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# SECURITIES REGULATION & LAW

REPORT



DISCLOSURE

## SEC Mandatory Climate Change Risk Disclosure Is on the Horizon

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Two years ago, the United States Supreme Court issued the much anticipated *Massachusetts v. EPA* decision and provided some clarity as to the federal government's authority to regulate greenhouse gas (''GHG'') emissions under the Clean Air Act (''CAA'').[1] Although the facts of *Massachusetts v. EPA* were limited to tailpipe GHG emissions, commentators predicted that this decision would spawn a wave of legislation and regulations directed at controlling GHG emissions and addressing climate change issues.[2] First, commentators expected that regulations imposing GHG disclosure requirements would be issued to provide regulators, industry and the public with a more complete picture of the nation's reliance on fossil fuels and GHG emission levels.[3]

Over the next two years, while several GHG bills failed to progress in Congress, the Environmental Protection Agency began to address climate change by issuing several proposed rules addressing GHG disclosures and emissions. In September, the EPA finalized a mandatory GHG emission disclosure rule for large sources. More recently, the EPA announced a proposal to regulate large sources of GHG by imposing permit requirements under the CAA. Beyond the EPA's GHG rules, however, predicting the scope of the emerging federal and/or state disclosure programs relating to GHG emissions and climate change risks still requires quite a bit of speculation.

Notably, the Securities and Exchange Commission has remained silent regarding disclosure requirements relating to climate change risk and GHG emissions. However, the EPA's actions following *Massachusetts v. EPA*, the growing body of scientific evidence regarding global warming, rising political pressure for GHG regulation and recent proposals for federal governance regarding GHG emissions and climate change risk disclosures all suggest that new disclosure rules are indeed on the horizon.

[1] *Massachusetts v. EPA*, 415 F.3d 50 (2007).

[2] *E.g.*, Lora Lucero, MASSACHUSETTS V. EPA - THE U.S. SUPREME COURT CONFRONTS CLIMATE CHANGE, American Bar Association, available at http://www.abanet.org/statelocal/lawnews/summer07/mass.html (last visited Nov. 10, 2009).

[3] David Rich, DESIGNING A U.S. GREENHOUSE GAS EMISSIONS REGISTRY, World Resources Institute Climate and Energy, Feb. 2008, available at http://www.ghgprotocol.org/files/wri_us_registry.pdf (last visited Nov. 10, 2009).

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Despite public companies' and investors' requests, the SEC has not issued formal rules or guidelines regarding GHG and climate change risk disclosure requirements. While companies wait for guidance, there remains considerable uncertainty over the appropriate scope of climate change related disclosure under the existing federal regulations. The existing SEC disclosure requirements for domestic public companies are arguably broad enough to require disclosure of ''material'' risks posed by GHG emissions and climate change issues. However, absent guidance from the SEC, public filers are left with the difficult task of determining at what point the mix of their business operations, proposed federal oversight and scientific evidence of global warming combine to create a ''material'' risk that management is required to disclose.

In light of uncertainties regarding SEC disclosure requirements, the likelihood of additional GHG regulations and the perceived market benefits of disclosure, several independent organizations have developed voluntary climate change risk disclosure databases, which have become increasingly popular. The National Association of Insurance Commissioners (''NAIC'') has gone a step further and passed a model rule mandating climate change risk disclosures for large insurance companies. These voluntary disclosure databases and the NAIC model rule appear to be responses to the private sector's increasing demand for information regarding GHG emissions, projections of potential capital expenditures associated with impending GHG emission regulations and preparation for the coming climate change disclosure rules. The voluntary disclosure surveys and the NAIC model rule questions may also provide some guidance as to the type of climate change related information that public companies may soon be required to disclose. This article reviews recent developments on the road to climate change disclosure regulations as well as current disclosure obligations under the existing SEC regulations.

## SEC to Review Climate Change Disclosure

The Securities Act of 1933 (the ''Securities Act''), the Securities Exchange Act of 1934 (the ''Exchange Act'') and the regulations promulgated under each act set forth disclosure requirements for the registration, sale, public offering and ongoing operation of U.S. public companies. No provision under the Securities Act, the Exchange Act or the related regulations is specifically tailored to address risks posed by climate change. However, Regulation S-K, which sets forth disclosure requirements for offerings under the Securities Act and periodic reporting under the Exchange Act, arguably requires certain public filers, depending on their business operations, to disclose material risks posed to their financial and physical health by climate change. Nevertheless, there is a significant amount of inconsistency in what companies choose to disclose or omit concerning climate change related risks.

A Ceres/Environmental Defense Fund study of 100 global companies in industries strongly linked to climate change issues (utilities, coal, oil, gas, transportation and insurance industries) reported that 59 percent of such companies did not even touch upon GHG emissions or their position on climate change in their Q1 2008 SEC filings.[4] Perhaps in part due to the low percentage of companies disclosing climate change related risks, a number of investors, state officials and nonprofit organizations petitioned the SEC for interpretive guidance regarding current federal climate risk disclosure requirements.[5] This petition, led by Ceres, requested that the SEC clarify the extent to which public companies are required to assess and disclose their financial risks due to climate change issues under existing law. Specifically, the Ceres petition (and 2008 supplement) asked the SEC to confirm that current law requires public companies to disclose physical risks due to climate change, financial risks due to compliance with foreseeable GHG regulation and litigation risks relating to legal proceedings based on climate change related claims.[6]

Although the SEC has not issued a formal response to Ceres, SEC Commissioner Elisse Walter stated in July 2009 that ''it's really time for [the SEC] to take another very serious look at the disclosure system in [the climate change] area.''[7] Commissioner Walter's comment has invited speculation that the SEC is either poised to propose specific disclosure requirements aimed at climate change related risks or, at minimum, intends to review and provide guidance as to the appropriate scope of climate change risk disclosure under the existing regulations.

## Reporting Obligations Under Existing SEC Regulations

In the interim, public companies will have to continue to wrestle with the uncertainties of their disclosure obligations under the current SEC regulations in their offering documents and quarterly and annual reports.

The most straightforward existing requirement is set forth in Item 103 of Regulation S-K. Item 103 requires companies to disclose material pending legal proceedings of which a company, its property or its subsidiaries are a party. The SEC has clarified that administrative actions, including environmental enforcement actions and orders, are proceedings within the scope of Item 103.[6] Therefore, Item 103 requires disclosure of enforcement actions, orders and lawsuits alleging wrongful GHG emissions or climate change related harms (such as a common law nuisance claim).[9] The disclo-

[4] Ceres and the Environmental Defense Fund, Climate Risk Disclosure in SEC Filings, June 2009, http://www.ceres.org/Document.Doc?id=473 (last visited Aug. 31, 2009).

[5] Petition for Interpretive Guidance on Climate Risk Disclosure, Sept. 18, 2007, http://www.sec.gov/rules/petitions/2007/petn4-547.pdf (last visited August 17, 2009).

[6] *Id.*; California Public Employees' Retirement System et al, Letter to SEC Secretary Nancy Morris, dated June 12, 2008, http://www.ceres.org//Document.Doc?id=358 (last visited Aug. 26, 2009).

[7] Evan Lehmann, SEC Turnaround Sparks Sudden Look at Climate Disclosure, New York Times, July 13, 2009.

[6] *See* Environmental Disclosure Requirements, Securities Act Release No. 6130, Fed. Sec. L. Rep. (CCH) ¶ 23,507B, at 17,203-4 n.2 (Sept. 27, 1979).

[9] For example, the United States Court of Appeals for the Second Circuit recently reinstated two lawsuits alleging public nuisance from GHG emissions that had been filed against several utility companies alleged to be large sources of GHG emissions. *State of Connecticut, et al. v. Am. Elec. Power Co. Inc., et al.*, Case Nos. 05-5104 & 05-5119.

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sure of legal proceedings arising under laws regulating the discharge of materials into the environment is limited to those proceedings which are ''material'' or involve amounts exceeding 10 percent of consolidated assists or involve a governmental party and sanctions will reasonably exceed $100,000.

While a company can estimate whether a proceeding meets numerical thresholds, the determination of whether a proceeding is ''material'' is not as straightforward. Federal securities case law defines information as ''material'' if ''there is a substantial likelihood that [it] would have been viewed by a reasonable investor as having significantly altered the 'total mix' of information made available.''[10] Although this definition is well grounded in case law, the SEC has not provided interpretive guidance regarding its application to GHG or climate change risk proceedings. Thus, public filers are in the precarious position of determining whether pending GHG emission or climate change related proceedings are material and must be disclosed, without any official guidance.

Item 101 of Regulation S-K, the Description of Business, requires companies to perform a more difficult analysis regarding their disclosure obligations. Item 101 requires companies to disclose in offering documents and periodic filings the material effects of compliance with laws relating to the protection of the environment on its ''capital expenditures, earning and competitive position.''[11]

In light of the increasing number of proposed and enacted rules addressing GHG emissions, public companies must stay apprised of legislative and regulatory developments and assess whether such developments have material effects on the company's expenditures, earnings and capital position. Because the governance of GHG emissions and climate change is a relatively new legal area, assessing the impact of compliance with new and proposed statutes and regulations will pose a difficult and uncertain exercise for many companies. However, despite the state of relative uncertainty, companies can at least acknowledge the potential for some degree of risk related to legal developments. For example, at the outset of its description of business in its annual filing for the year 2008, Xcel Energy states that ''there are significant future environmental regulations under consideration to encourage the use of clean energy technologies and regulate emissions of GHG to address climate change. Xcel Energy Inc.'s electric generating facilities are likely to be subject to regulation under climate change policies introduced at either the state or federal level within the next few years.''[12]

Item 101 also requires the disclosure of ''any material estimated capital expenditures for environmental control facilities for the remainder of [the company's] current fiscal year and its succeeding fiscal year and for such further periods as the [company] may deem material.''[13] Although not explicitly defined by the SEC, an ''environmental control facility'' generally includes facilities designed to abate, reduce or prevent environmental pollution, contamination or other releases. As such, Item 101 arguably requires the disclosure of capital expenses expected to be incurred for compliance with emissions allowances or clean energy technology. Likewise, Item 101 also arguably requires disclosure of material costs associated with potential carbon taxes. In its 2008 annual filing, for example, CNX Gas Corp. acknowledged the possibility of new environmental regulations translating into significant future costs but also stated that it had ''no significant environmental control facility expenditures for the years ended [2006-2008].''[14]

Item 303 of Regulation S-K, the Management Discussion and Analysis of Financial Condition and Results of Operation (''MD&A''), also arguably requires discussion of future regulation of GHG emissions, physical risks posed by climate change and related risks. Specifically, Item 303 requires companies to disclose known trends, events, obligations or uncertainties unless such issue is (i) not ''reasonably likely'' to occur or (ii) is not ''reasonably likely'' to have a material effect on a the company's liquidity, capital or operations. For example, the MD&A in Federal Express Corp.'s 2008 annual filing acknowledges the ''significant U.S. and international legislative and regulatory efforts to limit [GHG] emissions'' and the potential imposition of future emission allowance limitations.[15] The Federal Express Corp. MD&A goes on to state that ''[u]until the timing, scope and extent of such regulation becomes known, we cannot predict its effect on our cost structure or our operating results. It is reasonably possible, however, that it could impose material costs on us.''

In addition to assessing the potential impact of federal legislation and regulations on a company's capital, liquidity and/or operations, public companies must also consider the likelihood and gravity of risks stemming from physical impacts to business operations due to climate change. Businesses in the utility, oil, gas and insurance industries are especially susceptible to marketplace changes due to the physical impacts of climate change.

## Developing Federal Legislation and Rules

Several pending bills and rules should give public companies reason to examine whether their current disclosures satisfy their obligations in accordance with Regulation S-K. For example, the House of Representatives passed the American Clean Energy and Security Act (the ''Clean Energy Act'') in June 2009. Among other things, this bill includes a GHG emission reduction plan, renewable energy requirements for utilities and a cap-and-trade scheme for carbon emissions. Although the Clean Energy Act has only been placed on the Senate calendar and will likely not be considered until early 2010, passage of the Clean Energy Act or similar legislation is at least potentially on the short-term horizon. Therefore, public filers may now consider whether the bill will be passed in some form in the near future and whether that may lead to material mandated

[10] *TSC Industries v. Northway, Inc.* 426 U.S. 438, 448-49 (1976).

[11] 17 C.F.R. § 229.101(c)(1)(xii) (2008).

[12] Xcel Energy Inc., Form 10-K for the fiscal year ended December 31, 2008, at page 7.

[13] 17 C.F.R. § 229.101(c)(1)(xii) (2008).

[14] CNX Gas Corp., Form 10-K for the fiscal year ended December 31, 2008, at page 14.

[15] Federal Express Corp., Form 10-K for the fiscal year ended May 31, 2009, at page 34.

capital expenditures relating to the cap-and-trade and renewable energy statutory scheme.[16]

As Congress has been debating the merits of the Clean Energy Act, the EPA, in accordance with the Supreme Court's directive in *Massachusetts v. EPA*, has reconsidered regulation of GHG emissions under the CAA. Earlier this year, the EPA issued a proposed finding which declares that GHG emissions "endanger the public health and the welfare of current and future generations" and provides that GHG are subject to regulation under the CAA.[17] Accordingly, the EPA recently moved to expand GHG regulation in two areas. First, the EPA issued a new GHG reporting rule which mandates disclosure of GHG emissions from large sources in the United States but does not actually restrict GHG emissions.[18] Next, the EPA issued a proposal to regulate large sources of GHG under a CAA permit program. The GHG reporting rule becomes effective January 1, 2010 and will require suppliers of fossil fuels or industrial gas, manufacturers of heavy-duty and off-road vehicles and engines, and facilities annually emitting at least 25,000 metric tons of GHG to submit annual GHG disclosure reports to the EPA.[19] The first annual reports are due March 31, 2011. The 25,000 metric ton threshold is estimated to encompass over 10,000 large GHG emission sources and based on their disclosures, the EPA will monitor and assess GHG emissions through a national emissions registry. This public registry will constitute the nation's first attempt to gain a meaningful understanding of the extent of its GHG emissions.[20] If promulgated under the CAA, the proposed GHG permit program will require large industrial facilities that emit 25,000 or more tons of GHG per year to obtain construction and operating permits. When permitted facilities are constructed or modified, the facilities' permits must demonstrate the use of best available control technologies and energy efficiency measures to decrease GHG emissions.[21]

These GHG regulations will impact many public companies, especially those in the energy industry, and will require them to examine whether they are required to provide an emissions report to the EPA and also disclose related capital expenditure estimates or other related risks in their public filings. Furthermore, even those companies falling outside of the scope of the GHG reporting rule may need to reexamine whether they must include GHG emissions data and climate change related risks in their financial reports to comply with existing SEC disclosure requirements.

## NAIC Model Climate Disclosure Rule

Amidst the uncertainty regarding impending federal climate change disclosure requirements, the NAIC paved the way for the first industry-wide climate disclosure requirement by passing a Model Climate Change Risk Disclosure Rule on March 17, 2009 ("Model Rule"). If adopted by NAIC member states as written, the Model Rule would require insurers to submit an annual Insurer Climate Risk Disclosure Survey ("Insurer Survey") to their state of domestication. The Model Rule applies to insurers with annual premiums of $500 million or more and the first Insurer Survey is to be submitted in May 2010.

The Insurer Survey requires insurers to disclose the financial risks posed by climate change and the actions the insurer is taking to control these risks.[22] Among other requirements, the Insurer Survey requires insurers to disclose internal climate change policies, anticipated climate risks facing the company and its investment portfolio, and internal plans to assess, reduce and mitigate operational GHG emissions. In addition, the Insurer Survey requires insurers to disclose whether they have increased rates or limited sales in certain geographic regions due to increased climate change risks and to disclose the actions they have taken to encourage policyholders to reduce their climate change related losses. The Insurer Survey excludes disclosure of information which is commercially sensitive, proprietary or forward looking.[23]

According to the NAIC, the impetus behind the Insurer Survey is to provide a means for regulators to begin discerning insurers' risk assessments and risk management efforts related to climate change.[24] In addition, the Insurer Survey will allow consumers to make informed and educated decisions regarding the underly-

[16] American Clean Energy and Security Act, H.R. 2454, 111th Cong. (2009), THOMAS (Library of Congress), http://thomas.loc.gov/cgi-bin/Thomas (last visited Aug. 18, 2009).

[17] Proposed Endangerment and Cause or Contribute Findings for Greenhouse Gases Under Section 202(a) of the Clean Air Act, 74 Fed. Reg. 18,886 (Apr. 24, 2009) (to be codified at 40 C.F.R. pt. 86, 87, 89, et al.).

[18] Final Mandatory Greenhouse Gas Reporting, 74 Fed. Reg. 56,260 (Oct. 30, 2009) (to be codified at 40 C.F.R. pt. 86, 87, 89, et al).

[19] EPA Finalizes the Nation's First Greenhouse Gas Reporting System/Monitoring to begin in 2010, Sept. 22, 2009, available at http://yosemite.epa.gov/opa/admpress.nsf/d0cf6618525a9efb85257359003fb69d/194e412153fcffea8525763900530d75!OpenDocument (last visited Sept. 22, 2009).

[20] The rule excepts data constituting "Confidential Business Information" from public dissemination. *See* Final Mandatory Greenhouse Gas Reporting, 74 Fed. Reg., 56,356 (Oct. 30, 2009) (to be codified at 40 C.F.R. pt. 86, 87, 89, et al).

[21] EPA Fact Sheet - Proposed Prevention of Significant Deterioration and Title V Greenhouse Gas Tailoring Rule, (to be codified at 40 CFR Parts 51, 52, 70 and 71), available at http://www.epa.gov/ nsr/fs20090930action.html (the proposed rule is available at http://www.epa.gov/ nsr/documents/GHG TailoringProposal.pdf (last visited Oct. 7, 2009)).

[22] NAIC Insurer Climate Risk Disclosure Survey, Attachment Two-A Climate Change and Global Warming (EX) Task Force, Mar. 17, 2009, http://www.naic.org/documents/committees_ex_climate_climate_risk_disclosure_survey.pdf (last visited Aug. 26, 2009).

[23] *Id.*

[24] *Id.*

## Note to Readers

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ing value and security of competing insurance policies. Although the NAIC is a non-governmental association of insurance commissioners and relies on states to enact its model rules, the Model Rule serves as a starting point for insurers, and even companies in other industries, to consider effective means of assessing and minimizing their climate change risks in anticipation of state or federal disclosure mandates.

## Investor Demanded and Voluntary GHG Disclosure

A growing number of companies, nationally and internationally, have started to recognize the potential market benefits of voluntarily disclosing risks posed by climate change. Over the past few years, consumer and investor awareness of the potential environmental impacts of climate change has grown alongside increasing political discourse regarding GHG emission limits and climate risk disclosure requirements. As investors are considering the financial ramifications of potential cap-and-trade programs, they are seeking greater information regarding companies' dependence on fossil fuels, current operational GHG emissions and climate change risk preparedness, in order to fully assess the value of the companies. A company's refusal to provide investors with data regarding its fossil fuel dependency and GHG emissions can detract investors, especially in the energy industry. In addition, as aptly stated by Federal Express Corp. in its 2008 Form 10-K, even in the absence of a definitive climate change regulatory program, ''increased awareness and any adverse publicity in the global marketplace about the GHGs emitted by companies in the airline and transportation industries could harm [a company's] reputation and reduce customer demand for [its] services.''[25]

In 2004, American Electric Power and Cinergy Corp. were faced with pressure from shareholders seeking disclosure of how the companies were planning for climate change related risks. In response, the companies agreed to issue public reports, overseen by a committee of independent directors, disclosing the companies' plans of action to mitigate the economic impact of future environmental requirements to reduce GHG emissions.[26]

In addition to fostering investor and customer relations, participation in voluntary climate change risk disclosures provides companies with an organized methodology to assess their own preparedness for potential financial and physical risks due to climate change. After compiling information regarding their dependence on fossil fuels, GHG emissions and climate change risk preparedness, companies are better able to protect themselves from climate change risk, prepare for impending regulatory requirements and maximize economic opportunities brought about by shifting economic cycles due to the global impacts of climate change.

Several organizations have published climate change risk disclosure surveys, but the Carbon Disclosure Project (''CDP'') maintains the largest database of international corporate climate change surveys. The CDP is an independent non-profit organization which was created in 2000 for the purpose of collecting and distributing climate change risk information and is comprised of over 475 investors with combined assets exceeding $55 trillion.[27] The CDP survey is extensive and seeks information including management opinions regarding risks and opportunities presented by climate change, management strategy to decrease or increase such risks or opportunities, GHG emission audits and corporate governance policies regarding climate change.[28] Although the CDP survey is detailed, respondents tend to provide varying degrees of thoroughness in their answers.[29]

Since the CDP commenced its annual surveying initiative in 2003, the response rate has increased each year. The CDP issued its first climate disclosure survey in 2003 and received responses from 47 percent of the surveyed companies. In contrast, 77 percent of the 3,000 companies surveyed in 2008 submitted responses.[30] The significant increase in the response rate is likely indicative of the private sector's recognition that climate change disclosures foster investor relations. In addition, the increased response rate may also demonstrate that the private sector is seeking a structured means to inventory GHG emissions in preparation for future regulations.

The contrast between the increasing percentage of companies participating in the voluntary CDP survey and the comparably smaller number of companies publicly disclosing climate change related risks in SEC filings suggests that the private sector has a growing awareness of the potential risks posed by climate change but a hesitation to disclose such risks in SEC filings until the SEC clarifies climate change disclosure obligations. However, any public company which voluntarily discloses climate change related risks should ensure that such disclosures correlate with quarterly and annual SEC filings if such disclosures may be deemed ''material'' under applicable SEC regulations.

## Going Forward

Despite the current lack of federal laws mandating climate change disclosures, *Massachusetts v. EPA*, Congressional bills, the EPA's new GHG reporting rule and proposed GHG permitting rule, SEC statements, voluntary climate surveys and the NAIC Model Rule are all indicative of unmistakable momentum moving toward future regulation of GHG emissions and mandated climate risk disclosures. Although the private sec-

[25] Federal Express Corp., Form 10-K for the fiscal year ended May 31, 2009, at page 34.

[26] *See, e.g.*, American Electric Power, An Assessment of AEP's Actions to Mitigate the Economic Impacts of Emissions Policies, Aug. 31, 2004, available at http://www.aep.com/environmental/reports/shareholderreport/docs/FullReport.pdf (last visited Oct. 1, 2009); *see also* State of Connecticut Treasurer's Office, American Electric Power, Cinergy Agree to Report to Shareholders on Responses to Rising Pressure to Reduce Greenhouse Gas, Other Emissions, Feb. 19, 2004, available at http://www.state.ct.us/OTT/pressreleases/press2004/pr021904.pdf (last visited Oct. 8, 2009).

[27] Carbon Disclosure Project, About Us, available at http://www.cdproject.net/about-cdp.asp (last visited Aug. 26, 2009).

[28] Carbon Disclosure Project website, FAQs, available at http://www.cdproject.net/faqs.asp (last visited Aug. 26, 2009). Carbon Disclosure Project 2009 Survey,available at http://www.cdproject.net/ Investor-Questionnaire.asp (last visited Aug. 31, 2009).

[29] *Id.*

[30] *Id.*

tor is still in a place of uncertainty regarding the impact of GHG and climate change regulations on capital expenditures, liquidity and ongoing business operations, the prudent company would be wise to take advantage of the present to prepare for future regulation. For example, public companies should consider implementing climate change disclosure committees to (i) keep apprised of emerging laws and regulations in order to prepare for the inevitable federal oversight; (ii) review the company's voluntary statements and disclosures regarding climate change (company website, publications, voluntary disclosures to the CDP) to ensure that such disclosures correlate with current or future SEC disclosures and that all material disclosures are included in current SEC filings; and (iii) review sources of voluntary disclosure to ascertain the type of information that might be required in future disclosures. Companies might also consider commencing voluntary disclosure of GHG related risks. In short, prepare for mandatory climate change disclosure because, ready or not, disclosure rules are coming soon.




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