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Climate Change:
A Mounting Disclosure Risk?

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As the public attention to climate change continues to heighten, and with more climate change initiatives being proposed, public companies must assess how climate change and its consequences affect their disclosure obligations. This memorandum summarizes the federal securities rules that govern a public company's disclosure obligations and discusses a number of considerations relevant to a company's assessment of its climate change disclosure obligations.

It is now apparent that many of the climate change initiatives expected from the new Administration will not be delayed by the serious economic and financial crises we face. This was confirmed by President Obama during the first week of his administration, when he signed two executive orders, one directing the EPA to reconsider California's request to enforce higher greenhouse gas emissions standards for motor vehicles and the other directing the Transportation Department to finalize rules this spring to increase the fuel economy requirement for motor vehicles. Of more far reaching significance were President Obama's comments when he signed the two executive orders:

> "America will not be held hostage to dwindling resources, hostile regimes and a warming planet. We will not be put off from action because action is hard. Now is the time to make the tough choices. Now is the time to meet the challenge at this crossroad of history by choosing a history that is safer for our country, prosperous for our planet and sustainable."

The disclosure rules discussed later in this memorandum, including the prohibition against material misstatements and omissions, are not new and are rules with which all securities lawyers are very familiar. The challenge now is to apply these rules to a company's particular circumstances in a rapidly evolving and uncertain environment.

The most notable examples of the legal exposure to companies who fail to disclose climate change information are the investigations undertaken by the New York Attorney General beginning in September 2007 of the following five energy companies: AES Corporation, Xcel Energy, Inc., Dynegy, Inc., Dominion Resources, Inc., and Peabody Energy Corporation.[1] In each instance, the Attorney General asserted that the company had failed to adequately disclose in its Annual Report on Form 10-K for 2006 the risks to its business from climate change, including the possible effects of greenhouse gas regulations, arising from the company's existing or proposed coal-fired power plants. Among other allegations, the Attorney General asserted that each company's Annual Report on Form 10-K was deficient because it failed to disclose the company's current or projected carbon emissions and did not evaluate or quantify the possible effects of future greenhouse gas regulations or discuss their impact on the company.

In the case of Xcel, the Attorney General's investigation also focused on the fact that the company had failed to include these climate change disclosures in its securities filings but had made climate change disclosures in other publicly accessible venues, including its response to a questionnaire from the Carbon Disclosure Project ("CDP").[2] In its 2006 CDP response, Xcel provided detailed answers and information regarding the consequences of climate change. Although Xcel had at most only limited climate change disclosures in its securities filings, it nonetheless described climate change as a "fundamental challenge" to the company in its CDP response. Xcel's CDP response also included a discussion of the impact on the company of abnormal weather conditions, both inside and outside its service area; the costs to its customers and the effect on the regional and national economy of greenhouse gas regulation; strategies the company had already undertaken to lower its emissions and to mitigate the effects of regulation; and the opportunities Xcel foresaw as a renewable energy leader in the event of greenhouse gas regulation.

To date, the Attorney General has settled with two of the energy companies, Xcel in August 2008 and Dynegy in October 2008. Under the settlement agreements, each company agreed to address the challenge to it of climate change and to include in its future SEC filings an analysis of financial risks related to present and probable future climate change regulation, climate-change related litigation, and the physical impacts of climate change.[3] Each company also committed to a broad array of other climate change disclosures, which included reporting its current carbon emissions, projected increases in carbon emissions from planned coal-fired power plants, and strategies for mitigating and managing its emissions.

Although greenhouse gas regulation will have a much greater impact on energy companies than on many other companies, any climate change legislation is expected to affect most companies, albeit to varying degrees. The New York Attorney General's investigations also underscore several aspects of the risks in this area that are applicable to all public companies: the high profile nature of the risks involved, the fact that disclosure can be appropriate even though particular legislation has yet to be adopted, and the potential liability from the "selective disclosure" of climate change information, even though well intended, if such information is deemed material.

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[1] See http://www.oag.state.ny.us/media_center/2007/sep/sep17a_07.html.

[2] The CDP is the most prominent repository of corporate data related to climate change. The CDP's survey process and U.S. corporations' increased level of responding to its annual surveys are described later in this memorandum.

[3] See www.oag.state.ny.us/bureaus/environmental/pdfs/Attachment%20E%20-%20Xcel%20AOD.pdf; www.oag.state.ny.us/media_center/2008/oct/dynegy_aod.pdf.

Current Disclosure Requirements

The federal securities laws contain several rules relevant to the disclosure of climate change information. As a threshold matter, registration statements filed under the Securities Act of 1933 and periodic reports filed under the Securities Exchange Act of 1934 must disclose all information that is material to an investment decision. In addition, Rule 10b-5, the general anti-fraud rule, provides that it is unlawful to make an untrue statement of a material fact or to omit to state a material fact necessary to make the statements, in light of the circumstances under which they are being made, not misleading in connection with the purchase or sale of a security.

The touchstone when determining whether disclosure is required under the SEC rules is materiality. The overarching rule for determining the materiality of particular information is whether there is a substantial likelihood that a reasonable investor would have considered the information important in making his or her investment or voting decision.[4] Whether ***omitted*** information is material is determined on the basis of whether there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the "total mix" of information available.[5] The materiality of contingent or speculative events such as proposed climate change legislation is to be assessed by balancing the probability of an event occurring with its anticipated magnitude to the company.[6]

The SEC's rules in Regulation S-K prescribe the subject matter of items to be disclosed in SEC filings. Three of these rules may require a company to address climate change-related issues, especially given the current political, business and legal environment. In particular, one of these rules is intentionally open-ended and prospective in nature, requiring that material trends and uncertainties be disclosed in a company's Management's Discussion and Analysis. These rules are summarized below:

- Item 303 (MD&A):
  Item 303 requires a company to describe in its MD&A any known "trends, uncertainties or other factors" that are reasonably likely to affect the company's earnings, liquidity or capital expenditures. Item 303 is intended to allow investors to view the company "through the eyes of management" and create increased transparency. Specifically, forward-looking information is required in the MD&A where there are known "trends, uncertainties or other factors" that will result in, or that are reasonably likely to result in, a material impact on the company's liquidity, capital resources, revenues and continuing operations. The SEC has repeatedly stressed the importance of companies addressing those factors that are likely to impact their business in the future. For some companies the requirement to address these "known trends and uncertainties" in the MD&A will encompass the potential impact of climate change and the effect or risk of regulation, even though the severity of their impact is unknown and the associated cost is inestimable.

- Item 101(c)(xii) (Environmental Compliance):
  Item 101(c)(xii) requires a company to disclose any material effect that environmental compliance associated with **enacted** or **adopted** laws may have on its earnings, capital expenditures and competitive position. These disclosures must be made as to the material effects of complying with federal, state and local provisions regulating the discharge of materials into the environment. Thus, the cost of complying with any adopted federal, state and local greenhouse gas emissions regulations is the type of cost, if material, which is required to be disclosed in Item 101(c)(xii).

- Item 103 (Legal Proceedings):
  Item 103 requires disclosure of any material pending administrative or judicial proceeding to which the company is, or may become, a party. In addition, any such proceeding arising under any federal, state or local provisions regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment must be described if:

  - it is material to the business or financial condition of the company;
  - it involves damages, sanctions, capital expenditures or charges which exceed 10% of the company's current assets; or
  - a governmental authority is a party to such proceeding and it involves potential monetary sanctions, unless the company reasonably believes that such proceeding will result in monetary sanctions, exclusive of interest and costs, of less than $100,000.

  A company must therefore focus not only on any proceeding to which it is a party but also on those where the company is not a party if the outcome could materially affect the company's financial condition or competitive position.

Whether due to the above disclosure rules or merely as a voluntary or cautionary matter, a number of companies have begun including climate change disclosures in their registration statements and periodic reports. Although information about the current level of climate change reporting in SEC filings is mostly anecdotal and incomplete, many observers believe the level has been increasing and that 2009 will see this trend accelerate. Illustrative climate change disclosures made in relatively recent filings by Intel and Kinder Morgan are included in Appendix A.

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[4] See *TSC Industries v. Northway*, 426 U.S. 438, 439 (1976).

[5] See *Chiarella v. United States*, 445 U.S. 222, 235 (1980).

[6] See *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988).

Primary Factors to Consider When Evaluating Whether or Not Disclosure is Advisable

A corporation evaluating whether climate change disclosures are advisable will need to consider several general factors applicable to a broad range of companies, as well as those factors more specific to its particular circumstances. Perhaps foremost among the general factors to be considered is the increasing call for greater governmental action to counter climate change and the prospect of federal legislation and its potential consequences to a corporation, financial and otherwise. While the timing and prospects of "cap-and-trade" or other climate change legislation (such as a federal renewable portfolio standard) remain uncertain, committee leaders in both the Senate and the House of Representatives are developing comprehensive cap-and-trade bills to be introduced later this year. Also noteworthy is the strong support from varied and influential organizations for legislation that would impose a price on or otherwise curb emissions, whether under cap-and-trade legislation, a carbon tax or otherwise. These organizations include not only environmental groups and others concerned about climate change, but organizations focused on energy and national security and the need for greater energy independence, as well as utilities and energy companies seeking greater regulatory clarity and certainty. As a result, it would seem inevitable that at some point some form of federal greenhouse gas regulation will be adopted. In evaluating the materiality of such prospective regulation, a company must balance its potential adoption with its anticipated magnitude on the company.

A company must consider more than proposed federal legislation, however. It must also consider existing and prospective federal regulatory measures, as well as existing and prospective state and local legislative and regulatory measures. It is clear that the new Administration has begun considering new regulatory measures in many areas related to climate change, although at this early stage it may be difficult to evaluate fully what measures will be adopted. Equally important, many states have adopted climate change legislation and other states are proposing such legislation. In addition, several states have formed compacts to begin limiting greenhouse gas emissions and a number of municipalities have climate change initiatives. Appendix B provides an overview of some of the these state and local actions.

Such proposed and existing legislation and regulations have a number of potential financial implications that a company should consider. For example, a company will need to assess whether any of the foregoing actions will require significant capital outlays or affect its operating costs, such as for fuel or raw materials. As a risk factor in a recent Quarterly Report on Form 10-Q, Intel cautioned that climate change regulation could have a direct economic impact by increasing the cost of perfluorocompounds (PFCs), a gas which Intel uses in its manufacturing. Other potential costs to a company could arise if climate change legislation would cause a change in the company's products or operations. Additional financial concerns might include litigation risks and regulatory compliance and reporting costs.

A company will need to consider also the regions and states in which it has operations. As Appendix B indicates, the regulatory scheme varies substantially from state to state, as well as from region to region. There are other relevant geographical differences including:

- the mix of fuel used in the production of electricity in a region;
- the availability of natural resources, including water, in a region;
- a region's emphasis on cleantech or renewables, including by type (e.g., biofuels are a focus in corn-producing areas and the appeal of wind and solar depends in part on their strength and dependability in an area);
- the opportunities that climate change may present; and
- the physical or climatic effects predicted in the future for an area (e.g., drought in the southwest and sea level rise for coastal areas).

The nature of the company's industry is another key factor to be considered. For example, climate change is an issue of critical importance to electric utilities and energy producers and to the insurance industry. Many consumer-oriented companies have highlighted their concerns about climate change, recognizing the importance many members of the consuming public give this issue.[7] IBM, Nike and Coca-Cola have all taken steps to reduce their carbon emissions, and Google, Yahoo and Dell have vowed to become "carbon neutral." PepsiCo just announced the carbon footprint of a carton of its Tropicana division's orange juice and it will be releasing the carbon footprints of Pepsi, Diet Pepsi, Gatorade and Quaker granola bars in the coming months.[8]

In evaluating its disclosure obligations, a company must consider whether climate change and its consequences present opportunities. This would be true for cleantech and energy efficiency companies and also for companies in a number of other industries, such as energy transmission and sustainable construction. In some instances, superior sustainability performance vis-à-vis a company's competitors may provide a competitive advantage, as Xcel touted in its 2006 CDP report in describing itself as a renewable energy leader. The opportunities presented by the financial incentives included in the "stimulus bill" (the proposed American Recovery and Reinvestment Act) should be considered. If material, Item 303 of Regulation S-K contemplates the disclosure of any such opportunities.

A company must consider also whether it may already be making climate change disclosures other than through its SEC reports. This can arise from a company's disclosure on its website, in its marketing or press materials, communications to investors or analysts, or participation in surveys such as the CDP's surveys. If such disclosures are determined to be material, their omission would cause the company's SEC filings to be defective. In addition, depending upon the particular channel of disclosure, the selective disclosure of this information would cause the company to have violated Regulation FD, not an idle concern as evidenced by the New York Attorney General's investigation of Xcel.

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[7] Ceres recently issued a report that assessed how 63 of the world's largest consumer and information technology companies are preparing themselves to face climate change. *Corporate Governance and Climate Change: Consumer and Technology Companies* (December 2008). Available at www.ceres.org/Document.Doc?id=397.

[8] Andrew Martin, *"How Green is my Orange?"*, New York Times, January 21, 2009; Andrew Martin, *"Do Consumers Care About Carbon Footprints?"*, New York Times, January 22, 2009.

Additional Legal and Business Considerations to Evaluate

The views of various stakeholders about sustainability is a consideration of increasing importance. Certain investors and investor groups, as well as some analysts, have publicized their interest in knowing about a company's sustainability performance. This is evidenced by the 375 signatories to the CDP, who are institutional investors with $57 trillion under management, and in a number of other ways. The Dow Jones Sustainability Index, for example, tracks the financial performance of companies considered to be the leaders in sustainability performance.[9] Additionally, many prominent groups have advocated and continue to advocate for clearer or enhanced climate change reporting in SEC filings.[10]

A company should also consider its customers and suppliers and their view of sustainability. Many companies have begun to review the sustainability performance of their supply chain. Wal-Mart announced plans in September 2007 to require its suppliers across seven product categories to provide climate change information.[11] The CDP's Supply Chain Report grew out of this initiative. The CDP has also created the Supply Chain Leadership Collaboration (SCLC), currently comprised of 28 "blue chip" companies such as Cadbury, Dell, HP, Imperial Tobacco, L'Oréal, Nestle, and PepsiCo. The SCLC's pilot survey was sent to 328 suppliers who were asked to describe their understanding of climate change and describe any initiatives they had in place. Forty-four percent of the suppliers responded. In general, the suppliers indicated that they understood the risks associated with climate change, and 58% had calculated their greenhouse gas emissions.

A company should also be aware of the increasing prominence that the corporate community is giving to climate change concerns. For example, to collect its corporate data related to climate change, the CDP distributes a questionnaire to many U.S. and foreign public corporations requesting detailed information on greenhouse gas emissions, climate change risks and opportunities, greenhouse gas accounting and climate change governance. In 2008, 64% of S&P 500 companies responded to the questionnaire, compared to 47% in 2006 (the first year it was distributed to the companies comprising the S&P 500).[12] Perhaps more important than the increased rate of reporting was the qualitative improvement in reporting and in the sustainability efforts being undertaken. Increasingly, for example, members of the S&P 500 reported that they have a board or executive-level officer with overall responsibility for climate change management (rising to 65% in 2008 from 50% the year before).[13]

Conclusion

SEC disclosure rules have not changed, but the legislative and regulatory landscape related to climate change is changing and will likely continue to change at a rapid pace. In addition, an increasing number of climate change initiatives are being undertaken by many organizations and corporations. Against this backdrop a public company will need to assess its climate change disclosures while being mindful of the following:

- remaining compliant with federal and state disclosure laws and regulations;
- managing current, and possibly adopting new, disclosure controls and procedures to ensure the company remains well positioned for compliance with future disclosure obligations:
- addressing the climate change interests and expectations of investors, including institutional stockholders;
- managing customer and supplier relationships in regard to climate change matters:
- maintaining a corporate image consistent with the company's business strategies and core values; and
- ensuring that business opportunities arising from climate change are identified, appropriately communicated and, to the extent required, adequately disclosed.

This memorandum was prepared as of February 5, 2009. Readers should be aware that the matter of climate change initiatives, legislation and regulation is very dynamic. As a result, events occurring after the date of the preparation of this memorandum are likely to have a significant bearing on the topics covered in this memorandum. Further, this memorandum does not attempt to address the implications of foreign and international climate change laws, which can be significant for a company operating outside the U.S.

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[9] Launched in 1999, the Dow Jones Sustainability Indexes ("DJSI") are global indexes that track the financial performance of the leading sustainability-driven companies worldwide. See http://www.sustainability-index.com.

[10] In September 2007, 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 disclosure requirements. Available at http://www.sec.gov/rules/petitions/2007/petn4-547.pdf. The petition was repeated in June 2008 by 20 investors organized by the Investor Network on Climate Risk and the Environmental Defense Fund. Available at http://www.sec.gov/rules/petitions/2008/petn4-547-supp.pdf. On October 22, 2008, 14 of the nation's largest institutional investors urged the SEC as part of its 21st Century Disclosure Initiative to require improved climate change risk disclosures. Available at www.ceres.org/Document.Doc?id=376. More recently, on December 11, 2008, more than 60 shareholder and advocacy groups wrote the incoming administration requesting that it require companies to disclose financial risks posed by climate change. Available at www.iccr.org/news/press_releases/2008/Obamaletter.pdf.

[11] See http://walmartstores.com/FactsNews/NewsRoom/8709.aspx.

[12] The reports are available at http://www.cdproject.net.

[13] Similarly, the response rate for the questionnaire from the Global 500 has steadily increased from 44% in 2003 (the first year it was distributed to them) to 77% in 2008.

Appendix A

Examples of Climate Change Disclosures in SEC Filings

1) INTEL CORP [Quarterly Report on Form 10-Q filed October 31, 2008] (Risk Factors):

Climate change poses both regulatory and physical risks that could harm our results of operations or affect the way we conduct our business.

Climate change can increase our costs, as a result of climate change mitigation programs and regulation as well as the risk posed by climate events that may have a direct economic impact. For example, the cost of perfluorocompounds (PFCs), a gas we use in our manufacturing, could increase over time under some climate change focused emissions trading programs that may be imposed by government regulation. If the use of PFCs is prohibited, we would need to obtain substitute materials that may cost more or be less available for our manufacturing operations. We also see the potential for higher energy costs driven by global warming regulation. Our costs could increase if utility companies pass on their costs, such as carbon taxes, costs associated with emission cap-and-trade programs, or renewable portfolio standards. While we maintain business recovery plans that are intended to allow us to recover from natural disasters or other events that can be disruptive to our business, we cannot be sure that our plans will fully protect us from all such disasters or events. Many of our operations are located in semi-arid regions, such as the southwestern United States and Israel. Some scenarios predict that these regions may become even more vulnerable to prolonged droughts due to climate change.

2) KINDER MORGAN MANAGEMENT LLC [Registration Statement on Form S-3 filed January 16, 2009] (Risk Factors):

Climate change regulation at the federal, state or regional levels . . . could result in increased operating and capital costs for us.

Studies have suggested that emissions of certain gases, commonly referred to as "greenhouse gases," may be contributing to warming of the Earth's atmosphere. Methane, a primary component of natural gas, and carbon dioxide, a byproduct of the burning of natural gas, are examples of greenhouse gases. The U.S. Congress is actively considering legislation to reduce emissions of greenhouse gases. In addition, at least nine states in the Northeast and five states in the West have developed initiatives to regulate emissions of greenhouse gases, primarily through the planned development of greenhouse gas emission inventories and/or regional greenhouse gas cap-and-trade programs. The EPA is separately considering whether it will regulate greenhouse gases as "air pollutants" under the existing federal Clean Air Act. Passage of climate control legislation or other regulatory initiatives by Congress or various states of the U.S. or the adoption of regulations by the EPA or analogous state agencies that regulate or restrict emissions of greenhouse gases including methane or carbon dioxide in areas in which we conduct business could result in changes to the consumption and demand for natural gas and could have adverse effects on our business, financial position, results of operations and prospects.

Such changes could increase the costs of our operations, including costs to operate and maintain our facilities, install new emission controls on our facilities, acquire allowances to authorize our greenhouse gas emissions, pay any taxes related to our greenhouse gas emissions and administer and manage a greenhouse gas emissions program. While we may be able to include some or all of such increased costs in the rates charged by some of our pipelines, such recovery of costs is uncertain and may depend on events beyond our control including the outcome of future rate proceedings before the FERC and the provisions of any final legislation.

Appendix B

Examples of State and Local Climate Change Initiatives

The Environmental Protection Agency website offers maps by climate change policy area that show what actions each state is taking. By clicking on a state, details about the state's activities in that policy area are provided.[1]

Regionally, in the Northeast, the West and the Midwest, there are three compacts:

- Regional Greenhouse Gas Initiative (RGGI) — Ten states participate in RGGI: Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, and Vermont. Pennsylvania is an observer to RGGI. These states have imposed a mandatory cap-and-trade program on the carbon dioxide from power plants, which is underway and has already conducted two auctions of emissions allowances. See http://www.rggi.org/home.
- Western Climate Initiative (WCI) — Seven states and four Canadian provinces participate in WCI (with most of the rest of the Western states participating as observers). These states and Canadian provinces include Arizona, British Columbia, California, Manitoba, Montana, New Mexico, Ontario, Oregon, Quebec, Utah, and Washington. WCI has released its design recommendations for the cap-and-trade program and individual states now need to implement statutory or regulatory authority to implement the program, which is scheduled for implementation in 2012. See http://www.westernclimateinitiative.org.
- Midwest Regional Greenhouse Gas Reduction Accord — Six states and one Canadian province are partners in the accord. These states and provinces are Iowa, Illinois, Kansas, Manitoba, Michigan, Minnesota, and Wisconsin. Indiana, Ohio, Ontario, and South Dakota are observers. The Accord set emission reduction targets and is designing a multi-sector cap-and-trade program. For more information see http://www.midwesternaccord.org.

Of the states, California is generally viewed to have the most aggressive goals and requirements, although other states such as Florida have been very active. The state initiatives can vary widely, but some common state initiatives include:

- Climate Action — Greenhouse gas targets or goals (in 20 states), greenhouse gas inventories (42 states), and limits/required offsets for greenhouse gas from power plants (five states).
- Energy — Energy efficiency (many states, with a number predating other climate change initiatives), renewable portfolio standards (32 states), and green power pricing (many states).
- Transportation — California vehicle greenhouse gas standards (16 states poised to adopt), and ethanol mandates/incentives (39 states). Labels on new cars to indicate their smog and global warming contributions (five states - California, Florida, Massachusetts (beginning with 2010 models), Oregon and Washington).
- Building — Green building standards for state buildings (28 states), and residential/commercial energy codes (more than 40 states).

Local Initiatives (States, Counties and Cities)

- Mayors Climate Protection Agreement — strive to meet or exceed Kyoto standards in their cities (over 850 mayors have signed). See http://www.usmayors.org/climateprotection/about.htm.
- Various cities and counties have taken other climate change initiatives.

Please be cautioned that the foregoing listing, prepared on February 4, 2009, is intended to be a generally accurate summary of state and local initiatives but is not a comprehensive list and additional programs continue to be announced.

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[1] See http://www.epa.gov/climatechange/wycd/stateandlocalgov/state_actionslist.html.

[2] The following are observers to the WCI: In the United States, Alaska, Colorado, Idaho, Kansas, Nevada, Wyoming; in Canada, Saskatchewan; in Mexico, Baja California, Chihuahua, Coahuila, Nuevo Leon, Sonora, and Tamaulipas.

[3] The numbers listed are generally derived from the Pew Center on Global Climate Change's state action maps and descriptions. See http://www.pewclimate.org/what_s_being_done/in_the_states/state_action_maps.cfm.

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