



CERES

The Wirth Chair

2004 Leadership Forum
*Climate Change Risks
and the SEC*

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Summary Report

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Dear Colleague:

We are pleased to send you the summary report—*Climate Change Risks and the SEC*. This report is the result of a Leadership Forum attended by about 50 leaders from investment firms, corporations, academe, government and nonprofit groups, hosted by the Wirth Chair and Ceres at the Aspen Institute in Washington, D.C.

The agenda encompassed presentations and discussions concerning the financial risks of climate change for companies and investors, as well as the record to date on the extent and quality of climate risk disclosure required by the SEC. The Forum focused specifically on MD&A reporting by companies, which research indicates is inadequate in terms of reporting climate risk and with respect to enforcement by the SEC. Forum participants reached consensus that the SEC should issue an interpretative release clarifying a company's obligations under existing disclosure rules. They also asked the organizers of the Forum—Ceres and the Wirth Chair—to distribute this report and engage in discussions concerning implementation of its recommendations with key policy and business leaders.

We want to thank the individuals who presented at the Forum. They included: Michelle Chan-Fishel: Friends of the Earth; David Gardiner: David Gardiner & Associates; Gary Guzy: Marsh; Howard Rifkin: Connecticut Office of the State Treasurer; Robert Repetto: Stratus Environmental Consulting; and Beth Young: The Corporate Library. Their involvement helped stimulate dialogue and generate important agreements. We also want to express appreciation to the United Nations Foundation for their counsel in organizing the Forum and to its President, Timothy Wirth, for his thoughtful and provocative comments during the Forum. Lastly, we want to express appreciation to Beth Young of the Corporate Library and Jim Coburn of Ceres for their efforts in summarizing the Forum's proceedings into an insightful and succinct report.

We welcome your response to this document.

Sincerely,

Mindy Lubber, Ceres
Marshall Kaplan, Merage Foundations
Allan Wallis, The Wirth Chair

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Introduction

A scientific consensus supports the existence of global climate change resulting from human activity. Climate change, and measures adopted to mitigate it, give rise to a variety of financial risks—regulatory, physical, strategic and reputational—for U.S. public companies and those who invest in them. To examine the risks that climate change poses to investment portfolios and to determine how those risks can be managed, institutional investors representing over \$1 trillion in assets under management attended the Institutional Investor Summit on Climate Risk at the United Nations on November 21, 2003. At the Summit, which was co-hosted by Ceres and the United Nations Fund for International Partnerships, investors discussed both the science of climate change and its financial implications.

A 10-point “Call for Action” was issued at the Summit by eight state and city treasurers and comptrollers and two major labor pension fund leaders¹ who, among other things, urged the Securities and Exchange Commission (SEC) to enforce and strengthen corporate disclosure requirements related to climate risk. These investors also announced the creation of the Investor Network on Climate Risk (INCR). INCR’s mission is to promote better understanding of climate risk among institutional investors and to coordinate investor actions, including follow-up on the Call for Action.²

To explore further the SEC’s role in ensuring that investors are fully informed about climate risk, the Wirth Chair at the University of Colorado and Ceres brought together 45 leaders from corporations, institutional investors, financial firms, government, non-governmental organizations and the academy. The Forum was moderated by Marshall Kaplan, executive director of the Merage Foundations and former executive director of the Wirth Chair in Environmental and Community Development Policy at the University of Colorado at Denver and Health Sciences Center.

The Forum examined four broad questions:

1. What are the financial risks of climate change for companies and their investors?
2. What is the quality of existing company disclosure of these risks?
3. What measures can the Securities and Exchange Commission (SEC) take to improve inadequate climate risk disclosure?
4. What recommendations should the Forum make to the SEC regarding climate risk disclosure?

¹ The Call for Action has since been endorsed by four additional institutional investors.

² More information on the Investor Summit, the Call for Action and INCR is available at www.incr.com.

Summary of Recommendations

The Forum concluded that climate change imposes material financial risks, as well as creates opportunities, for companies and their investors. Although an increasing number of corporations are voluntarily reporting climate risk impacts on projected profitability, Forum participants believed that the failure of most companies to analyze climate risk rigorously and report to investors stems from strategic failures at the highest level—top management and boards—as well as reflecting a short-term orientation toward profit maximization reinforced by the financial markets.

In light of the fact that SEC rules already require disclosure of likely future developments known to management that are “reasonably likely to have a material effect” on a company’s financial results, the Forum recommended that the SEC should clarify the application of that requirement to climate risk through an interpretive release. The Forum agreed that the SEC has ample authority to issue such a clarification, and if necessary, should engage outside experts for technical assistance regarding the analysis of climate risk.

Climate Change—Risks and Opportunities for Companies and Investors

Presentations from Dr. Robert Repetto and Gary Guzy focused on the risks and opportunities for companies resulting from climate change. Both Repetto and Guzy provided strong support for the notion that climate risk poses several challenges for companies and their investors—including increased costs from regulation, expenses related to changes in the physical environment, and significant threats to the health and well-being of companies. Regrettably, many companies have not started analyzing climate risk. However, some companies in climate risk-prone sectors have both initiated risk analysis and begun to look at the associated business opportunities.

Industry Studies

Robert Repetto, Senior Advisor to Stratus Consulting, a Professor at the Yale University’s School of Forestry and Environmental Studies and a former Senior Wirth Fellow, discussed studies of companies in four industries: pulp and paper, oil and gas, automobiles, and electric utilities. The studies examined the financial impacts of various environmental regulatory developments, including carbon emissions restrictions, and the extent to which these effects were disclosed by companies in the affected industries. Repetto found:

- There are “winners and losers” in each industry. Within each industry, some companies had much larger financial exposures than others, either because of differences in their asset base, voluntary measures they have already undertaken, or other factors.

- The exposures of some companies were undoubtedly material within the meaning of SEC disclosure rules, with the most exposed companies facing estimated compliance costs equal to over 20 percent of 2002 revenues.³
- There is no simple proxy for determining financial exposure. For example, in the electric utility industry, emissions per kilowatt hour does not predict financial exposure resulting from emissions restrictions.
- Companies, even those whose exposures were estimated to be highest, did not sufficiently disclose or analyze climate risk in their SEC filings.⁴

Undisclosed liabilities

In addition to these findings, Repetto discussed his study of the hard rock mining industry, which focused on the disclosure of environmental liabilities.⁵ The study examined ten instances of financially material environmental risks that were known to management. Of those, nine were not adequately disclosed to shareholders.

For example, the Royal Oak Mining Co. had accumulated 240,000 tons of lethal, water-soluble arsenic trioxide in underground mine vaults that were leaching into the water table. The company had no plans to remove the waste, and freezing it in place would have cost more than \$200 million. Royal Oak had not booked this item as a contingent liability, established reserves for dealing with it, or described the problem as a material risk before it filed for bankruptcy protection.

Auto industry case study

Repetto also summarized a study of the automobile industry which exemplifies a rigorous approach to assessing the financial ramifications of climate risk. The study examined the impact of emissions restrictions on the ten largest automobile manufacturers and found that emissions constraints could “influence competitive balance within the industry.”⁶ It determined each company’s “carbon intensity of profits,” the extent to which the company relies on high-carbon emitting vehicles to generate profits, and analyzed the companies’ technological advantages and management quality, which assist in evaluating their ability to adapt to a changing regulatory environment. Because future regulations are difficult to predict, the study used two emission standards scenarios to evaluate the costs companies would incur to meet carbon constraints between 2003 and 2015.

The study found significant differences in risk exposure. Honda emerged as having the smallest immediate risk from carbon constraints, due to its less carbon-intensive product mix

³ The concept of materiality is discussed in more detail on pages 8-11.

⁴ The SEC’s specific disclosure requirements and interpretations are described on pages 9-10.

⁵ Robert Repetto, Silence is Golden, Leaden, and Copper: Disclosure of Material Environmental Information in the Hard Rock Mining Industry (2004).

⁶ Duncan Austin et al., Changing Drivers: The Impact of Climate Change on Competitiveness and Value Creation in the Automotive Industry (2003).

(including hybrid vehicles), while BMW had the largest risk. Toyota was ranked highest in its management of lower-carbon technologies, in large part due to its “unique competitive position” in hybrid technology.

Finally, the study translated the rankings into financial terms by converting qualitative measures into changes in EBIT (earnings before interest and taxes), a key measure of profitability, from 2003 through 2015. The study used third-party forecasts of sales growth and changes in EBIT margins to establish a baseline. Management quality indicators were incorporated to reflect the effect of opportunities, as well as risks, on company prospects. A range of potential effects was found, from an eight percent increase in EBIT to a ten percent decrease.

A Corporate Perspective on Climate Risk

Gary Guzy, former EPA General Counsel and now Senior Vice President of Marsh Inc., provided a big picture view of the evolution of corporate environmental risk management and analysis. He asserted that:

- In the 1970s, a regulatory enforcement model held sway. Government used powerful tools that seemed draconian to some companies. During that time, the government had more information on environmental issues than most companies did.
- By contrast, today most large companies have very sophisticated internal environmental management capabilities. This corporate capability provides a complement to the enforcement-type accountability that government provides in an uneven manner. It also allows the integration of environmental reports into financial reports.
- Regularization of corporate environmental management has a downside. It creates an organizational “box” in which corporate management often places environmental decisions. As a result, climate risk, like other significant issues which also impact the environment, may be put in an environmental box and not be considered by top management and the board.⁷

Guzy noted that some companies in the insurance sector are becoming attuned to climate risk, because climate change has the potential to affect their business in several ways. Catastrophic losses have risen sevenfold in the past 30 years, posing risks of business interruption, infrastructure damage (including communications, power and transportation), and disruption in the availability of resources to make products or service customers. Catastrophic problems also present difficulties for the underwriting process, with respect to the changing physical environment. Moreover, as significant investors in the capital markets, insurers are concerned about the unpredictability of the current regulatory environment and the risk that coming regulations will create substantial strategic challenges for many businesses.

⁷ Guzy opined that corporate officers and directors, spurred by the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”), will likely feel more pressure to be accountable on these issues.

A Forum participant from a financial services firm questioned Guzy's assertion that most companies have sophisticated systems in place for managing and analyzing environmental risk. The participant stated that this was not always the case, especially for companies that are not direct polluters.

Participants concurred, however, with Guzy's assessment of climate risk as strategic in nature and thus different from other environmental problems which companies face. In other words, responding to climate risk requires a company to evaluate its product or service mix and competitive position, as well as its ability to manage likely transitions resulting from anticipated future regulations. By contrast, litigating liability for a Superfund site, or identifying remediation costs, are generally more bounded exercises. They can be undertaken by either outside counsel or middle management.

Climate Risk Disclosure—Existing Practice and the Legal Framework

Currently, companies in industries vulnerable to climate change show uneven levels of reporting of climate risk, and wide variation in the quality of disclosure. In particular, companies in industries most directly affected by emission reduction requirements, such as electric utilities, are more likely to analyze climate risk than some companies in industries, in which regulation plays a less prominent role.

Forum participants agreed that the problem of inadequate disclosure calls for a response by the SEC. The Forum considered the legal framework for disclosure and agreed that the SEC has an appropriate mechanism at its disposal—the interpretive release—to clarify companies' obligations under the existing rules. The Forum identified ways in which such a release could improve disclosure—by reminding companies to avoid unhelpful boilerplate disclosure, providing examples of ideal and unsatisfactory disclosure, and clarifying companies' obligation to quantify risk, where possible.

The Quality of Existing Disclosure

Michelle Chan-Fishel, program manager of the Green Investments Program at Friends of the Earth, discussed her research on the extent and quality of climate risk disclosure by companies in five industries affected by the regulatory or physical risks of climate change: automobile manufacturing, property and casualty insurance, integrated oil and gas, plastics and rubber-based chemicals, and electric utilities.⁸ She examined whether a company made any mention of climate change or related issues, as well as the quality of their disclosure. Chan-Fishel completed similar studies in 2001, 2002 and 2003, which enabled her to describe trends in disclosure as well as current findings.

In 2004, Chan-Fishel found significant non-reporting by companies in every industry except electric utilities, where 24 of 26 companies made some disclosure of climate risk. Climate risk was mentioned by only:

⁸ Michelle Chan-Fishel, Friends of the Earth – US, Third Survey of Climate Change Disclosure in SEC Filings of Automobile, Insurance, Oil & Gas, Petrochemical, and Utilities Companies (July 2004).

- 5 of 23 automobile manufacturers (28%);
- 3 of 27 property and casualty insurance companies (11%);
- 9 of 19 integrated oil and gas companies (47%); and
- 4 of 18 petrochemicals companies (22%)

Among companies that did mention climate change, there was wide variation in the quality of disclosure. High quality disclosure, in Chan-Fishel's view, describes relevant climate change-related regulations, analyzes the potential impact of climate change and regulation on the company and its industry, reports on the company's responses to climate risk, and discloses greenhouse gas emissions. By that benchmark, few companies made high-quality disclosure, and most fell far short of the mark. Some companies simply mentioned potential regulation, but did not explain how the company would be affected. A few made statements suggesting a lack of comprehension of the nature of the risk, such as the statement by an oil and gas company that as long as there is demand for oil and gas, there is no risk for that company.

Of companies disclosing climate risk, their conclusions about its impact varied. Of the 44 companies:

- 23 (52%) said climate change would have an adverse impact on their business;
- 10 (23%) did not discuss the impact;
- 6 (14%) said climate change would have little or no effect on their business; and
- 5 (11%) said it was impossible to predict the impact.

Overall, Chan-Fishel found that the number of companies disclosing climate risk has increased over the past few years, and the quality of reporting has generally improved. She also indicated that there are notable laggards, like most of the American insurance industry. Chan-Fishel speculated about three factors behind these trends: the increased focus on accounting and internal controls fostered by Sarbanes-Oxley, a higher level of interest from shareholders, and a more empowered SEC resulting from recent corporate scandals. Chan-Fishel noted that for the first time this year, companies disclosed lobbying efforts related to climate change, positions on the Kyoto Protocol, and participation in emissions trading schemes.

Finally, Chan-Fishel compared companies' disclosure in their 10-K filings with their disclosure in response to a query by the Carbon Disclosure Project (CDP).⁹ She pointed to General Motors, ExxonMobil, AIG and Ace as providing more robust CDP disclosure, and Southern Company as having higher quality disclosure in its 10-K filing. These differences may

⁹ CDP asks businesses to disclose investment-relevant information concerning their greenhouse gas emissions. In its second information request in 2003, 95 institutional investors asked the 500 largest companies in the world about their emissions, and 59% of companies responded. See www.cdproject.net.

stem from the different orientations of those preparing the disclosure. Because liability attaches to SEC disclosure, filings are intensively reviewed by attorneys who focus on risk disclosure but may know little about the effect of a risk on a company's competitive position. CDP responses, by contrast, carry no risk of liability and thus may be prepared by non-legal personnel, such as environmental management or investor relations professionals.

The Legal Framework Requiring Disclosure

Beth Young, attorney and Senior Research Associate at the Corporate Library, described the genesis and interpretation of current disclosure requirements. Securities laws and SEC rules require companies whose securities are sold to the public and traded on U.S. stock exchanges to give investors certain information about their securities and their business. Some SEC rules require disclosure of specific information such as executive compensation, legal proceedings against the company, or the filing of a bankruptcy petition. Adding new items like these requires the SEC to engage in formal rulemaking.

The Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), which is found both in registration statements and periodic filings,¹⁰ is more flexible because it gives companies great leeway as to how to respond to generally stated disclosure requirements. Far more flexibility is granted than in many other SEC rules, because management decides what to disclose based on their analysis of their company's business. The MD&A requires companies to disclose, among other things, "known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance."¹¹ This flexibility was intentional on the SEC's part. When the MD&A requirement was first adopted, the guidelines reflected the SEC's experience with its previous narrow and overly literal disclosure mandates.

The importance of the MD&A requirements to investors has long been emphasized by the SEC. According to the Commission, the requirements "are intended to provide . . . prospective textual disclosure enabling investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant's prospects for the future."¹² Furthermore, MD&A disclosure "is of paramount importance in increasing the transparency of a company's financial performance and providing investors with the disclosure necessary to evaluate a company and to make informed investment decisions."¹³ In fact, Alan Beller, SEC Director of the Division of Corporation Finance, recently stated that MD&A "is, after the financial statements themselves, generally the most important portion of an issuer's disclosure."¹⁴

¹⁰ A registration statement is filed when securities are offered to the public, while periodic reports—Reports on Forms 10-K, 10-Q, and 8-K, to name the most common—are, broadly speaking, filed by issuers whose securities are widely held and traded on an exchange.

¹¹ Item 303(a)(3)(ii) of Regulation S-K, 17 C.F.R. sec. 229.303(a)(3)(ii).

¹² Securities Act Release No. 6835 (May 18, 1989), Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, 54 FR 22427, 22438 (footnote omitted).

¹³ Release No. 33-8182, Final Rule: Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations.

¹⁴ Alan L. Beller, Speech, Rocky Mountain Securities Conference, Denver, CO (May 17, 2002).

Young discussed materiality, which is a flexible concept like the MD&A. The Financial Accounting Standards Board (FASB) has stated that “[t]he omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.”¹⁵ In 1999, SEC Staff rejected the use of quantitative “rules of thumb,” stating that a quantitatively immaterial item may nonetheless be qualitatively material under the circumstances.¹⁶

The SEC designed the MD&A to give investors a view of the company through management’s eyes. The Commission hoped that the MD&A would complement backward-looking information in financial statements. The MD&A would thus help investors understand the extent to which a company’s earnings were likely to be recurring. This is a critical factor in valuing a security.

The flexibility of the MD&A guidelines, concerning the content of disclosure and the related analytical methods that companies use, has advantages:

- Disclosure can be tailored to each individual company depending on its strengths and challenges.
- The disclosure requirements need not be revised to keep up with a changing business environment.
- Materiality is determined in light of all the facts and circumstances, and not by reference to an easily-skirted numeric threshold.

But the MD&A’s flexibility also carries with it several disadvantages:

- Companies make the decisions about what must be disclosed, and outsiders may not have all the information they need to evaluate these decisions.
- Disclosure can be inconsistent from company to company, even when their businesses are very similar.

With some exceptions such as disclosure by mutual funds, SEC staff in the Division of Corporation Finance is charged with enforcing the disclosure requirements. Historically, the SEC has been extremely under-resourced. Although some investors have assumed that SEC staff regularly reviews registration statements and periodic filings, in reality they only review a small fraction of them. Because new issuers tend to have the most disclosure problems, staff attention is focused on registration statements filed in connection with initial public offerings (IPOs). This was especially true during the bull market of the late 1990s.

¹⁵ Statement of Financial Accounting Concepts No. 2.

¹⁶ SEC Staff Accounting Bulletin No. 99—Materiality (August 12, 1999).

Inadequate disclosure is most frequently addressed through “comment letters” from staff to a company. These letters will soon be available on the SEC’s web site. However, when staff finds a systematic problem, the SEC can issue a Staff Guidance or an interpretive release.

Interpretive releases allow the SEC to offer substantial direction to companies without engaging in rulemaking. The Commission has used this tool several times to discuss MD&A disclosure. For example, subsequent to its comments suggesting that better enforcement and clarity under the existing rules would be helpful, the Commission in 1989 issued an interpretive release clarifying the MD&A requirement.¹⁷ The release followed an internal SEC study of the quality of MD&A disclosure, identifying several areas in which disclosure was inadequate.

Participants acknowledged that an interpretative release cannot impose new substantive requirements, or formal rulemaking—an extended and often difficult process—will be triggered. But they also acknowledged that there is empirical and legal support for an interpretative release. At present there exists considerable confusion about the application of existing rules and their enforcement concerning climate change.

Clearly, an interpretative release could be developed by the SEC to clarify a company’s disclosure obligations under current MD&A requirements. Such a release would:¹⁸

- Remind companies that climate risk is not confined solely to emitters of greenhouse gases, but may be a material risk to companies in a variety of industries;
- Reinforce the presumption that a risk must be disclosed unless a company can conclude it is not reasonably likely to come to fruition, or if it is, that a material effect on the company’s operations is not reasonably likely to occur;
- Provide examples of boilerplate and generic disclosure that do not comply with the rules or the SEC’s previous guidance; and
- Discuss the circumstances under which quantification of risk is required.

Having heard evidence that compliance with existing rules is spotty, the Forum compared the merits of disclosure mandated by regulation (mandatory disclosure) with disclosure obtained on a company-by-company basis through engagement, activism or other means (voluntary disclosure). Several participants representing financial firms argued that private disclosure driven by market considerations—for example, the desire of a company to borrow money or obtain equity financing at the lowest possible cost—is often more helpful than disclosure in SEC filings. One observed that before FASB mandated better financial statement disclosure of pension obligations, market participants were already making such disclosures.

¹⁷ See SEC Release Nos. 33-6835, Management’s Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures (May 18, 1989).

¹⁸ For more information on the need for interpretive guidance on disclosure of climate risk, see Ceres Memorandum to the SEC: Corporate Disclosure of Risks Related to Climate Change (May 11, 2004), available at http://incr.com/wc_lead_forum.htm.

Participants debated the effects of disclosure by a few companies such as Ford and American Electric Power (AEP). Whatever their motive—investor pressure, desire for good will, or desire for competitive advantage—these companies have provided voluntary disclosure of climate risk. Their efforts serve as a model for others. Some participants argued that Ford and AEP’s actions put pressure on other companies to disclose or risk seeing their cost of capital rise. However, a corporate representative countered that more disclosure could sometimes put a company at a competitive disadvantage. Moreover, as an NGO participant noted, sometimes the “market shoots the messenger” before finally accepting that the issue is real.

Although approving of voluntary disclosure, most Forum participants argued in favor of mandatory disclosure. Several argued that markets are imperfect and do not always recognize important issues before a crisis develops. Many participants expressed concern about the short-term focus of financial markets, and their disconnect with the longer-term investment horizons of institutional investors. Further, several institutional investor participants bemoaned the resource-intensive nature of seeking voluntary disclosure on a company-by-company basis. Clearly participants agreed that mandatory disclosure, if climate change is determined to be a material risk, will require more robust reporting and will induce a more robust response from affected companies.

Discussion centered on the structural reasons why companies might not disclose climate risk or might have inadequate disclosure. Several participants believed that institutional change—within corporations as well as between corporations and their advisors—must happen to ensure optimal climate risk disclosure. A few participants who work with corporations or outside counsel remarked that information is often compartmentalized, and measures must be put in place to ensure that it flows to those responsible for preparing and reviewing SEC filings, and to the board of directors. An SEC interpretive release could facilitate such institutional change by reminding corporate counsel of their responsibility to ensure that they have all relevant information and that the information is up-to-date. Increased attention to this issue could also lead company attorneys to ask environmental managers or others with relevant technical or strategic expertise to review portions of the MD&A before filing.

Several Forum participants expressed concern about the SEC staff’s capacity to evaluate companies’ analyses of climate risk. One institutional investor participant opined that the SEC’s staff appeared to question the scientific basis for climate risk and did not seem to understand the risks to companies. Another participant suggested that the SEC could require more raw data from companies and let investors perform their own analyses. Many participants disagreed with this approach, however, arguing that the MD&A is geared toward analysis—seeing the company through the eyes of management—and that analysis is not only possible, but is almost certainly being done already within companies. A consensus supported seeking higher quality analysis.

Making Climate Risk Disclosure Useful to Investors

The Forum discussed how the SEC can help shape climate risk disclosure that is truly useful to investors. Participants heard from a large U.S. institutional investor and a former White

House climate change expert, who drew from both U.S. and foreign sources for possible solutions.

An Institutional Investor Perspective

Howard Rifkin, Deputy Treasurer of the State of Connecticut, stated that he views climate risk through the lens of fiduciary responsibility to the participants and beneficiaries of the \$20 billion Connecticut State Retirement Plans and Trust Funds (CRPTF). Because 80% of the CRPTF's domestic equity allocation is invested passively, the fund remains invested in each of the companies in the relevant indices¹⁹, unless they are dropped from an index. Thus, it is important for the CRPTF to ensure that index companies are managing and disclosing climate risk adequately.

Rifkin explained that there are four routes to ensuring adequate climate risk disclosure: regulation, voluntary action by corporations, market mechanisms, and litigation. Rifkin argued that an SEC interpretive release would improve climate risk disclosure across the wide spectrum of companies in which the CRPTF invests. As to the likelihood of success, Rifkin stated that he is both a cynic and an optimist. Rifkin noted that the SEC has been under tremendous pressure to perform at a high level following the wave of corporate scandals that started with Enron in 2001. In this context, the SEC has received additional resources. The increased U.S. focus on corporate governance and other "soft" factors could also help persuade the SEC to issue an interpretive release, especially since climate risk is arguably more quantifiable than those factors.

Models for Climate Risk Disclosure

David Gardiner, president of David Gardiner and Associates and former director of the White House Climate Change Task Force, outlined some investor-driven models or approaches that could guide the SEC as it seeks to enhance climate risk disclosure. He described three types of tools that are useful to investors:

- Corporate governance assessments, which evaluate a company's response to climate risk, including the extent to which climate change is handled as a strategic challenge;
- Emissions assessments, which benchmark a company's exposure; and
- Financial assessments, which determine the financial effect on the company of climate risk and associated regulatory responses.

Gardiner provided examples of each. Corporate governance assessments include studies of disclosure like Chan-Fishel's survey, and evaluations of risk management and board

¹⁹ Passive investors invest in all stocks in a particular stock index, such as the Standard & Poor's 500 index of large capitalization stocks. The success of the strategy thus depends on the strength of the market represented by the index, rather than on stock-picking ability or other active management techniques.

processes, like those promulgated by the Carbon Disclosure Project, and by Ceres in conjunction with the Investor Responsibility Research Center.

For benchmarking tools, Gardiner discussed the Ceres/National Resources Defense Council/PSEG Electric Utility benchmarking study, which rated companies based on total emissions and emissions per kilowatt hour, as well as Environmental Defense's Auto Carbon Burdens assessment tool for vehicles. He noted that his position differs from other participants regarding the usefulness of emissions data in evaluating climate risk. On balance, Forum participants believed that emissions data could serve a useful benchmarking function, and could assist investors who screen for social factors to identify companies in which to invest.

Gardiner offered studies by Innovest/World Wildlife Fund and the World Resources Institute, as well as American Electric Power's own analysis of its climate risk, as examples of financial assessments that investors can use. He praised AEP's report for identifying strategic choices, quantifying the impact of possible scenarios, and discussing technological options.

Finally, Gardiner highlighted the approaches taken by regulators in the U.K. and France:

- In the U.K., proposed rules would require the Operating and Financial Review (the British analogue to the MD&A) to include "information relating to environmental matters and employee matters" as well as "[t]he main trends and factors which are likely to affect their future development, performance and position."
- The U.K.'s *OFR: Practical Guidance for Directors*²⁰ recognizes the importance of the indirect effects of climate change, stating that "while climate change may not be an immediate risk to many businesses, the longer term consequences may be highly significant in terms of the price of energy, or insurance coverage for manufacturing facilities in low-lying areas."
- France requires public companies to report on how they take into account "the social and environmental consequences of [their] activities." Companies must report on 40 variables, including energy consumption, energy efficiency measures, and emissions.

Gardiner emphasized that some companies, including those that do not make specific disclosure statements, are likely already analyzing climate risk when they make long term investment decisions and report emissions to governmental entities. Many of these companies will not be asked to do something new.

The Forum agrees that the U.K. standard provides useful guidance, and a number of participants urged that the threat of competitive disadvantage for American companies functioning in Europe should be stressed when pressing the SEC on climate risk disclosure.

²⁰ U.K. Department of Trade and Industry, *The Operating and Financial Review: Practical Guidance for Directors* (2004).

There was also concurrence that the definition of a “reasonable investor,” on which the determination of materiality hinges, has changed, especially if one considers non-U.S. investors.

The attendance of institutional investors such as Goldman Sachs at the 2003 U.N. Investor Summit on Climate Risk shows that the issue is no longer the concern solely of socially conscious investors, but is considered a risk factor that affects investment decision making for large companies. As measured by votes on shareholder proposals, climate change is now on par with executive compensation, board diversity and other corporate governance issues. For example, a 2003 proposal on disclosure of climate change at AEP was supported by 27 percent of shares voting, and 24 percent of shares favored a proposal that year at TXU. This level of interest contrasts starkly with the level of interest found by the SEC in 1975 and 1980, when the SEC rejected efforts to require broad social disclosure on the ground that only a tiny sliver of investors—so-called “ethical investors”—desired the disclosure.²¹

Several Forum participants, while acknowledging the desirability of SEC action, argued that investors should continue using other tactics, especially engaging investment managers and consultants who know something about climate risk. One participant echoed that sentiment, noting that institutional investors like Fidelity are more activist outside the U.S. when pressured by clients. Concern was expressed by several participants from diverse backgrounds that institutional investors may be discouraging investment managers from thinking about long term issues, because performance benchmarking and compensation tend to be based on relatively short periods of time.

Where Do We Go From Here? The SEC and Climate Risk Disclosure

Former U.S. Senator and United Nations Foundation President Timothy Wirth posited that the “tipping point”—when climate risk and energy issues take center stage and climate change is indisputably considered to pose a material financial risk to companies—will arrive soon. He pointed to several developments that, notwithstanding the U.S.’s rejection of the Kyoto Protocol, are speeding the arrival of this tipping point, including:

- Tony Blair’s leadership in committing to reduce carbon emissions 60 percent in the United Kingdom by 2050;
- Implementation of the Kyoto Protocol by signatories, including the European Union, following the recent ratification by Russia that brings the treaty into force;
- Unexpectedly strong support in the Senate for the McCain-Lieberman Climate Stewardship Act of 2003²², and McCain’s promise to continue moving this issue in Congress; and

²¹ Cynthia A. Williams, “The Securities and Exchange Commission and Corporate Social Transparency,” 112 Harv. L. Rev. 1197, 1251-53, 1262 (1999).

²² The bill received support from 43 Senators in a vote held on October 31, 2003.

- Increased recognition by corporations that climate change can create opportunities as well as risks.

Forum participants agreed that climate risk creates real and material financial exposures for some companies. There was broad agreement that the climate risk report recently issued by AEP in response to urgings by shareholders shows that analysis of climate risk is feasible, and companies should not be permitted to claim that the risk is too speculative or too difficult to analyze and therefore should not be disclosed to investors. Participants further concurred that analyzing the financial impact of emissions restrictions is especially urgent now that the Kyoto Protocol will soon be operational.

Recommendations and Next Steps

Forum participants agreed that most companies are not fully disclosing the material financial risks posed by global climate change, thus putting investors at risk. This problem calls for a response by the SEC, which has primary responsibility for remedying failures of MD&A disclosure. The SEC can improve disclosure substantially simply by issuing an interpretive release.

An interpretive release would clarify companies' obligations under the existing disclosure rules and provide examples to assist corporate counsel. Such a release could improve disclosure in several ways—by reminding companies to avoid unhelpful boilerplate disclosure, by providing examples of sufficient and insufficient disclosure, and by clarifying companies' obligation to quantify climate risk, where feasible. It would also likely stimulate the institutional change within companies and in the relationship between companies and their outside counsel needed to ensure that material information within companies is made available to investors.

To that end, the Forum recommended that institutional investors and their corporate as well as non profit, public sector and University colleagues continue the dialogue concerning issuance of an interpretative release with the SEC. Institutional investors should also raise awareness of the climate risk issue by engaging members of Congress and other regulatory agencies such as the EPA and the Department of Energy. Finally, methodologies to evaluate climate risk, now being developed by scholars and by companies that are providing voluntary disclosure, should be furnished to the SEC to provide assurance that meaningful disclosure is possible.

Appendix A: Sponsors

Ceres

Ceres' vision is of a world where a robust business community contributes to the ecological health of the planet and the welfare of human society.

Ceres' mission is to move businesses, capital, and markets to advance lasting prosperity by valuing the health of the planet and its people.

Ceres is a coalition of 85 activist and investor organizations united to advance corporate responsibility. Managing more than \$400 billion in assets, investor members of Ceres include state and municipal pension funds, socially responsible investment firms, religious groups, union funds, and foundations. It is this unique combination of the investor perspective, which requires profitable companies and robust economies, and the environmental perspective, which prizes the goal of a healthy planet, that shapes Ceres' strategies and methods. We believe that economic prosperity and protection of the earth cannot be pursued separately.

Ceres' work on corporate accountability began in 1989 with the Ceres Principles, a 10-point code of corporate environmental conduct. Today more than 70 companies have adopted the Principles and joined Ceres as corporate endorsers, including Bank of America, Baxter International, Coca-Cola, Ford, General Motors, Nike and Sunoco. In partnership with the United Nations Environment Programme, Ceres created the Global Reporting Initiative (GRI), an international, multi-stakeholder effort to create a common framework for reporting the economic, environmental and social impacts of corporate activity.

Ceres is secretariat for the Investor Network on Climate Risk (INCR). Launched in 2003 by 10 investor leaders at the Institutional Investor Summit on Climate Risk at the United Nations, INCR promotes better understanding of the risks of climate change among institutional investors. INCR also coordinates actions by institutional investors to reduce portfolio exposure to large financial risk resulting from the economic costs and opportunities associated with climate change.

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The Wirth Chair in Environmental and Community Development Policy

The Wirth Chair is committed to helping governments, businesses, non-profit groups and community organizations form sustainable development partnerships that carefully balance economic, environmental and expanded social welfare objectives and strategies.

Mission

The mission of the Wirth Chair is to foster effective sustainable development strategies that will strive to meet the needs of the present without compromising the ability of future generations to meet their own needs.--The Brundtland Commission

The Wirth Chair works to develop:

- meaningful environmental protection policies and programs
- cost-effective energy management and energy efficiency programs
- sound greenhouse gas emission reduction strategies
- fair and effective growth management strategies

Background

In 1993, the University of Colorado established the Wirth Chair in Environmental and Community Development Policy. It is the first Chair in public policy in the University and the only Chair at the University of Colorado at Denver. It honors the environmental and sustainable development achievements of former Senator and Undersecretary of State Timothy E. Wirth. Wirth's work in Congress, in the State Department and now as President of the United Nations Foundation has truly made a difference. His efforts have helped foster an improved quality of life for individuals in Colorado, in the United States and throughout the world.

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Appendix B: Participants

Climate Change Risks and the SEC

A Leadership Forum Sponsored by

Ceres &

The Wirth Chair in Environmental and Community Development Policy

October 18, 2004, The Aspen Institute, Washington, DC

John Beale	Environmental Protection Agency
Mitchell Berns	Hargraves McConnell & Costigan, P.C.
Michelle Chan-Fishel	Friends of the Earth
William Chew	Standard & Poor's
Jim Coburn	Ceres
Doug Cogan	Investor Responsibility Research Center
Reid Detchon	Energy Future Coalition
Amir Dossal	United Nations Fund for International Partnerships
Sally Ericsson	Pew Center on Global Climate Change
Steve Eubanks	State of North Carolina, Treasurer's Office
Chris Fox	Ceres
Julie Fox Gorte	Calvert Group
Taryn Fransen	United Nations Foundation
Rob Frederick	Ford Motor Company
David Gardiner	David Gardiner & Associates
Gary Guzy	Marsh Inc.
Mark Helmke	Senate Foreign Relations Committee
Marshall Kaplan	Merage Foundations for the American Dream
Tim Little	Rose Foundation for Communities and the Environment
Mindy Lubber	Ceres

Steven Lydenberg	Domini Social Investments
Louis Malizia	International Brotherhood of Teamsters
David Maltz	Cinergy Corporation
Duncan Marsh	United Nations Foundation
Chris Miller	Senate Committee on Environment and Public Works
Michael Moran	Goldman, Sachs & Co.
Robert Repetto	Stratus Environmental Consulting, Inc.
Howard Rifkin	Connecticut Office of the State Treasurer
Jack Riggs	The Aspen Institute
Helen Sahi	Bank of America
David Sandalow	The Brookings Institute
John Stanton	National Environmental Trust
Allan Wallis	Wirth Chair, University of Colorado at Denver
Kathleen Welch	The Pew Charitable Trusts
Fred Wellington	World Resources Institute
Caroline Williams	Nathan Cummings Foundation
Cynthia Williams	The University of Illinois College of Law
Timothy E. Wirth	United Nations Foundation
Diane Wittenberg	California Climate Action Registry
David Wood	Standard & Poor's
Beth Young	The Corporate Library