



Disclosing Environmental Risks

By making financial risks tangible, the BP disaster may accelerate trends

BY LORI PIZZANI

Should public companies provide investors with disclosures related to climate change and environmental issues?

The BP oil disaster in the Gulf of Mexico has brought a new sense of urgency to the question, but a turning point may have come in January 2010 when the U.S. Securities and Exchange Commission (SEC) voted to provide enhanced guidance to U.S. public companies and foreign private issuers regarding such disclosures.

The guidance did not impose any new legal requirements on public companies and was intended to assist companies in more adequately addressing business and financial risk factors, as well as legal and regulatory developments related to the potential impact of climate change on their businesses. In February 2010, the SEC released its interpretative guidance, which reminded companies that they must disclose (among other things) the following items:

- the impact and costs of complying with federal, state, and local laws and regulations;
- the impact on their business of international accords and treaties, such as the Kyoto Protocol;
- all material litigation related to environmental issues for the company and/or its subsidiaries;
- all risks specific to a company, including potential risks related to climate change;
- physical risks a company might expect and the consequences from climate change events, such as floods or severe weather, which could affect manufacturing, personnel, transport of products, and the possible financial impact; and

- the indirect consequences of new environmental regulations on business trends, such as the potential decrease in demand for manufactured goods producing significant greenhouse gas emissions.

The SEC's new guidance wasn't an admonishment to companies that they were not complying with disclosure rules. "Nothing suggests the SEC wants page upon page of new disclosure. It's not the quantity but the quality," says Michael Littenberg, partner with the law firm of Schulte Roth & Zabel. "The SEC hasn't said it is looking to take enforcement action or draconian measures regarding this."

But the SEC isn't the only standard setter to identify environmental concerns as risks that require better disclosure by companies. In March 2009, the National Association of Insurance Commissioners (NAIC), the organization of state insurance regulators, issued its risk-disclosure rule for climate change. Concerned about a 2008 report indicating that climate change risks could pose significant financial burdens on insurance companies, the NAIC began requiring all insurers with annual premiums of US\$500 million or more to submit an annual Insurer Climate Risk Disclosure Survey to the domestic regulator beginning in May 2010.

Surveyed insurers are asked about their legal and physical risks, greenhouse gas emissions, and new opportunities that climate change issues present. One insurer noted that it is considering a reduction in casualty/property premiums for the construction of new wind-resistant buildings based on predictions that global warming will increase the frequency and severity of hurricanes.

Although the NAIC policy requires only that such disclosures

KEY POINTS

- In February 2010, the U.S. Securities and Exchange Commission provided clearer guidelines for corporate disclosure of climate change and other environmental risks.
- The National Association of Insurance Commissioners requires insurance companies to complete an annual survey on climate change risks.
- Environmental issues, as well as related business, financial, and reputational risks, are increasingly the focus of investor scrutiny.
- The 2010 U.S. corporate proxy season showed an increase in shareholder-led proposals related to climate change.
- Recent industrial and environmental disasters may be catalysts for greater disclosure of environmental factors.

be provided directly to state insurance regulators for purposes of analysis, the information is public. In most cases, insurance companies are already making similar disclosures in their annual reports and often in periodic corporate responsibility statements publicly available on insurers' websites. How far will this trend go?

The Investor Perspective

A more fundamental question is "What do investors do with this information?" says Eric Shostal, head of environmental, social, and governance (ESG) proxy research at RiskMetrics Group, ISS Governance Services in Rockville, Maryland. "How does this information relate to balance sheets and to a company's share price?"

The problem is that these disclosures are speculative. No one knows for sure what changes, if any, will ultimately occur. Consequently, says Shostal, companies are hedging their bets with conditional statements—"if we have one hurricane, x will happen; if we have 15 hurricanes, y will happen."

Proponents of enhanced disclosure argue that climate change and related environmental factors can have a negative impact on shareholders

because they pose significant risks to a company's short- and long-term financial well being. One example is Mindy Lubber, president of Ceres (a leading coalition of investors, environmental groups, and public interest organizations based in Boston) and director of Ceres' Investor Network on Climate Risk, (created in 2003). She takes the view that investors don't want hidden risks. "They want to know which companies are preparing for climate changes, which are not, and which are exposed to risks," she said at a March 2010 teleconference with members of the media.

Institutional and individual investors may see the matter differently. Individual investors tend to put all environmental concerns in the category of socially responsible investing. Thus, only those who place special emphasis on the environment are likely to focus on related disclosures. Many institutional investors, however, have adopted an ESG approach that makes environmental considerations central.

"Institutional investors worked long and hard and spoke to the SEC commissioners to petition for better disclosure," says Jack Ehnes, CEO of the California State Teachers' Retirement System (CalSTRS), the second largest U.S. pension fund, which has US\$138 billion in assets under management. "For the past seven years, CalSTRS has been working on climate change issues," he adds. "The CalSTRS corporate governance board treats the environment as a major guiding principle."

Shareholder Activists

Activist institutional investors have also been turning up the heat on proxy resolutions filed with public companies. The 2010 corporate proxy season resulted in a record 100 shareholder-driven proposals related to climate change issues, according to Rob Berridge, senior manager of investor programs at Ceres. This number is up from 68 in 2009. Ceres has also tracked 50 withdrawals of shareholder-led environmental resolutions, usually a sign that corporate

management would rather talk than wage a proxy battle with investors.

This year's resolutions covered a wide array of topics: what actions companies are taking to reduce their carbon footprint, the risks of coal-waste disposal, the risks companies are assuming in supporting the oil sands project in Alberta, Canada (where difficult-to-extract oil may cause major environmental problems), and proposals that newly elected corporate directors at energy companies be required to have expertise with environmental issues. The proxy votes tracked by Ceres suggest that many companies are experiencing a record number of investors voting in favor of climate change resolutions. "With these highly significant votes, we think it sends a very strong message," Berridge says.

In October 2009, the SEC reversed its ban on shareholder-led proxies that ask corporations about the business and financial risks related to climate change. Previously, the regulator had deemed these issues to be "ordinary business" matters that were outside the purview of shareholder-led proxies.

The mutual fund industry is also beginning to get involved. According to a recent Ceres report on how 46 mutual fund complexes with more than US\$5 trillion in assets under management voted their corporate proxies over the past six years, support for climate related shareholder resolutions has spiked from 14 percent in 2004 to 27 percent for the 2009 proxy season (full results for the 2010 proxy season were not available by press time). In addition, Ceres found a marked decrease in opposition to environmental resolutions, from 76 percent voted no in 2004 to 55 percent in 2009.

According to the report, OppenheimerFunds, which had previously failed to approve a single climate resolution, changed its tactics, supporting two-thirds of these in 2009. Additionally, in 2010, State Street revised its proxy voting policy from generally opposing shareholder environmental proposals to generally

abstaining on these, a change seen as a small but measurable victory by environmental activists.

The Wake-up Call?

Perhaps the Massey Energy coal mine accident of early April 2010, which killed 29 employees, or the BP oil disaster in the Gulf of Mexico, which killed 11 employees and caused an environmental and economic disaster in the region, will have an effect on how future proxy votes are cast. In the short term, the effect appeared to be negligible.

"I think the proxy voting guidelines for institutional investors were already in place before April," says Shelley Alpern, vice president and director of ESG Research & Shareholder Advocacy at Trillium Asset Management in Boston. "I anticipate it may be something of a wake-up call in the 2011 proxy season," she predicts.

"The BP incident sharpens the discussion and takes it from an academic discussion to a real-life one," says CalSTRS' Ehnes. "You certainly don't want an oil spill to be the reason people get on board. But this is not just a financial concern. There's an emerging reputation risk from liability."

"This has the potential to be the turning point for how the investment community thinks about environmental risk," says Andrew Logan, Ceres' director of shareholder advocacy for the oil and gas industry, who notes that BP lost significant market value because of an offshore oil well that did not have a large impact on overall operations. "This," says Logan, "made financial risks tangible." ■

Lori Pizzani is an independent journalist based in Brewster, New York.

RECOMMENDED RESOURCES

"The 21st Century Corporation: The Ceres Roadmap for Sustainability: Featuring 20 Expectations for Companies by 2010" Ceres (March 2010)

"Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors" Codes, Standards, and Position Papers (May 2008) (www.cfapubs.org)