Climate Change Risk Disclosure: An Update on Evolving Voluntary and Mandatory Reporting Programs and Implications for Insurers and Their Insureds

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Interest in corporate disclosure of climate change-related risks continues to grow. The mortgage-backed securities debacle and the falling stock market are leading to investor demands for more disclosure of climate change-related risks. Investors want more information on the business risks and opportunities resulting from climate change. As a result, in October 2008, the Investor Network on Climate Risk, representing a large number of institutional investors, again called on the SEC to clarify the disclosure requirements for climate change risks. Shareholders also have been filing a record number of climate change-related shareholder resolutions, some of which called for increased disclosure.[1] State regulators also have developed a heightened interest in climate change risk disclosure. For example, the National Association of Insurance Commissioners (NAIC) Climate Change and Global Warming Task Force approved a climate risk disclosure survey on February 24, 2009, and the NAIC Executive Committee likely will vote on the proposal at its March 2009 meeting. If adopted by the NAIC, individual states could then enact the climate risk disclosure requirements for insurers in 2009 and require initial responses in 2010. This development comes on the heels of the New York Attorney General's settlements with two major power companies relating to reporting of climate change risks on their Form 10-Ks to the SEC. Insurers and their insureds, therefore, need to monitor and address the existing and forthcoming climate change risk reporting requirements.

Many companies already participate in a number of voluntary reporting programs. Over the last several years, voluntary reporting programs including the Ceres Carbon Disclosure Project (and voluntary programs for reporting greenhouse gas emissions such as the Climate Registry, EPA Climate Leaders, and a Department of Energy program) have been developing but responsiveness has varied because the programs are not mandatory. Recently, standard-setting organizations such as ASTM and trade associations also have expressed interest in developing climate risk disclosure guidance. In deciding how to respond to requests for climate change risk disclosure, companies must balance the mounting public pressure for disclosure, the resources needed to address overlapping yet differing disclosure questions, the need to protect competitively sensitive confidential business information from disclosure, and the difficulty in estimating the business risks posed by climate change. Mandatory risk disclosure requirements for insurers seem likely to develop in this economic and political climate.

Below is a summary and discussion of some of the existing mandatory and voluntary climate-related reporting programs and the possible development of additional mandatory standards.

Existing Mandatory Disclosure Requirements

SEC Requirements

Publicly traded companies may have an obligation to disclose certain kinds of climate change-related risks under existing regulations pursuant to SEC Regulation S-K, which governs the contents of periodic reports filed with the SEC.

Item 101 of Regulation S-K requires companies to disclose material costs and effects of compliance with environmental laws and anticipated material capital expenditures for environmental control facilities.[2] Companies would need to disclose material expenditures on emissions controls subject to this provision. Companies could benefit from guidance on determinations of materiality in the climate change context. Similarly, Item 503 of Regulation S-K requires discussion of significant risk factors faced by publicly traded companies. These risk factors often include discussion of environmental risks when environmental issues are significant enough to trigger disclosure under Item 101.

Item 103 requires companies to disclose material pending legal proceedings other than ordinary routine litigation incidental to a company's business.[3] Companies subject to this provision often have to disclose material environmental proceedings because the requirement specifies that administrative or judicial proceedings arising under provisions relating to the discharge of materials into the environment or for the primary purpose of protecting the environment are not considered ordinary and routine.

Item 303, the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), requires companies to "describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[4] Pursuant to the MD&A requirement, companies with significant climate change risks could be required to disclose those risks. Proponents of more disclosure argue that at this point in the debate, climate change could qualify as a "known trend" or at a minimum a known uncertainty that will have a material effect on continuing operations. Costs associated with enactment of climate change legislation and regulations and severe weather events could also fall within this disclosure obligation.

Sarbanes-Oxley Act requirements also could be relevant to climate change risk if climate risks are deemed "material." The Act creates civil and criminal penalties for the violation of detailed reporting and certification requirements.[5] Section 302 of the Act, for example, requires CEOs and CFOs to certify that a financial report "does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading."[6] Section 302 also requires CEOs and CFOs to fairly present in all material respects the financial condition and results of operations in financial statements.[7] As legal requirements for control of GHG emissions evolve, and disclosure obligations with respect to the effects of environmental and climate change risks expand, these certification requirements could take on new meaning for companies and their officers as they examine whether they have sufficiently addressed these issues in their periodic reports.

Recent repeated requests by investors for SEC guidance demonstrate that there is uncertainty about what climate risks must be reported pursuant to current laws and regulations. In response to the request for comments on the SEC's 21st Century Disclosure Initiative, in October 2008, the Investor Network on Climate Risk (INCR) called for SEC guidance on climate change risk disclosure.[8] This is the latest request for climate risk guidance from this significant group of investors. The INCR previously sought guidance from the SEC on climate risk disclosure in 2004 and 2006.[9] The INCR has argued that SEC filings, corporate sustainability reports, and voluntary responses to questionnaires provide insufficient information for investors to evaluate climate risk, and thus more disclosure in SEC documents is needed.[10] In September 2007, a group of investors, state regulators, and environmental groups, including some INCR members, petitioned the SEC for changes but so far no action has been taken.[11] The SEC eventually may respond to these requests by issuing guidance, but states likely will take the lead in requiring climate risk disclosure.

New York State Disclosure Trends

New York regulators have chosen to move ahead without waiting for SEC guidance. The New York Attorney General recently applied its interpretation of the SEC disclosure requirements for high-carbon emitters such as power companies. In September 2007, AG Andrew Cuomo subpoenaed the executives of several energy companies, including Dynegy, Xcel, AES, Dominion Resources, and Peabody Energy, seeking information on whether disclosures to investors in filings with the SEC adequately described the companies' financial risks related to global warming. New York attorney generals have used their broad powers to investigate financial records of target companies now in the environmental context. AG Cuomo used New York's authority under the Martin Act of 1921, N.Y. Gen. Bus. Stat. Art 23-A, § 352 et seq. and Executive Law § 63(12) to pursue these power companies.

AG Cuomo settled with Xcel on August 26, 2008 and Dynegy on October 23, 2008.[12] Pursuant to the settlement agreements with Xcel and Dynegy, Xcel and Dynegy agreed to provide disclosure of material risks associated with climate change in its "Form 10-K" filings, the annual summary report on a company's performance required by the SEC. The required disclosures include an analysis of material financial risks from climate change related to (1) present and probable future climate change regulation and legislation; (2) climate-change related litigation; and (3) physical impacts of climate change.

Additionally, Xcel and Dynegy have committed to a broad array of climate change disclosures including: (1) current carbon emissions; (2) projected increases in carbon emissions from planned coal-fired power plants; (3) company strategies for reducing, offsetting, limiting, or otherwise managing its global warming pollution emissions and expected global warming emissions reductions from these actions; and (4) corporate governance actions related to climate change, including if environmental performance is incorporated into officer compensation.

AG Cuomo is still negotiating with AES, Dominion Resources, and Peabody Energy. Through use of New York law, the New York AG has stepped up the disclosure requirements for companies doing business in the state even though the SEC has not yet chosen to take such significant steps. Given AG Cuomo's initial successes, New York may serve additional subpoenas on companies trading securities in New York. So far, New York has targeted power companies. Publicly traded companies in other carbon-intensive sectors of the economy or even companies with lower emissions should consider whether their reporting would satisfy the standards being imposed by New York. Both insurers and insureds in carbon-intensive sectors should evaluate coverage for potential claims and monitor state-level actions related to disclosure that may affect their business operations.

Existing Voluntary Disclosure Programs

Ceres and the Carbon Disclosure Project

One of the best known voluntary disclosure programs is the Carbon Disclosure Project run by Ceres. Ceres is a coalition of investors, environmental groups, and other public interest organizations. In 2006, Ceres developed a Global Framework for Climate Risk Disclosure and encouraged companies to apply the framework through mandatory and voluntary reporting mechanisms.[13] The Framework recommends four elements of disclosure: (1) total historical, current, and projected greenhouse gas emissions, (2) strategic analysis of climate risk and emissions management, (3) assessment of physical climate risk, and (4) analysis of risk related to the regulation of greenhouse gas emissions. Ceres also directs the Investor Network on Climate Risk, which has been actively petitioning the SEC and NAIC for mandatory climate risk disclosure requirements.

Since 2003, Ceres has issued a questionnaire each year seeking information on the business risks and opportunities presented by global warming and greenhouse gas emissions data from the world's largest companies. Companies can choose whether or not to make their response to Ceres publicly available. Ceres reviews the responses and assigns each company a score. The companies with the highest scores in the carbon-intensive and non-carbon-intensive sectors are included in the Carbon Disclosure Leadership Index.

Not all companies have agreed to participate, but voluntary participation in the Carbon Disclosure Project has continued to grow each year in large part due to peer pressure and investor demands. For example, in 2008, 77% of FTSE Global Equity Index Series companies (the "Global 500") and 64% of S&P 500 companies responded to the CDP questionnaire.[14] 85% of

Global 500 respondents and 77% of S&P 500 respondents made their responses publicly available.[15] The responses of the remaining companies were available only to Ceres.[16]

Future Mandatory Disclosure Requirements

NAIC Disclosure and Expected State Disclosure Requirements for Insurers

After working on many iterations of an insurer climate risk disclosure questionnaire over the last couple of years, the NAIC Working Group on Climate Disclosure ("Working Group") approved a Climate Risk Disclosure Survey for insurers in December 2008. The Working Group's parent, the NAIC Climate Change and Global Warming Task Force led by Wisconsin Insurance Commissioner Dilweg, approved the Survey on February 24, 2009. The NAIC Executive Committee will vote on the proposed Survey at or before its March meeting, and states likely will begin requiring insurers to complete the disclosure survey in 2010.

According to the Working Group, the proposed Climate Risk Disclosure Survey is intended "to provide regulators, shareholders and the public with substantive information about risks posed by climate change to insurers and the actions insurers are taking in response to their climate change risks."[17] The Working Group also has noted that the proposal is important to evaluation of insurer solvency and assurance of insurance availability and affordability. Insurers receiving over $300-500 million in premiums would have a mandatory reporting requirement, depending on when the survey is approved and codified by the states. There is some confusion over where the insurer will be required to report. The Working Group has stated that survey responses should be submitted to the insurer group's lead state, the regulator overseeing the insurers within the group that reports the largest direct written premium volume. States likely will clarify this jurisdictional requirement when they adopt the survey.

The Climate Risk Disclosure Survey under final consideration by the NAIC Task Force and Executive Committee contains the following eight questions:

- Does the company have a plan to assess, reduce or mitigate its emissions in its operations or organizations? If yes, please summarize.

- Does the company have a climate change policy with respect to risk management and investment management? If yes, please summarize. If no, how do you account for climate change in your risk management?

- Describe your company's process for identifying climate change-related risks and assessing the degree that they could affect your business, including financial implications.

- Summarize the current or anticipated risks that climate change poses to your company. Explain the ways that these risks could affect your business. Include identification of the geographical areas affected by these risks.

- Has the company considered the impact of climate change on its investment portfolio? Has it altered its investment strategy in response to these considerations? If so, please summarize steps you have taken.

- Summarize steps the company has taken to encourage policyholders to reduce the losses caused by climate change-influenced events.

- Discuss steps, if any, the company has taken to engage key constituencies on the topic of climate change.

- Describe actions your company is taking to manage the risks climate change poses to your business including, in general terms, the use of computer modeling.

The instructions accompanying the survey state that insurers can submit narrative responses and that insurers are not required to submit quantitative information, commercially sensitive or proprietary information, or forward-looking information. The NAIC provided these caveats in response to industry concerns with disclosure of proprietary information to competitors, potential liabilities associated with forward-looking information that may turn out to be confusing or misleading, and the difficulty in quantitatively calculating climate risk at this stage of the climate debate. Earlier versions of the risk survey required (1) submission of forward-looking information but provided that such submissions would be subject to safe harbor protection, and (2) provided for submission of proprietary and commercially sensitive information on a confidential basis. Some insurers, however, were concerned that states did not have a means of enforcing a safe-harbor provision or to protect the confidential information. Thus, compromises were made resulting in the current proposal. The caveats for forward-looking and proprietary information in the new version, however, have not assuaged all concerns because the questions themselves appear to conflict with the instructions in that they appear to seek out forward-looking and quantitative information that is deemed not required in the instructions.

The interpretation of instructions and survey questions likely will play out at the state level. Insurers likely will learn from the states how much detail is expected and required. The NAIC Task Force, however, has vowed to work with states to enact the model survey so that states do not develop a burdensome patchwork of different disclosure requirements. Consistency has been a concern since the Working Group decided not to include the climate risk questions in the insurers' required annual financial statement filings with state regulators.

Insurers and insurance industry trade groups should continue to work with state regulators on climate risk disclosure issues. If adopted, it is not yet clear how regulators plan to review and use the insurer responses.

EPA Greenhouse Gas Reporting Rule

The EPA also is developing a rule requiring reporting of greenhouse gas emissions. Fiscal Year 2008 Consolidated Appropriations Act, Public Law 110-161, directed EPA to publish a mandatory greenhouse gas reporting rule pursuant to the Clean Air Act. The explanatory note in the Appropriations Act stated that EPA should "use its existing authority under the Clean Air Act" to develop a mandatory greenhouse gas reporting rule. The 2008 Appropriations Act stated that "not less than $3,500,000 shall be provided for activities to develop and publish a draft rule not later than 9 months after the date of enactment of this Act, and a final rule not later than 18 months after the date of enactment of this Act, to require mandatory reporting of greenhouse gas emissions above thresholds in all sectors of the economy." EPA missed the September 2008 deadline for a proposed rule.

On March 10, 2009, the EPA Administrator proposed a rule that requires mandatory reporting of greenhouse gas emissions from large sources in the United States. The EPA proposed that suppliers of fossil fuels or industrial greenhouse gases, manufacturers of vehicles and engines, and facilities that emit 25,000 metric tons or more per year of greenhouse gas emissions submit annual reports to EPA. The gases covered by the rule include carbon dioxide (CO_2), methane (CH_4), nitrous oxide (N_2O), hydrofluorocarbons (HFC), perfluorocarbons (PFC), sulfur hexafluoride (SF_6), nitrogen trifluoride (NF_3), and hydrofluorinated ethers (HFE). The purpose of the reporting rule is to gather accurate data that can be used for future climate change policies and programs, such as emissions trading, as well as to establish one consistent standard for measuring and reporting emissions. This EPA reporting rule will affect a number of categories of insureds. Stakeholders will have sixty days to comment on the proposed rule.

The Evolving Playing Field

Climate risk disclosure programs and standards continue to appear on the horizon. ASTM, for example, is in the process of drafting a standard for climate change financial disclosures. Some trade associations also have indicated that they may weigh in on disclosure standards. With more and more reporting programs and standards developing, there is a need for consistency in the evolving disclosure standards. The SEC should clarify the climate risk financial disclosure requirements for publicly traded companies. Voluntary reporting organizations, however, likely will lead the way in establishing climate risk disclosure programs and standards. States likely will weigh in first on disclosure requirements for insurers, and state requirements will apply to all insurers, not just publicly traded entities.

Implications for Insurers and Insureds

Rising demands for climate risk disclosures affect insurers in two ways. First, insurers may choose to respond to voluntary programs such as the CDP and may have obligations to disclose risks in SEC filings or to state insurance regulators. Inaccurate or misleading disclosures could lead to shareholder lawsuits (depending on how the insurer is organized), problems with state regulators, and loss of good will. Second, insurers may be subject to claims arising out of their insureds' voluntary or mandatory climate change risk submissions.

Insurer Corporate Liability

In order to avoid any direct liability or loss of good will, insurers need to ensure that their disclosures of climate risk are well thought out and accurate. Outside the emissions reporting context, narrative answers may be more accurate and less misleading than quantitative financial responses based on assumptions and many uncertainties. Narrative answers may provide for better protection of confidential business information yet still satisfy the request for climate risk disclosure. Companies, however, should follow generally accepted accounting principles in their responses. Consistency in reporting to various entities is also important. Because the scientific, regulatory and legislative environment for climate change is so dynamic, disclosures also should be periodically updated to reflect new trends.

Developing proper responses will take significant resources but the input of time is worthwhile. If companies do not address these upcoming disclosure requirements seriously, they could face unwanted claims from investors and regulators. Companies, however, will be better able to assess, plan for, and capitalize on the potential risks of climate change through the disclosure process.

Impacts on Underwriting and Claims Exposure

As climate risk disclosure increases, insurers may review the climate risk disclosures of their clients in underwriting comprehensive general liability, directors and officers, and other policies. This will help insurers better understand and price the risks they are underwriting. Insurers should consider requiring submission of climate change-related disclosures during the underwriting process.

Actions by shareholders or regulators against insureds based on inaccurate or otherwise faulty climate risk disclosures, however, may lead to a rise in D&O claims. Given the difficulties with climate change tort litigation (e.g., standing, causation, the political question doctrine), plaintiffs may set their sights on claims related to climate risk disclosure issues rather than on tort theories. Insurance coverage disputes are likely to arise out of interpretation of pollution exclusions, severability clauses, and the definition of the insurance application in D&O policies. Depending on the jurisdiction, rescission of D&O liability policies also could be considered if there were misrepresentations in the application to obtain the policies. Given the rising interest in climate risk disclosure, insurers should consider these issues and evaluate their current underwriting and claims handling practices and insureds should evaluate their current coverage and working with their underwriters to obtain the desired coverage.

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[1] Ceres, *Investors File Record Number of Global Warming Resolutions with U.S. Companies, 14 Resolutions Already Get Results From Companies*, Press Release, March 6, 2008.
[2] 17 C.F.R. § 229.101.
[3] 17 C.F.R. § 229.103.
[4] 17 C.F.R. § 229.303.
[5] 15 U.S.C. § 7241; 18 U.S.C. § 1350.
[6] 15 U.S.C. § 7241.
[7] *Id.*
[8] Letter from INCR to Florence Harmon, Oct. 22, 2008. The letter is available at www.incr.com.
[9] Letter from INCR to Christopher Cox, June 14, 2006 (also referring to the 2004 letters). The letter is available at www.incr.com.
[10] *Id.*; *see also supra* note 5.
[11] The petition is available at www.incr.com.
[12] The settlements are available at http://www.oag.state.ny.us/media_center/2008/oct/oct23a_08.html and http://www.oag.state.ny.us/media_center/2008/aug/aug27a_08.html.
[13] The Framework is available at www.incr.com.
[14] 2008 Carbon Disclosure Project Quick Facts, available at http://www.cdproject.net/reports.asp.
[15] *Id.*
[16] *Id.*
[17] The proposed Climate Risk Disclosure Survey and related comments are available at http://www.naic.org/committees_ex_climate_risk_disclosure.htm.