Financial Disclosure of Climate Change Risks:

By James R. Williams and Christine M. Morgan

Recent Developments and a View of the Future

Financial disclosure of climate change risks has become a controversial and complex issue as states and investor and industry groups clamor for more thorough reporting of the risks relating to greenhouse gas ("GHG") emissions and climate change. While New York has pushed for climate change risk disclosure through its own enforcement mechanisms tied to filings with the Securities and Exchange Commission ("SEC"), trade and investor groups have focused on seeking greater guidance from the SEC and on preparation of "best practices" guidelines through ASTM International. California, on the other hand, may be on the path to creating new laws requiring comprehensive climate change risk disclosure rather than waiting for federal guidance.

Financial disclosure of environmental risks is not a new topic. For many years, the SEC has required disclosure in 10-K filings of the material effects of compliance with environmental regulations (17 C.F.R. § 229.101(c)(1)(xii)) and costs of environmental litigation with potential liability exceeding $100,000 (17 C.F.R. § 229.103). Recognizing that the SEC regulations provided little guidance to companies regarding the required scope and applicability of the environmental disclosure standards, ASTM International issued standards in 2001 to establish a framework for companies to use in complying with the SEC environmental risk disclosure requirements. ASTM, Standard Guide for Disclosure of Environmental Liabilities, E2173-07. Yet despite ASTM's efforts to develop a uniform environmental disclosure framework, the standards have not been widely accepted or adopted by issuers.

In recent years, investors and other groups have raised concerns that, under the existing framework, companies were not fully disclosing the financial risks posed by climate change. This new focus is driven by both the increased likelihood of GHG regulation at the federal level and the materializing risk of litigation relating to climate change in some industry sectors. In addition, there is a new focus on climate change risks such as damage to physical assets and market shifts related to public and investor sensitivity to climate change concerns.

This article discusses how the increased focus on financial risks associated with climate change has resulted not only in state enforcement and legislative initiatives seeking greater financial disclosure of climate change risks by companies, but also in a new push at several levels for guidance from the SEC and ASTM regarding how climate change risks should be quantified and reported in financial disclosures.

INVESTOR GROUP ADVOCACY FOR CLIMATE CHANGE RISK DISCLOSURE GUIDANCE

In September 2007, a group of environmental organizations, state officials, and institutional investors filed a petition asking the SEC to issue interpretive guidance on the scope of public companies' reporting obligations with respect to climate change risk in corporate disclosures under existing SEC regulations. Petition for Interpretive Guidance on Climate Risk Disclosure, filed with the SEC on Sept. 18, 2007. Additionally, on the same date, the petitioners also submitted a letter to John W. White, the director of the SEC's Division of Corporation Finance, asking that the Division, when reviewing a company's 10-K and 10-Q filings, devote "particular attention to the adequacy, under existing regulations, of disclosures concerning climate risk." Letter to Mr. John W. White, Sept. 18, 2007.

Citing research from the Intergovernmental Panel on Climate Change and others that evidence of climate change is now "unequivocal," the petition outlines the implications on the financial condition of businesses, such as physical damage to facilities, new regulatory compliance costs, and market shifts in demand for products and/or services. Because of these implications, the petition argues that information regarding material climate change risks for business is imperative for investors to make informed investment decisions and for the market to respond to climate change. The petition states that it is not seeking new rulemaking from the SEC, but rather guidance that clarifies that the SEC's existing regulations, specifically Items 101, 103, and 303 of Regulation S-K, already require disclosure of material information regarding climate change risk. The petitioners argue that "corporate practice on climate risk disclosure is lagging behind the rapidly evolving economic, legal, and scientific developments related to climate change." Petition for Interpretive Guidance filed with the SEC, at 20. Absent guidance, the petitioners express concern that the existing inconsistency of reporting climate change risk information will continue, to the harm of investors.

In order to respond to arguments that climate change risks are too speculative or uncertain to require disclosure, the petition outlines then-current, pending, and proposed state, national, and international regulations regarding GHG emissions and characterizes material regulatory developments as a "known trend," the effects of which, if material, must be disclosed under Regulation S-K. It concludes that the risks of climate change meet the materiality threshold for disclosure, because this is the very type of information that a reasonable investor would consider important in assessing a company's value. Based on these assertions, the petition seeks to have the SEC issue interpretive guidance that requires reporting companies to:

- Perform a thorough review of the implications of climate change for their financial condition and operations, including calculation of current and projected GHG emissions associated with their operations; and

- Disclose climate change risks that are material (either as material contingent liabilities on the balance sheet or notes to financial statements or in disclosures pursuant to Regulation S-K).

Additionally, the petition suggests that three categories of climate change risk should be assessed and disclosed: physical risks, financial risks associated with present or probable future regulation, and legal proceedings.

Although it has been more than a year since the petition was filed, the SEC has yet to respond to the petition or to issue interpretive guidance. In the meantime, the activist investor group Investor Network on Climate Risk has sought SEC inclusion of climate change risk disclosure as part of the SEC's 21st Century Disclosure Initiative. *See* http://www.sec.gov/comments/4-567/4567-20.pdf (web sites last visited May 13, 2009). Additionally, the Senate Appropriations Committee report issued in July

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2008 to authorize the SEC's funding specifically states that the SEC "is encouraged to give prompt consideration to this petition and to provide guidance on the appropriate disclosure of climate risk." S. Rep. 110-417, at 108. Collectively, the petition itself, other pressures on the SEC, the likelihood of GHG regulation, the increase in GHG-related litigation and investor awareness of GHG issues, and the Senate recommendation greatly increase the likelihood of SEC action under the new administration. Given that the petition does not seek a change in law but rather a clarification of existing law, even in the absence of SEC action, public companies will likely face greater scrutiny of their climate change disclosures (or lack thereof).

RECENT STATE INITIATIVES

As further evidence of the growing focus on climate change risk disclosure, the State of New York recently began an enforcement initiative to mandate climate change financial risk disclosure for public corporations with connections to New York. In September 2007, the New York attorney general ("AG"), Andrew Cuomo, initiated an investigation into alleged incomplete disclosures by Xcel Energy Inc. and four other energy companies. Claiming authority under the Martin Act, N.Y. Gen. Bus. Law § 352 (2007), which forbids the use of any deception or other misrepresentation in connection with the issuance or distribution of securities in the State of New York, the New York AG alleged that Xcel violated the Martin Act by failing to properly disclose climate change-related risks in its 2006 10-K filing to the SEC. Specifically, the AG cited as a Martin Act violation the failure to disclose the GHG-related risks from Xcel's proposed opening of a coal-fired electric generating unit in Colorado. Xcel Energy Inc., Assurance of Discontinuance, AOD #08-012, at 1, *available at* http://www.oag.state.ny.us/media_center/2008/aug/xcel_aod.pdf.

In July 2008, Xcel and New York settled the matter. Xcel contended and believed its SEC filings, as well as other publicly available Xcel documents (such as its annual Triple Bottom Line report), adequately disclosed climate change risks in a manner fully compliant with SEC and state requirements, and Xcel settled the matter voluntarily and without admission to any violations of the Martin Act. In moving forward with a voluntary settlement, Xcel saw an opportunity to consolidate its climate change disclosures into its 10-K filing. As part of this settlement, Xcel agreed to disclose the following information and analysis in its SEC 10-K filings for the next four years: (a) an analysis of financial risks from present and probable future regulation of GHG emissions; (b) an analysis of financial risks from GHG-related litigation; (c) an analysis of financial risks from the physical impacts of climate change (including increased sea levels and extreme weather conditions related to climate change); and (d) a strategic analysis of climate change risk and emissions management, including Xcel's current position on climate change, current and anticipated emissions management, and corporate governance actions concerning climate change. *Id*. at 3–5. The AG settled similar allegations against Dynegy under substantially the same terms in October 2008. Dynegy, Inc., Assurance of Discontinuance, AOD #08-132, *available at* http://www.oag.state.ny.us/media_center/2008/oct/dynegy_aod.pdf.

New York's direct regulation of Xcel's climate change disclosure policies and practices under the Martin Act would be relatively unremarkable except for the fact that Xcel provides services in only "eight Midwestern and Western states." Xcel Energy Inc., Assurance of Discontinuance, at 2. It does not provide any services within the borders of New York, and the main activity prompting the action by the AG—the prospective building of a coal-fired electricity plant—was to occur in the State of Colorado.[1] Nevertheless, the AG claimed jurisdiction under the Martin Act over Xcel, based on the fact that the New York State Common Retirement Fund was a "significant" holder of Xcel stock.[2] Significantly, the Retirement Fund holds stock in nearly 2,000 American companies, each of which, under this theory, is potentially subject to Martin Act jurisdiction. Also, since nearly 4,000 American companies currently list stock on the New York Stock Exchange[3] and more than 2,800 American companies list stock on the New York-based NASDAQ exchange,[4] a substantial number of American companies could possibly be subject to scrutiny by New York under the Martin Act. *See* N.Y. Gen. Bus. Law § 352 (2007) (forbidding misrepresentation in connection with the issuance or sale of securities in New York). Because the Xcel settlement was a voluntary decision to disclose, it sets no legal precedent requiring heavy GHG producers to disclose climate change risks. The New York AG's broad and aggressive exercise of jurisdiction, however, shows that thousands of companies nationwide are potentially at risk of enforcement, even though the scope of current requirements for disclosure of climate change risks at the federal level is not fully developed.

In a move for even broader control at the state level of climate change disclosure, California's legislature recently attempted to require statewide climate change risk disclosure as well. On May 22, 2008, the California State Senate passed Senate Bill 1550, a measure that would require the State Controller to develop a climate change disclosure standard for all companies doing business in California by December 1, 2009.[5] The State Assembly passed an amended version of the bill on August 13, 2008.[6] The Assembly's amended version of the bill failed to pass in the Senate by one vote, however, and any discussion of the bill must therefore be deferred to the 2009 session. Although the California bill failed to pass both houses by a single vote, the lesson to be learned is that some states are serious about mandating climate change disclosure now—with or without SEC action. Additionally, California's example demonstrates that state initiatives may well go beyond the imposition of requirements on publicly traded companies regulated by the SEC, possibly imposing GHG risk reporting obligations on private companies. The implications of this broad jurisdiction would be significant and costly.

ASTM INTERNATIONAL DRAFT CLIMATE CHANGE RISK DISCLOSURE STANDARD

As with its development of ASTM E2173 for disclosure of environmental risks, ASTM International observed a gap in guidance regarding disclosure of climate change risks, and beginning in 2008, it has acted to address this apparent gap. Specifically, ASTM recognized that investor groups and other parties, such as the petitioners in the SEC matter, were looking for greater consistency and thoroughness of financial disclosure by public companies of climate change risks. Accordingly, ASTM's Committee E50 on Environmental Assessment, Risk Management and Corrective Action created a Climate Change Task Group as part of its Subcommittee 50.05—Environmental Risk Management. This task group performed extensive research regarding climate change issues and risks and sought interested-party

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consensus regarding best practices for financial disclosure of these risks. The result was the Draft ASTM Standard entitled "Disclosure of Financial Impacts Attributed to Climate Change," which was first balloted in October 2008 and is now undergoing its second subcommittee ballot. A copy of the Draft Standard is available through ASTM. Significantly, in researching climate change issues and preparing the Draft Standard, ASTM has specifically declined to take a position regarding the scientific proof of climate change or the source of any climate change.

As with the petition and the New York actions, the Draft Standard focuses on the financial impacts of climate change, such as costs arising from enforcement of or compliance with environmental laws, anticipated changes in resource availability or cost, asset impact (such as by way of weather changes), or litigation by third parties. The Draft Standard provides guidance to companies regarding how to identify this information, how to quantify the information and determine materiality, and what content the disclosure may need to include. For example, the Draft Standard provides guidance for when a reporting entity may need to include a GHG emissions summary and how management should present a statement concerning its strategic analysis of the company's climate change financial risk.

LOOKING FORWARD

Pending any formal guidance from the SEC, ASTM's climate change Disclosure Standard, if formalized, may ultimately provide the best guidance for the thousands of publicly traded companies that face financial risks as a result of climate change. In any event, the regulatory and litigation trends discussed here point only to growth in potential business impacts due to climate change—whether by way of federal regulation of GHGs or by virtue of actual physical impacts on company assets resulting from altered climate conditions. This continued growth in climate change risks will most certainly continue to bring greater SEC and investor scrutiny of public companies' disclosures regarding such risks. Even if the Draft Standard is finalized, absent SEC regulatory guidance, publicly traded companies will continue to face complex disclosure decisions when reporting their climate change risks, along with increased risks of inadequate disclosure regarding this complex phenomenon. ■

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[1] Letter from Katherine Kennedy, Special Deputy Attorney General, State of New York, to Xcel Energy Inc., Sept. 14, 2007.

[2] *Id*. As of November 14, 2008, the Retirement Fund held 1,559,974 shares of Xcel Energy. Mutual Fund Facts About Individual Stocks, http://www.mffais.com/institutions/125321/. This represented 0.3 percent ownership of outstanding Xcel stock. *The Wall Street Journal*, Market Data, http://online.wsj.com/public/quotes/main.html?type=djn&symbol=XEL.

[3] The NYSE Listings Directory, http://www.nyse.com/about/listed/lc__all__overview.html.

[4] The NASDAQ Listed Companies, http://www.nasdaq.com/services/listed-companies.stm.

[5] California Senate Bill No. 1550, May 22, 2008, *available at* http://info.sen.ca.gov/pub/07-08/bill/sen/sb__1501-1550/sb__1550__bill__20080424__amended__sen__v97.pdf.

[6] Senate Bill 1550, History, *available at* http://info.sen.ca.gov/pub/07-08/bill/sen/sb__1501-1550/sb__1550__bill__20080831__history.html.