PUBLIC INTEREST in climate change continues to grow, and widespread domestic regulation of greenhouse gas (GHG) emissions appears inevitable. Private parties have sought to spur governmental action, to seek voluntary emission reductions, and to challenge projects with high GHG emissions, such as power plants. In addition, public companies have been pressured to disclose their climate change risks in spite of the uncertainty over the form of future GHG regulation and an absence of Securities and Exchange Commission guidance on climate change disclosure.

This article focuses on the need to disclose climate change risks in annual and quarterly SEC filings. Environmentalists demand disclosure of climate change risks hoping to focus market pressure on the issuer, and investors hope to identify financial risks. The environmental group Friends of the Earth conducts annual surveys of SEC filings to assess the rate and extent of climate change disclosures broken down by industry. Faith-based, “socially responsible” and traditional investors have introduced climate change disclosure proxies.

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In 2007, 43 such proxies were filed with 36 U.S. publicly traded companies; 30 similar proxies were filed in 2006, 33 in 2005 and 25 in 2004. Some shareholder proxy votes achieved nearly 40 percent approval rates, and others were withdrawn after management agreed to disclose, or take action to mitigate, climate change risks.

There have been other demands for action. Two bills currently before Congress would require the SEC to regulate climate change disclosure.

On June 14, 2006, the Coalition for Environmentally Responsible Economies (CERES), on behalf of institutional investors managing $1 trillion in assets, sent a letter to SEC chairman Christopher Cox calling for action to require climate change disclosure.

On March 19, 2007, CERES sent a similar letter to President Bush on behalf of institutional investors managing $4 trillion in assets. The 2007 letter was signed by 10 state treasurers, executive officers from more than 12 leading corporations (including Alcoa, BP America, DuPont, Exxon, PG&E and Sun Microsystems), institutional investors and asset managers (including Merrill Lynch), and state pension funds (including CALPERS).

When Disclosure Is Required

The Securities Act of 1933 and the Securities Exchange Act of 1934 regulate the registration and public trading of securities. Pursuant to Regulation S-K, these acts require issuers of securities to disclose liabilities to provide investors access to material information necessary for informed decision-making, including certain narrative disclosures in an issuer's SEC filings. Items 101, 103 and 303 may be most applicable to climate change disclosure.

Item 101 regulates disclosure of the material effects that compliance with "enacted or adopted" laws may have on an issuer's capital expenditures, earnings or competitive position. Disclosure is required for the current and succeeding fiscal years, as well as any other periods believed by the issuer to be material.

Item 101 may be most applicable to issuers with operations in Kyoto-signatory countries or with operations in areas where domestic regulations have already been adopted (such as auto manufacturers with California sales or the Massachusetts coal power industry).

As more domestic laws are adopted, more issuers will need to disclose under Item 101. However, future laws could vary widely; for example, regulation could apply to all sources of GHG emissions or be limited to power plants or other high GHG emitters, use an emission tax, a consumer tax, financial incentives for emission reductions, emission trading, or strict emission limits, or any combination thereof.

Until the timing, scope and extent of future laws becomes known, Item 101 arguably imposes only limited disclosure requirements.

Item 103 requires disclosure of material pending legal proceedings (including proceedings "known to be contemplated" by governmental authorities) to which the issuer is, or may become, a party. Although Item 103 expressly relates to parties, other issuers likely to be affected by proceedings should consider disclosure if the resolution thereof could materially impact their capital expenditures, earnings or competitive position.

Item 303 regulates disclosure of information necessary to understand the issuer's "financial condition, changes in financial condition and results of operations" in the Management's Discussion and Analysis (MD&A) section. MD&A disclosure includes "known trends, events or uncertainties that are reasonably likely to have material effects." However, disclosure is limited to information available "without undue effort or expense," and is not required with respect to "forward-looking information." Disclosure of such forward-looking information, which includes anticipated future trends or events, or a less predictable impact of a known trend or uncertainty, is voluntary.

Although not expressly referenced in Item 303, SEC guidance has recognized some environmental matters, including Superfund liabilities, as "known uncertainties" that require disclosure. However, the extent to which this guidance applies to other environmental uncertainties is, itself, uncertain.

To help determine when an event qualifies as a "known trend or uncertainty" for MD&A disclosure, the SEC has developed a two-part test that focuses on predictability and materiality.

First, unless the issuer can determine that the trend or uncertainty is not reasonably likely to occur, the issuer needs to assume that it is reasonably likely to occur. Second, if the trend or uncertainty is reasonably likely to occur, then disclosure is required unless the issuer can determine that the occurrence thereof is not reasonably likely to have a material effect on the issuer.

Proposed laws can arguably be interpreted as a known trend, event or uncertainty. For example, a 1989 SEC release concluded that "disclosure of material information relating to the impact of proposed or implemented" laws or regulations would be required.

As future GHG regulation becomes less of an uncertainty and more of an event, the second step of the materiality test will be more crucial.

Generally, an item is material if there is a "substantial likelihood that a reasonable investor would attach importance in deciding" whether to invest. However, there is no specific rule for determining what information would qualify, and both quantitative and qualitative analysis is required.

In other words, even if the total financial impact is not large, an item can be material if it would be deemed important to a reasonable investor. As a result, disclosure could arguably be necessary for extremely large companies even if these companies have a higher quantitative level of materiality. Questions arise as to who is a reasonable investor (e.g., is a small faith-based investor included?) and what climate change information is material (e.g., could future climate change or GHG regulations, even if there is no material financial impact on the issuer, impact on a reasonable investor's decision to invest?).

Who Should Consider Disclosure

Climate change disclosure has been considered by, and proxies have been filed for, auto manufacturers, utilities, mining companies, oil refiners, insurance companies, hotels, food retailers and myriad other types of companies. Issuers incurring or expecting to incur material costs to comply with GHG regulations may need to disclose under Item 101, and issuers subject to pending material GHG-related proceedings may need to disclose under Item 103. Determining whether disclosure is required under Item 303 is more difficult.

Issuers that should consider disclosure under Item 303 include companies:

(i) with operations in Kyoto-signatory countries;

(ii) with high quantities of GHG emissions;

(iii) that may be indirectly affected by climate change or GHG regulations (including suppliers to high GHG emitters and finance and insurance companies);
(iv) that may be directly impacted by the warming effects of climate change; and
(v) that may benefit from future climate change regulation.

Although some categories are more likely than others to require disclosure, the materiality of GHG regulations can vary for every company within each category.

Operations in Kyoto-signatory countries may trigger disclosure obligations. Depending on the industry, companies may already be incurring, or planning how to incur, material costs to meet Kyoto GHG emission goals. However, since GHG regulations can vary greatly from country to country, disclosure obligations can also vary.

In addition, until the issuer identifies its manner of compliance, determining the scope, cost or extent of any emission reductions, or emission credit purchases, might be forward-looking.

For companies with operations in both the U.S. and Kyoto-signatory countries, the decision whether to disclose may depend on whether compliance with Kyoto or any other related climate change risks are material only to the foreign operations or to the entire company.

CERES recognizes that issuers in industries with high GHG emissions have been among the most likely to disclose. GHG regulations would be most likely to materially impact auto manufacturers, oil refineries, electric utilities and similar companies. This could trigger disclosure obligations unless the related costs would not be material for the company as a whole, for example, to the size or varied nature of company-wide operations.

The need for disclosure can be unclear for issuers that could be indirectly affected by GHG regulation, such as suppliers of resources, parts or services to auto manufacturers or electric utilities. Demand for the suppliers’ business could be reduced if its customers incurred a material impact. However, the supplier company may need to perform three steps of prediction:

(a) the future regulations,
(b) the impact on its customers, and
(c) how the impact on its customers would impact its business.

Various finance and insurance companies could also be indirectly impacted due to investments or insured risks. For example, insurance claims could rise if climate change increases weather-related risks, and loan repayment could decrease due to climate change impact or increased operating costs from future GHG regulations.

Assessing climate change’s impact on indirectly affected companies is arguably forward-looking and may require undue effort or expense. However, even though indirect, if the impact is material, disclosure may be required.

Some industries could be impacted by climate change itself. For example, the worldwide ski industry could be adversely affected if global warming continues to melt glaciers and snow. The need for, and costs of, artificial snowmaking could increase, and warmer weather may reduce the amount of available days for skiing.

Recognizing this risk, several ski resort owners have joined the Chicago Climate Exchange, and the Aspen Skiing Company filed an amicus brief in the recent Massachusetts v. Environmental Protection Agency U.S. Supreme Court case. If global warming-related cost increases or revenue losses become material, then disclosure may be required.

Companies that seek to benefit from future climate change regulation may also face a disclosure dilemma. Climate change-related business opportunities could arise, for example, for manufacturers of equipment that improves fuel efficiency, reduces GHG emissions or conserves energy, or for producers of “green” energy such as wind or solar power. Similarly, a company that reduces its overall GHG emissions can potentially seek to receive salable “credits” for the reduced emissions, thereby generating an asset in return for its emission reductions. However, if asserted with too much certainty, the benefiting company could overstate its increased business or other anticipated benefits.

Until their timing and structure is known, a risk remains that the future regulations would not require the company’s pollution control product or allow the generation of emission reduction credits. As a result, business opportunity disclosures may warrant a parallel disclosure of the risk that the opportunity might not arise.

Issuers incurring or expecting to incur material costs to comply with GHG regulations may need to disclose under Item 101, and issuers subject to pending material GHG-related proceedings may need to disclose under Item 103. Determining whether disclosure is required under Item 303 is more difficult.

What Should Be Disclosed

Although the SEC has issued guidance documents as to how information should be disclosed, there are no specific rules or guidance as to the length, scope or substance of climate change disclosure.

A July 2004 Governmental Accounting Office (GAO) report determined that, although a majority of electric utilities disclosed climate change risks in their SEC filings, “the amount and type of information varied widely.” Climate change disclosures have ranged from a passing reference to several pages of discussion of the potential impact of such regulations and the issuer’s proposed compliance strategy.

Disclosure for some issuers is either voluntary or shareholder-requested, but may not be required. Calls for a standard disclosure format have come from environmental groups, investors, issuers and, as described below, Congress.

Congressional Action

Two of the six climate change bills currently before Congress would require SEC-mandated disclosure of climate change-related risks, although the initial press releases for both bills were silent on this issue.

The Global Warming Pollution Act (S. 309), also known as the Sanders-Boxer bill, and the Global Warming Reduction Act of 2007 (S. 485), also known as the Kerry-Snowe bill, would each require the SEC to issue climate change disclosure rules within two years. Specifically, the bills would require disclosure of risks relating to the “financial exposure of the issuer” due to the issuer’s GHG emissions and to the “potential economic impacts of global warming” on the issuer itself. The disclosure provisions in each bill are identical, but the Kerry-Snowe bill would restrict required disclosure to publicly or privately held issuers with a market capitalization exceeding $1 billion.

Both bills would require the SEC to establish a uniform format for climate change disclosure, and to issue an interpretive release to “clarify” that, with respect to Items 101 and 303, (1) the United States’ international commitments related to climate change are “considered to be a material effect” and (2) global warming constitutes a “known trend.”

If climate change is a “material effect,” Item 101 could require disclosure of its effect on the issuer’s capital expenditures, earnings and competitive position. In addition, if the United States’ international commitment itself is a “material effect,” the bills arguably require that the issuer disclose if its own GHG emissions will materially affect the nation’s ability to meet its international commitments. If climate change is a “known trend,” Item 303 could also require disclosure of potential material impact on an issuer’s financial condition and results of operations due to climate change.

Conclusion

The scope or timing of domestic climate change regulation remains unknown, which can make the need for disclosure in SEC filings unclear for many issuers.

The mere inclusion of corporate disclosure requirements in two bills before Congress demonstrates the need for SEC “clarification” on this issue. However, in the face of public challenges by environmental groups and investors, decisions need to be made about whether and how to disclose—either voluntarily or because of a perceived requirement—in SEC filings before any future regulations or SEC clarification.

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