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Home > Publications > Climate Change Disclosures in SEC...

Climate Change Disclosures in SEC Filings "Heat Up"

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On August 27, 2008, New York Attorney General Andrew Cuomo announced that his office had reached an agreement with Xcel Energy Inc. (the "Xcel Energy Agreement") in which Xcel Energy agreed to provide greater disclosure on climate change and associated risks in its future annual reports on Form 10-K filed with the Securities and Exchange Commission (the "SEC"). The Xcel Energy Agreement emphasizes the need for public companies to consider whether to include disclosures regarding climate change in their SEC filings. This alert discusses existing SEC disclosure obligations that may trigger climate change disclosures, legislative and litigation developments that may necessitate climate change disclosures, activist efforts concerning climate change disclosures and related matters, recent trends in company disclosures regarding climate change and the specifics of the Xcel Energy Agreement.

Existing SEC Disclosure Requirements

Existing SEC disclosure rules do not specifically require disclosures in SEC filings about climate change. Instead, these rules require disclosure of "material" information in a variety of contexts, including four requirements in SEC Regulation S-K that may obligate a public company to make climate change disclosures in its SEC filings: Item 101 (Description of Business), Item 103 (Legal Proceedings), Item 303 (Management's Discussion and Analysis of Financial Condition and Results of Operations) and Item 503(c) (Risk Factors).

- Item 101 requires a public company to disclose, among other things, the "material effects that compliance with Federal, State, and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings, and competitive position" of the company. Possible changes in environmental laws also may need to be disclosed because Item 101 requires disclosure of "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" that the company deems material.
- Item 103 requires a public company to disclose "any material pending legal proceedings" (including proceedings known to be "contemplated" by government authorities) to which the company or any subsidiary is a party, to which its property is subject. While ordinary routine litigation incidental to the business need not be disclosed under Item 103, the instructions indicate that administrative or judicial proceedings arising under any government provisions related to regulating the discharge of materials into the environment or that primarily protect the environment must be disclosed if the proceeding is material to the company or if a governmental authority is a party in the proceedings and potential monetary sanctions may equal or exceed \$100,000.
- Item 303 ("MD&A") requires a public company to disclose any known trends, demands, commitments, events or uncertainties that are both presently known to management and reasonably likely to materially impact the company's financial condition or results of operation.
- Item 503(c) requires a discussion of the most significant risks that could impact a company's business, financial condition or future results.

In addition, Rule 10b-5 under the Securities Exchange Act of 1934, as amended, the general antifraud rule, prohibits misleading disclosure and the omission of facts necessary to make the issuer's

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statements to investors not misleading. As articulated by the U.S. Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*, "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." [1]

SEC rules also require companies to include in various SEC filings financial statements prepared in accordance with generally accepted accounting principles ("GAAP"). Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, states that under GAAP a company must recognize a loss contingency in its financial statements if a loss is probable and the amount of the expected loss is material and reasonably estimable. However, even if a loss is only reasonably possible or if it is probable but cannot be reasonably estimated, a company need not recognize the loss but must disclose in the notes to its financial statements the nature of the possible loss. Additionally, the SEC staff issued Staff Accounting Bulletin No. 92 in 1993 expressing its views regarding accounting and disclosures relating to loss contingencies, including contingent environmental liabilities.[2]

Legislative, Regulatory and Litigation Developments on Climate Change

There are numerous pending legislative and regulatory initiatives that could necessitate climate change disclosures under the SEC rules discussed above. The bill in the U.S. Congress that has come the closest to enactment is the Lieberman-Warner Climate Security Act, which the Senate Environment and Public Works Committee passed in December 2007. [3] In addition to establishing a national "cap and trade" system for greenhouse gas ("GHG") emissions, the bill would require the SEC to issue an interpretive release under Items 101 and 303 of Regulation S-K clarifying that (1) the nation's commitments to reduce GHG emissions are considered to be a material effect, and (2) global warming constitutes a known trend. Second, the bill would direct the SEC to promulgate regulations requiring public companies to inform investors of the material risks relating to the company's financial exposures due to the company's GHG emissions and the potential economic impacts of climate change on the company's interests. Even though the Lieberman-Warner bill failed to gain enough support in the full Senate this past June to be brought to a vote, it (or a variation) likely will be reintroduced in the new Congress. Moreover, it is likely that any future climate change legislation will include provisions concerning SEC disclosures because the disclosure provisions of the Lieberman-Warner bill were not among those that prevented the bill from coming to a Senate vote, and other bills pending in Congress would similarly require the SEC to act in this regard.

Even in the absence of legislation mandating the disclosure of risks related to climate change, new initiatives are underway at the Environmental Protection Agency ("EPA") that could dramatically impact the regulatory burden on companies in all industries and thus influence public company disclosures. For example, in response to the United States Supreme Court's mandate in *Massachusetts v. EPA*, [4] the EPA recently issued an Advanced Notice of Proposed Rulemaking concerning the regulation of GHG emissions from motor vehicles. [5] Additional regulation would result if this rulemaking leads to the EPA making an "endangerment finding," (*i.e.*, a finding that GHG emissions from motor vehicles "cause or contribute to air pollution which may reasonably be anticipated to endanger public health or welfare." [6]). However, the EPA acknowledged in the notice that an "endangerment finding" for motor vehicles could potentially lead to a cascade effect covering both mobile and stationary sources and may trigger a broad duty on the EPA to regulate all significant sources of GHGs under the Clean Air Act. Any such new regulations could trigger additional disclosures in SEC filings under Item 101 of Regulation S-K discussed above.

For example, an endangerment finding by the EPA for mobile sources also may lead to the regulation of GHGs under the Clean Air Act's New Source Review ("NSR") program. The NSR program requires preconstruction review and permitting for "major stationary sources." "Stationary sources" include "any building, structure, facility or installation" that emits or may emit a regulated pollutant, [7] and a source can be considered "major" if it has the potential to emit as little as 100 tons per year of a regulated pollutant. [8] One hundred tons per year is a very low threshold for carbon dioxide, and could cover office and apartment buildings, hotels, enclosed shopping malls, large retail stores and warehouses, college buildings and hospitals.

Similarly, an endangerment finding for mobile sources could require the EPA to establish a national ambient air quality standards ("NAAQS") for carbon dioxide and other GHGs. If a NAAQS is set at or below the current atmospheric concentration of these substances, then the individual states, which implement the NAAQS requirements through federally approved state implementation plans ("SIPs"), would be required to enact regulations to reduce GHG emissions from sources within their borders. Although states have considerable latitude in the regulatory approach they select, any regulatory program would likely cover many currently unregulated sources in order to reduce their carbon

dioxide emissions. To the extent that the EPA's regulation of GHG emissions imposes significant regulatory burdens that have a material effect on a public company, existing SEC requirements could require disclosure.

In addition to these federal efforts, there are a number of regional initiatives underway to reduce GHG emissions from large sources – the Regional Greenhouse Gas Initiative, the Western Climate Initiative, and the Midwest Greenhouse Gas Accord – that likewise may impose significant regulatory burdens and thus require SEC disclosures.

Finally, members of the industries that are the major emitters of GHGs – the transportation, electrical generation and petrochemical industries – continue to be subject to tort claims alleging that their emissions of GHGs constitute a public and private nuisance, thereby subjecting them to civil liability. None of these actions has yet made it past a motion to dismiss. A successful tort action to compensate alleged victims of climate change could result in significant damages and thus possibly trigger disclosure under Item 103 of Regulation S-K.

Activist Calls for Greater Disclosure in SEC Filings and Attention to Climate Change

Institutional shareholder activists and environmental groups increasingly are calling for the SEC to adopt rules and issue interpretive guidance with respect to climate change disclosure as they believe that the disclosure currently provided by public companies is inadequate. For example, in January 2007, Ceres (a national network of investors, environmental organizations and public interest groups working with companies and investors to address sustainability issues) and Calvert (a socially responsible mutual fund) issued a study on climate risk disclosures by companies in the S&P 500.^[9] The study concluded that "disclosure practices among the nation's 500 largest companies are severely lacking." The study also called on all companies "to examine the physical and weather impacts from climate change, regulatory changes that may affect energy prices and reputational and competitive risks that may affect companies that lag their peers in understanding and managing the impacts" of climate change.

In September 2007, a group of 22 state pension plans and institutional investors petitioned the SEC to issue interpretive guidance clarifying that material climate change information must be included in SEC filings under existing SEC disclosure requirements.^[10] At the same time, the coalition sent a letter to the director of the SEC's Division of Corporation Finance asking that the Division consider in its reviews of public companies' SEC filings the adequacy of disclosures related to climate risk.^[11] The coalition supplemented its petition in June 2008 with information on recent developments and reiterated its request that the SEC "proceed expeditiously" to issue the requested interpretative advice.^[12]

In response to these efforts, in October 2007, the United States Senate Banking Committee's Subcommittee on Securities, Insurance and Investment held a hearing titled "Climate Change: Measuring Financial Risks and Opportunities." In December 2007, U.S. Senator Christopher Dodd and Senator Jack Reed sent a letter to SEC Chairman Christopher Cox urging the SEC to issue guidance on climate disclosure and requesting both updates about efforts to enhance guidance and a report on the adequacy of climate change disclosures.^[13]

Critics of increased climate change disclosures similarly have asked the SEC to intervene. In July 2008, the Free Enterprise Action Fund (the "Fund"), a publicly traded mutual fund, submitted a petition to the SEC for interpretive guidance that would "warn registrants against making potentially false and misleading statements pertaining to global warming and other environmental issues."^[14] The Fund's petition criticized as potentially false and misleading recent statements by several public companies regarding the causes of and risks associated with climate change. The Fund also provided examples of sources questioning the severity and causes of global warming.

Investors also advocate a consistent set of principles for companies to follow in disclosing climate change risks in their SEC filings. In October 2006, a group of leading institutional investors and public interest groups, including the California Public Employees' Retirement System ("CalPERS") and Ceres created the Global Framework for Climate Risk Disclosure.^[15] Its purpose is to communicate "investor expectations about the characteristics of successful corporate climate risk disclosure." The Framework identifies four key areas in which investors expect disclosure related to climate change in securities filings and reports to shareholders. Specifically, the Framework calls for companies to disclose:

- data on GHG emissions, including historical, current and projected future emissions;
- their strategic analysis of climate risk and emissions management (*i.e.*, a corporate policy statement on climate change, a discussion of the company's strategy to reduce or offset emissions, and a description of the company's corporate governance actions to address climate change risk);
- the physical risks to their business and operations associated with climate change; and
- information regarding regulatory risks, including potential financial impacts of future climate change regulations.

Activists also are submitting record numbers of shareholder proposals asking companies to report on climate change strategies or engage in various activities to mitigate climate change. According to data from RiskMetrics Group (formerly Institutional Shareholder Services), a record 66 shareholder proposals on climate change and energy efficiency were submitted during the 2008 proxy season, which accounted for almost two-thirds of all proposals related to energy and environmental issues filed during that period. Industries targeted for shareholder proposals include oil and gas, electric power, financial services, automobile manufacturers, homebuilders, property managers and retailers. Approximately 26 of these proposals were either excluded from company proxy statements under the SEC's shareholder proposal rule or withdrawn following negotiations between the company and the shareholder proponent. Of the proposals voted on to date for which voting results are public, an average of approximately 20.1% of votes cast supported these proposals compared to approximately 10.8% in 2005. Fifteen of these proposals were submitted by critics of global warming, and a few companies received a shareholder proposal asking that they reduce GHG emissions as well as a proposal suggesting that climate change is not caused by GHG emissions.

Recent Trends in Climate Change Disclosures

Many public companies already include disclosures regarding GHG emissions and other climate change information in their SEC filings. For example, a recent article by Politico.com noted that in the first quarter of 2008, public companies mentioned "climate change" 7,634 times in their SEC filings, as compared to 536 times in the first quarter of 2006.^[16] Climate change-related disclosures in 2008 Forms 10-K included discussion of:

- Risks to business, including: increased regulation of GHG emissions resulting in greater costs (*e.g.*, higher capital expenditures) and permitting delays; public opinion regarding climate change reducing demand for company products; incentives for encouraging energy efficiency resulting in increased demand for competitors' products; risks related to extreme weather (*e.g.*, increased downtime and maintenance costs, higher insurance premiums and greater exposure under insurance policies); and increased difficulties financing facilities that emit GHGs;
- Risks related to pending legislation and current and possible future regulation, including possible EPA rulemaking following the U.S. Supreme Court's decision in *Massachusetts v. EPA* and federal legislation and state or regional programs that would mandate future reductions in GHG emissions (discussed above); and
- Risks related to litigation, including recent cases asserting that GHG emissions constitute a public and private nuisance.

In addition to climate change disclosures in SEC filings, many U.S. companies voluntarily disclose information about their GHG emissions. For example, the Carbon Disclosure Project ("CDP") distributes a questionnaire to companies requesting information on GHG emissions, climate change risks and opportunities, GHG accounting and climate change governance. According to the CDP, 65% of S&P 500 companies responded in 2008 compared to 47% in 2006. ^[17] Separate from their SEC filings, more than one-half of the United States' 100 largest publicly traded companies now voluntarily report on their sustainability efforts according to a recent report by the Sustainable Investment Research Analyst Network. ^[18] These sustainability reports typically describe the economic, environmental and social impacts of the companies' businesses. Approximately one-third of these reports are prepared using the Global Reporting Initiative ("GRI") framework for sustainability reporting. GRI is a complex reporting scheme that includes multiple reporting principles as well as standard disclosures to guide companies in formulating sustainability reports.

Xcel Energy Agreement with New York Attorney General

The Xcel Energy Agreement^[19] follows an investigation of Xcel Energy by New York Attorney General Cuomo. The New York Attorney General subpoenaed Xcel Energy, as well as AES Corporation, Dominion Resources Inc., Dynegy Inc. and Peabody Energy Corp., in September 2007 for information regarding whether the companies had adequately informed their investors about the potential risks associated with developing power plants that could generate significant GHG emissions. The subpoenas noted the increased likelihood of regulation of GHG emissions. The subpoenas were issued under the authority granted by New York's Martin Act, a state securities law that gives broad powers to state prosecutors. The New York Attorney General's investigation of the four other companies is ongoing.

Under the Xcel Energy Agreement, Xcel Energy's disclosures in its Form 10-K filings will include:

- An analysis of the material financial risks to Xcel Energy associated with the regulation of GHG emissions, which at a minimum must include identification and an analysis of the material financial effect of GHG legislation or regulations in effect in states and countries in which Xcel Energy operates as well as a discussion of expected trends in and the potential material financial effect on Xcel Energy's business of GHG legislation or regulations likely to be adopted.
- An analysis of the material financial risks associated with any litigation related to climate change involving Xcel Energy, with materiality based on whether the outcome will likely have a material financial effect on Xcel Energy and any climate change-related decisions issued by the United States Supreme Court, any United States Court of Appeals, or any court in any jurisdiction in which the Company operates that the Company concludes may have a material financial effect on its business.
- The material financial risks to Xcel Energy's operations from the physical impacts associated with climate change, including the impact, if any, of an increase in sea level and changes in weather conditions, such as increases in extreme weather events, changes in precipitation resulting in drought or water shortages, and changes in temperature.
- To the extent Xcel Energy's GHG emissions materially affect its financial exposure from climate change risk, a description of:
 - Xcel Energy's current position on climate change;
 - Xcel Energy's corporate governance actions concerning climate change, including the role of the board of directors, and a statement regarding whether environmental performance (including meeting climate change objectives) is incorporated into officer compensation; and
 - A description of Xcel Energy's emissions management efforts, including:
 - estimated GHG emissions for the reporting year and expected increases in GHG emissions from planned new coal-fired electric generation projects;
 - strategies for (and the results of those taken to date) reducing climate change risk and adapting to the physical impacts of climate change, including actions being taken to reduce, offset or limit GHG emissions; and
 - the expected effect of such strategies on future GHG emissions, including the GHG emission reduction goals Xcel Energy seeks to achieve from such strategies.

What Companies Should Do Now

In light of the activity discussed above concerning climate change disclosure, public companies (particularly those in affected industries) should examine their climate change disclosures, if any, and consider what disclosures are appropriate. In this regard, activists will look to the Xcel Energy Agreement as an outline of possible disclosures to consider in SEC filings. Discussions about possible climate change disclosures in SEC filings should include: the company's securities law counsel; environment, safety and health as well as government relations personnel; and other members of the company's disclosure committee. In addition to SEC filings, public companies should examine their other public disclosures (*e.g.*, on websites and in investor presentations) and determine whether to expand existing disclosures on sustainability issues to address climate change information. In this regard, it is important that companies consider whether voluntary disclosures about GHG emissions

and other matters related to climate change (e.g., as part of the Carbon Disclosure Project or in sustainability reports) are consistent with the information disclosed in their SEC filings.

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- [1] 426 U.S. 438, 449 (1976).
- [2] 58 Fed. Reg. 32843 (1993).
- [3] America's Climate Security Act of 2007, S. 2191, 110th Cong. §9002.
- [4] 127 S. Ct. 1438 (2007).
- [5] *Regulating Greenhouse Gas Emissions under the Clean Air Act*, 73 Fed. Reg. 44,354 (July 30, 2008).
- [6] 42 U.S.C. § 7521.
- [7] 42 U.S.C. § 7411(a)(3).
- [8] 42 U.S.C. § 7479(1).
- [9] Available at http://www.calvert.com/pdf/ceres_calvert_sandp_500.pdf.
- [10] Available at <http://www.sec.gov/rules/petitions/2007/petn4-547.pdf>.
- [11] Available at <http://www.incr.com/NETCOMMUNITY/Document.Doc?id=185>.
- [12] Available at <http://www.sec.gov/rules/petitions/2008/petn4-547-supp.pdf>.
- [13] Available at the following link.
- [14] Available at <http://www.sec.gov/rules/petitions/2008/petn4-563.pdf>.
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