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Climate Change Disclosure Heats Up

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What public companies are, and are not, disclosing about their climate change risks and opportunities is becoming increasingly important in Canada and the United States. Securities regulators in Ontario and Alberta are scrutinizing environmental disclosure in general, and institutional investors are engaging in discussions with them about climate risk. In the United States, renewed pressure continues to mount on the Securities and Exchange Commission (SEC) to focus on climate change disclosure, and state regulators are beginning to take up the issue. Following the recent U.S. election, there is a heightened expectation that climate change disclosure requirements will receive further attention.

At the same time, the regulatory environment is rapidly developing. In Canada, the federal government's framework continues to evolve alongside efforts of individual provinces to regulate carbon emissions, to participate in regional cap-and-trade initiatives and to impose carbon taxes. To obtain the data necessary to effectively develop these initiatives, some jurisdictions have begun to require large industrial emitters to disclose information about their greenhouse gas (GHG) emissions.

More significantly, voluntary disclosure initiatives are proliferating as a result of pressure from institutional investors and other stakeholders. Key examples of that pressure include the adoption of proxy voting guidelines by major institutional investors and the launch of shareholder proposals at issuer's annual meetings seeking enhanced climate change disclosure. Although there is no standard Canadian market practice on climate change and GHG emissions disclosure, issuers will be in a better position to make prudent carbon disclosure decisions by carefully considering climate change–related risks and opportunities in the context of securities laws and other regulatory requirements, and by monitoring existing voluntary initiatives.

Securities Law Disclosure Obligations

Securities laws in Canada, as well as the listing requirements of the Toronto Stock Exchange, may, in certain circumstances, require issuers to consider and disclose climate risk in their continuous disclosure filings. Chief among these legal requirements are those related to an issuer's disclosure in its annual information form (AIF) and its management's discussion and analysis (MD&A). These requirements key off the concept of materiality. What is material at any

time is a matter for the issuer's judgment, based on facts and circumstances prevailing at that time; the test is whether a reasonable investor's decision whether or not to buy, sell or hold the issuer's securities would likely be influenced or changed if the information in question were to be omitted or misstated.

National Instrument 51-102, *Continuous Disclosure Obligations*, requires issuers to disclose in their MD&A any known trends, demands, commitments, events or uncertainties that are reasonably likely to affect the issuer's business or that management reasonably believes will materially affect the issuer's future performance. In addition, an issuer must discuss in its AIF material information regarding

- the financial and operational effects of environmental protection requirements on the capital expenditures, earnings and competitive position of the issuer in the current financial year and the expected effect in future years;
- environmental policies fundamental to an issuer's operations and the steps taken to implement them; and
- risk factors and regulatory constraints that would be likely to influence investor decision-making.

With respect to MD&A disclosure, the Canadian Institute for Chartered Accountants (CICA) in its 2005 brief, "MD&A Disclosure about the Financial Impact of Climate Change and Other Environmental Issues," stated, "Climate change and other environmental issues should be disclosed and discussed if they either have, or are reasonably likely to have, a current or future effect, direct or indirect, on the entity's financial condition, changes in financial condition, results of operations, liquidity, capital expenditures or capital resources that is material to investors."

On November 26, 2008, the CICA released its publication *Building a Better MD&A: Climate Change Disclosures* (the Guide). Building on the 2005 CICA guidance, the Guide is designed to assist issuers in deciding how to assess the business and financial impact of climate change issues for the purpose of their MD&A.

The Guide identifies various types of information that investors and analysts are increasingly seeking, including information relating to whether the company has factored climate change issues into its business strategy; whether climate change poses physical, regulatory, reputational or litigation risks to the company; the company's direct and indirect GHG emissions; whether climate change issues have or are expected to have an impact on a company's financial operations, cash flow or financial condition; and what governance processes and resources a company has dedicated to these issues. As part of considering whether any particular information is material and thus to be disclosed, the Guide suggests that management should consider whether the impact of a climate change issue might reasonably be expected to grow over time, potentially making early disclosure of the issue important to long-term investors.

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The information that an issuer chooses to disclose in its MD&A and AIF will depend on its exposure to the direct or physical impacts of climate change and on the applicable climate change regulation and climate change-induced market shifts in the jurisdictions where it and its subsidiaries operate, have significant assets or sell their products. Although for many issuers the immediate consequences of climate change and its regulation may remain remote, other issuers may now determine that there is material information to disclose, given the scientific consensus on climate change and its specific physical effects, the introduction of carbon taxes and GHG emission regulations in certain jurisdictions, the proliferation of emissions trading markets and the imminent introduction of GHG emission and other regulations in other jurisdictions.

Canadian securities regulators have provided little specific guidance on climate change disclosure. However, the Alberta Securities Commission has signalled its intent to focus generally on environmental disclosure, and the Continuous Disclosure Review Team of the Ontario Securities Commission (OSC) published a report on February 27, 2008, regarding a targeted review of disclosure of environmental-related matters. The OSC staff reported on its findings and recommendations following a review of the environmental disclosure of 35 reporting issuers regarding, among other things, the AIF requirements referred to above.

Although the report does not specifically address climate change, it is nevertheless useful in its guidance. In particular, the OSC indicated that issuers should include a quantification of the costs associated with environmental protection requirements, which could extend to such matters as GHG emissions regulations and carbon taxes, and the impact or potential impact of these costs on financial and operational results. With respect to environmental policies that an issuer identifies as fundamental to its operations, the OSC stated that the issuer should evaluate and describe the impact or potential impact these policies may have on its operations, including quantitative information where that is reasonably available. Similarly, the OSC stated that if any risks relating to environmental laws, whether national or international, are material to an issuer's operations, the issuer should include a detailed dis-

cussion of these laws, including whether or not the issuer is in compliance and any costs of compliance.

In the United States, there is continuing momentum on climate change disclosure. On September 18, 2007, a broad coalition of institutional investors formally petitioned the SEC to issue an interpretive clause clarifying that material climate-related information be included in MD&A and other periodic disclosure under existing reporting requirements (which, incidentally, are very similar to the Canadian requirements described earlier). On June 12, 2008, the coalition filed a supplement to the original petition stressing new evidence that indicated the need for an immediate SEC response to the petition: a growing body of state, federal and international laws and regulations to limit GHG emissions that provide extensive economic opportunities for U.S. companies developing climate-friendly solutions and pose material risks to U.S. companies that decline to innovate. Then, on October 22, 2008, the coalition submitted a further request for guidance in response to the SEC's request for comments regarding its 21st Century Disclosure Initiative.

Legislators are also pressuring the SEC. Following a hearing on climate change disclosure, the Senate Subcommittee on Securities, Insurance and Investment sent a letter to the SEC on December 6, 2007, requesting it to provide "definitive guidance in the form of an interpretive release to ensure greater consistency and completeness in disclosure of material information related to climate change and current and probable future governmental regulation of greenhouse gas emissions; provide information for registrants on whether and how to disclose such matters; and ensure that investors have access to material climate change information."

Following this, on July 18, 2008, the Senate Appropriations Committee approved language in the Financial Services Appropriations Bill calling on the SEC to issue guidance for publicly traded companies to assess and fully disclose their financial risks from climate change. Observers believe that the SEC may have been waiting until after the U.S. election to respond – but it is generally believed that it will respond. If the SEC does issue guidance, Canadian securities regulators are likely to monitor and review that carefully.

In other developments, the New York Attorney General's Office, in connection with a disclosure investigation conducted under New York State securities legislation, has entered into settlement agreements with two power companies, Xcel Energy Inc. and Dynergy Inc., Under these agreements, the companies will have to make specific and significant climate change-related disclosure in their annual Form 10-K filings with the SEC. The agreements require the power companies to disclose an analysis of financial risks from present and probable future climate change regulation and legislation, climate change-related litigation and the physical impacts of climate change on their operations. The companies have also agreed to disclose their carbon emissions; projected increases in carbon emissions from planned coal-fired power plants; strategies for reducing, offsetting, limiting or otherwise managing its global warming pollution emissions and expected global warming emissions reductions from these actions; and their corporate governance actions related to climate change, including whether environmental performance is incorporated into officer compensation.

Other Regulatory Disclosure Obligations

As federal, provincial and state regulators move to implement GHG reduction measures, some have begun to require the disclosure of certain GHG emissions information to obtain sound data for their policy decisions. In Canada, the federal government began to require large industrial emitters to disclose specific data on their GHG emissions in 2005, in that case for the 2004 calendar year. These requirements have become more comprehensive in recent years; in December 2007, an Environment Canada notice required certain industrial facilities to provide a detailed report on their 2006 emissions, the baseline year for the proposed federal cap-and-trade regime. Most recently, Environment Canada issued a notice requiring any person who operates a facility that emitted 100,000 or more tonnes of carbon dioxide equivalent (CO2e) in the 2008 calendar year to submit certain information about those emissions to the federal government no later than June 1, 2009.

At the provincial level, Alberta issued its Specified Gas Reporting Regulation in 2004, requiring industrial facilities that emit more than 100,000 tonnes of CO2e to submit annual reports on these emissions. This information was collected to establish baseline emissions for the province's cap-and-trade regime, the first to take effect in North America. Alberta has also developed its Specified Gas Reporting Standard, which outlines how regulated facilities should be measuring and calculating their GHG emissions. As with the federal requirements, Alberta's reporting obligations require companies to assess their "carbon footprint," which is often the first step in assessing how future GHG regulations might affect company value.

The U.S. federal government has begun to implement similar reporting requirements, particularly after the U.S. Supreme Court's decision in Massachusetts v. EPA, in which that Court ruled, among other things, that the federal Clean Air Act's definition of "air pollutant" includes GHGs. Subsequently, the U.S. Congress, in its Consolidated Appropriations Act, 2008, directed the Environmental Protection Agency (EPA) to publish a rule that would require mandatory reporting of GHGs "above appropriate thresholds in all sectors of the

economy." The EPA is responsible for determining these thresholds, and Congress has instructed the EPA to publish a proposed rule on the matter by September 2008, and a final rule by June 2009.

At the state level, an increasing number of U.S. states have also implemented mandatory GHG reporting schemes. Wisconsin has been requiring certain industrial facilities to report on their emissions since 1993, the first of these states to do so. California has adopted mandatory GHG reporting requirements effective December 2, 2008, under its *Global Warming Solutions Act* of 2006.

As more U.S. states and Canadian provinces join regional GHG reduction initiatives, mandatory reporting requirements are expected to proliferate at the state level as well. For example, data will be collected to establish baselines for mandatory GHG reduction requirements in 2012 by the members of the Western Climate Initiative (WCI), a cooperative effort of seven U.S. states and four Canadian provinces (Ontario, British Columbia, Manitoba and Quebec) to establish a regional cap-and-trade regime. WCI's recommendations for the Regional Cap-and-Trade Program, released September 23, 2008, proposes mandatory emissions measurement, monitoring and disclosure for all regulated entities; first reports will likely be due in early 2011, detailing GHG emissions in the 2010 calendar year. The Regional Greenhouse Gas Initiative (RGGI), an effort by U.S. states to reduce carbon dioxide emissions from electricity generators through a cap-and-trade program, also employs ongoing reporting requirements. The regime's framework, outlined in RGGI's Model Rule, contains detailed requirements for owners or operators of regulated facilities, first, to establish an emissions monitoring system and, then, to use such a system to record and report a variety of information about the facility's CO2 emissions.

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Voluntary Climate Change Disclosure Initiatives

Investors have taken specific additional initiatives to increase climate change disclosure by issuers. These include the introduction of proxy voting guidelines, such as those introduced in April 2008 by the California Public Employees Retirement System (CalPERS). These guidelines require companies that CalPERS invests in to disclose their financial exposure to global warming, as well as what they are doing to remediate those risks and how they might capitalize on opportunities created by global warming.

CERES, an investor coalition supported by major investors in the United States and Canada, has published a 14-point "Corporate Governance Checklist" to guide its members in incorporating climate risks (both in terms of the obligation to disclose and to act) into their governance principles for investments and their proxy voting guidelines. As well, some institutional investors have taken leading roles in launching shareholder proposals. The 2008 Canadian proxy season was rife with examples of shareholder proposals, among other things, to cause companies to augment their climate risk disclosure, to incorporate the cost of carbon emissions into their business strategy, to disclose methods for evaluating and mitigating climate risks, to reduce their GHG emissions, and to adopt policies on the use of renewable energy. The same has been the case in the United States, with a very public example being the four shareholder proposals made at the most recent annual meeting of Exxon Mobil. Although none of those proposals received more than 31% of the vote, they nevertheless received significant management attention.

Investors have also become increasingly active in groups or networks focused on climate-related issues. One of the most important initiatives taken by investor groups occurred in October 2006, when a group of leading institutional investors established the Global Framework for Climate Risk Disclosure (on which the California Senate bill referred to above is based). It describes a set of principles and information that investors often consider when analyzing an investment's climate risks, including the investment's current and historical GHG emissions, its climate change policy and any corporate and operational steps it has taken to reduce identified risks. The Framework encourages companies to disclose this information through mandatory financial reporting (described above) and voluntary reporting mechanisms, such as the Carbon Disclosure Project (CDP) and Global Reporting Initiative (GRI), a framework that outlines benchmarks against which organizations can measure and report their economic, environmental and social performance.

The CDP now represents investors with over US$57 trillion in assets under management, including major Canadian financial institutions and pension plans. Some of the world's largest companies have answered its annual questionnaire, including 383 of the world's FT500 companies for its sixth report, CDP6. On November 5, 2008, the Canadian version of CDP6 was launched with the support of 103 companies on the Toronto Stock Exchange. The Canadian survey received responses from 55% of the 200 Canadian companies sur-

veyed, up from 45% the previous year. Among the report's key findings was that 54% of high-GHG-emitting companies voluntarily disclosed their fossil fuel and electricity costs, which investors are increasingly requesting from companies whose energy costs are material to their production costs. The report disclosed that Canadian companies are increasingly taking action on climate change, with 82% of respondents reporting GHG emissions data, and of those respondents, 74% noting that they used internationally recognized protocols to measure these emissions. In addition, 84% of the respondents indicated that they have taken, or plan to take, action to manage their climate change risks.

Furthermore, on February 4, 2008, three large U.S. banks, Citi, JPMorgan Chase and Morgan Stanley, announced "The Carbon Principles" to provide guidance to energy companies in managing carbon risks. The Principles result from intensive consultation with seven of the largest power companies in the United States, and include greater emphasis on energy efficiency and renewable/low-carbon energy technologies, as well as better risk analysis for conventional forms of energy generation. This effort set the stage for the development of a consistent approach among major lenders and advisers in evaluating climate change risks and opportunities in the U.S. electric power industry, and could ultimately be emulated across other sectors.
Voluntary initiatives like the ones discussed above normally propose that issuers deal with the following general areas:

- assessing their "carbon footprint";
- analyzing the risks and opportunities presented by climate change; and
- managing these risks and opportunities.

Protocols and standards are developing to assess carbon footprints. One of the most widely used standards for GHG emissions reporting is the Corporate Accounting and Reporting Standard (revised edition) of the Greenhouse Gas Protocol, developed by the World Business Council for Sustainable Development. Another widely used standard is ISO 14064 GHG Accounting and Verification Standard, which has been adopted by the Canadian Standards Association. Increasingly, large issuers, including major financial institutions, are coupling this footprint disclosure with publishing their intentions to reduce that footprint in quantified ways over a specified time frame.

While investors applaud the enhanced disclosure that voluntary mechanisms yield, issuers themselves may face a conundrum in terms of determining whether that information, once disclosed, could itself become material to investors, and hence bring with it an elevated disclosure and reporting standard under securities laws, or whether the publication of such information could trigger an inquiry as to whether, in hindsight, the information should properly have been previously disclosed in the issuer's continuous disclosure documents. In addition, information disclosed in voluntary reports, including in corporate sustainability reports, may subject the issuer, its directors and responsible officers to civil liability in the secondary market if the reports contain a misrepresentation within the meaning of applicable Canadian securities laws.

For all these reasons, issuers should carefully assess whether voluntary disclosure of climate information should be formally addressed and monitored through their established formal disclosure controls and related policies.

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