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Will the SEC Weigh In on the Climate Change Debate?

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Special to The Legal

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If asked what federal agencies are being pressed to promulgate climate change programs, the first answer for most would likely be the Environmental Protection Agency. But in September, a coalition of public interest groups, government officials and institutional investors filed a petition before the Securities and Exchange Commission requesting that the SEC provide explicit guidance on the need for public companies to disclose all material information related to the impact of climate change risk.

The petition was accompanied by a request for the SEC to begin to evaluate climate change disclosures even in the absence of SEC guidance. Additionally, in October the Senate Banking, Housing and Urban Affairs' Subcommittee on Securities, Insurance and Investment held a hearing titled "Climate Disclosure: Measuring Financial Risks and Opportunities," where witnesses and senators urged the SEC to issue a more definitive statement on climate change disclosure.

The petition and hearing are the latest manifestations of an ongoing effort to advance climate change issues through capital market mechanisms. In response, many companies are beginning to tackle difficult issues on how to assess and disclose climate change risks against a backdrop of substantial uncertainty about the ultimate shape of greenhouse gas regulation, and how such regulation and other contingencies related to climate change could affect company operations.

This article will discuss the market forces driving the recent SEC petition, and how climate change risk fits within the current SEC reporting scheme. Regardless of the outcome of the petition, however, it appears that the trend toward more climate risk disclosure will continue, and companies — both public and private — should be prepared to devote additional resources to analyzing and disclosing the effect of climate change on company operations.

Before exploring why the petitioners are seeking a more definitive statement from the SEC concerning climate change risk disclosure, it is useful to understand the extent to which the private marketplace has already forced companies to examine and disclose potential material adverse effects due to climate change. This unprecedented private market response to the desire for information about climate change risk has led to a dramatic increase in voluntary climate change disclosure in recent years.

A number of organizations are working to advance sustainability issues by proactively engaging companies to disclose the climate change risks associated with their operations. For example, CERES, a coalition of investors, environmental organizations and public interest groups and one of the parties on the petition before the SEC, coordinates the Investor Network on Climate Change (INCR), a network of institutional investors representing more than $4 trillion in assets, and which includes among its members the Pennsylvania and New Jersey state treasurers. In October 2006, the INCR, along with other global investment groups, issued the Global Framework for Climate Risk Disclosure, a four-part framework designed to elicit more comprehensive climate risk disclosures from companies worldwide. Similarly, the Climate Disclosure Project (CDP), another organization of 315 institutional investors, conducts an annual climate risk disclosure survey of the world's largest companies. The annual response rate to the CDP survey has increased from 47 percent in 2003 to 77 percent in 2007.

In addition to the pressure applied by these investor coalitions, many private investing firms and other consultants have created various climate change services for investors, shining additional light upon business risk issues associated with climate change. Testimony at the October congressional hearing noted that major investment banks have produced more than 50 white papers in the past five years on climate change topics, and the petition before the SEC highlights four current market indices designed to track risks and opportunities related to climate change.

Individual investors have also attempted to force corporate disclosure of climate risk through shareholder proposals aimed at greenhouse gas issues. CERES has reported that 42 shareholder proposals related to climate change were filed with 36 companies as of May 31. Shareholders withdrew a significant portion of these resolutions after reaching agreements with the companies about additional climate risk disclosure.

ARGUMENT FOR SEC GUIDANCE

Despite the acknowledged increase in voluntary disclosure of climate change risk, proponents of SEC action argue that voluntary disclosure is insufficient for two general reasons. First, without mandatory directives, a number of companies do not provide public disclosure of climate risk issues.

Second, in the absence of SEC guidance, the climate risk disclosure currently provided is inconsistent in terms of substance and quality. This inconsistency of information on climate risk fails to provide the information necessary for investors to make informed business decisions about a company's prospects.

Notably, the proponents of SEC action are not yet advocating a sweeping change in the current SEC disclosure requirements. Rather, they are seeking clarification from the SEC that current disclosure requirements mandate disclosure of material risks related to climate change. These potentially material risks include:

- Physical risks associated with climate change (e.g., effects of warmer temperatures, rising sea levels and severe weather events on business operations, including the supply chain);
- Financial risks and opportunities associated with current and probable greenhouse gas regulations; and
- Legal proceedings related to climate change.

The current disclosure framework referenced by the SEC petitioners is intended to implement the requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934. A fundamental aspect of all disclosure under these laws is the requirement to disclose "material" information. According to the Supreme Court and SEC rules, information is material if "there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having altered the 'total mix' of information made available." The materiality calculus is not a bright line determination, but must include both quantitative and qualitative analysis.

Regulation S-K governs the content of the narrative portions of a number of major SEC filings. There are three items under regulation S-K that most likely call for narrative disclosure of climate change issues. First, item 101, "Description of Business," specifically requires disclosure of any material effects associated with compliance with environmental laws. Thus, to the extent a registrant is subject to international, state, local or (possibly at some point) federal greenhouse gas regulatory programs, any material costs of compliance must be discussed.

Item 103, "Legal Proceedings," requires a description of material environmental litigation to which the registrant is a party and is material to the business or financial condition of the registrant, involves damages in excess of 10 percent of the registrant's current assets, or involves potential sanctions — fines or penalties — in excess of $100,000. Litigation over climate change issues is relatively new, but the number of cases can be expected to increase as climate change regulatory programs mature. Examples of litigation that could fall within the scope of item 103 disclosure include challenges to regulatory programs that materially affect a registrant's business, challenges to permitting decisions with climate change impacts, or mass tort suits where damages are allegedly attributable to climate change — property damage caused by an extreme weather event, for example.

Item 303, "Management Discussion and Analysis," is a broad disclosure requirement that calls for companies to disclose "known trends, events and uncertainties reasonably expected to have material effects" on a company's financial position. The SEC has interpreted this requirement broadly, requiring disclosure unless management has determined that the known trend, event or uncertainty is not reasonably likely to occur, or, if unable to make that determination, that the consequences of the known trend, event or uncertainty are not reasonably likely to have a material effect on the company, assuming that it will occur.

While climate change risk disclosure appears to be relatively straightforward under items 101 and 103, it is easy to see how companies could face difficult disclosure questions under item 303. Global climate change as a phenomena is probably now fairly characterized as a "known event" based upon the strong scientific consensus that has developed, and there are certain companies directly affected by greenhouse gas regulation, such as utilities and automakers, for which some discussion of climate risk is clearly required under item 303. There are a number of other companies, however, that may not be subject to greenhouse gas regulation, but nevertheless may experience other significant impacts from such regulation. For example, high energy use companies may experience a sharp increase in costs operating in a carbon-constrained marketplace. In addition, certain industries dependent upon climate, such as ski resorts, may suffer as temperatures rise. The possible impacts of these risks may be important, yet difficult to quantify given the state of scientific uncertainty surrounding the possible effects of climate change.

For financial statements, Statement of Financial Accounting Standards No. 5, a "Generally Accepted Accounting Principle" governing disclosure of contingent liabilities, requires companies to record against current income material liabilities that are probable and reasonably estimable. As greenhouse gas regulatory programs mature in the U.S., more companies will be faced with the challenge of estimating and recording on their balance sheets contingent liabilities related to climate change.

INTERNAL CONTROLS

Probably as significant as the request for clarification as to the types of climate change risk that companies must disclose, is the petitioners' corollary request that the SEC include a statement that companies are required to "review the adequacy of their internal mechanisms for gathering information about, and assessing, climate risk and ... establish institutional mechanisms necessary to ensure careful and well-informed review of potential climate risks."

Even absent such a statement from the SEC, the Sarbanes-Oxley Act arguably requires CEO's and CFO's to certify that their internal mechanisms are sufficient to ensure that material information concerning climate change risks is made known to officers and others within the company.

Along these lines, the SEC petitioners posit that a necessary component of any internal control related to climate change is a robust assessment of the company's greenhouse gas emissions associated with the entire production cycle, including supply and distribution chains. In addition, other mechanisms must be sufficient to evaluate the impact of the rapidly changing greenhouse gas regulatory framework.

The recent focus on climate disclosure in SEC reports is the latest expression of the marketplace desire for additional information concerning the effects of climate change on a company's operations and financial condition. As the issue of climate change disclosure progresses, one can expect that all companies, whether public or private, will be forced to analyze and disclose to government agencies, lenders, potential business partners, and the investing public, business risks related to climate change. A systematic and thorough assessment of these risks will, due to uncertain and dynamic nature of various legal requirements and technical issues associated with climate change, necessarily require companies to rely increasingly upon an experienced team of professionals, including lawyers and technical consultants, familiar with business, securities and environmental issues, to ensure that appropriate climate change information is disclosed, while protecting against potential fraud and misrepresentation claims. •