent scientific and regulatory developments indicate that the risks and opportunities associated with climate change represent the material information that is required to be incorporated into and analyzed in corporate filings. Companies should consider disclosing on a timely basis the physical, regulatory and financial consequences to them of climate change. With the increasing call for more thorough disclosure regarding the impact of climate change, companies should also be prepared to provide a clear picture as to how they are addressing the risks and, if applicable, opportunities that climate change presents.

19 *See* "Petition for Guidance on Climate Risk Disclosure," dated September 18, 2007, at 15.

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