May
June
2014

Asset Allocation

Essential Ideas for Investors

Importance of Impact Investing

Relating Corporate Event Waves to EMH

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ON THE ISSUE OF CLIMATE CHANGE — WHITE HOUSE AND REGULATORS ACT ON ISSUE, CORPORATE DISCLOSURE IN FOCUS

The United States of America is often described as a nation based on the rule of law. The usual process for creating the laws that are designed to protect investors and directly regulate public company operations for the past 80 years has been as follows:

1. A crisis occurs (e.g., the October 1929 stock market crash);
2. Congressional hearings and post-mortems are conducted;
3. Relevant committees of Congress adopt positions and draft bills;
4. The committees then pass the drafts on to the entire body for voting;
5. The Senate and the House negotiate their differences; and
6. Upon passage and with the president's consent, the law is created.

For securities laws, the Securities and Exchange Commission (SEC) and other regulatory and oversight agencies begin the complex rule-making process with public participation. Once the rules have been adopted, the corporate sector must adjust and comply with the mandated disclosure and reporting policies.

This was the case with the more recent adoption of the Sarbanes-Oxley Act[1] of 2002 and the Dodd-Frank Act[2] in 2010. The former followed the financial collapse of Enron, WorldCom, and other large-cap companies; the latter followed the 2008 financial crisis, which dramatically affected credit markets, global securities market participants, investors, and public and corporate finances.

The landmark financial reporting and investor protection statutes (1933, 1934, 1940, 2002, 2010, etc.) allow the SEC and other financial regulators to develop and adopt rules, implement enforcement actions, issue interpretive releases, and generally act in accordance with the statutes.

In the public debate over these processes, the point is raised that the statutes and rules cannot keep up with the frequently changing nature of the financial markets or corporate operations. Regulators also struggle to keep up with these changes. It is important to note that in addressing the Enron and other corporate failures, the new laws that were passed in 2002 built upon the foundation of the securities protection laws of the 1930s.

Getting ahead of the issues — Focus on risk

But what if regulators use the already existing statutes and regulations to try to get ahead of change or at least anticipate the consequences of present events to take action before the issue becomes critical? We are seeing some of that happening today in the politically and culturally contentious area of climate change. The Obama administration, the SEC, and the Environmental Protection Agency (EPA) are among the federal agencies on point for the topic.

Let's briefly explore the agencies' foundational moves in the debate on climate change.

The Obama administration. Executive Order (EO) 13514 was signed by President Barack Obama on October 5, 2009, during the first year of his tenure. This was "Federal Leadership in Environmental, Energy, and Economic Perfor-

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mance," which expanded the requirements for federal agencies from EO 13423. EO 13514 requires each agency to reduce their greenhouse gas (GhG) emissions and to report on their performance annually. Because the federal government is the largest purchaser of goods and services in the nation, the effects will be felt by companies of all sizes (e.g., automotive equipment, construction and leasing, chemicals, energy, etc.).[3]

SEC. The Securities and Exchange Commission was created by Congress through the Securities Exchange Act. It has five members (including the chairman) appointed by the president with nominations by both major parties (Republicans and Democrats). Staff recommendations are considered by the entire commission with the chairman breaking a tie vote. The Commission has adopted climate change rules, which we will discuss here.

EPA. This cabinet-level office is usually headed by a member of the president's own party (the administrator). The EPA was created on December 2, 1970, by the executive order of President Richard Nixon and then ratified by the House and Senate. President Nixon had previously signed the landmark National Environmental Policy Act of 1969 (NEPA), which was passed by the House and Senate into law on January 1, 1970, as Public Law 94-52. The major stimulus for the Act was the Santa Barbara oil spill in California in 1969. The law created the Council of Environmental Quality (CEQ) in the executive office of the president. The EPA has been in the forefront of actions taken to address the issue of climate change and does not shy away from "global warming" terminology.

ON JANUARY 27, 2010, IN AN OPEN MEETING OF THE COMMISSION, CHAIRMAN MARY SCHAPIRO DISCUSSED THE SEC'S POSITION ON CLIMATE CHANGE. ACTION WAS NEEDED, SHE SAID. THE COMMISSION WAS NEITHER ATTEMPTING TO DEFINE "MATERIALITY" NOR WEIGHING IN ON THE POLITICALLY CHARGED TOPIC OF GLOBAL WARMING.

SEC adopts important position on climate change

On January 27, 2010, in an open meeting of the commission, chairman Mary Schapiro discussed the SEC's position on climate change. Action was needed, she said. The Commission was neither attempting to define "materiality" nor weighing in on the politically charged topic of global warming. After consultation with the Division of Corporate Finance, the Division of Risk, Strategy, and Financial Innovation, and the Office of General Counsel, she said the Commission should be comfortable providing interpretive guidance to corporate issuers as part of the broader risk management discussion.[4]

The proposal sought to provide corporate issuers with guidance on existing SEC disclosure policies as they apply to business or legal developments related to climate change and to provide clarity and consistency of information for public companies and their investors. This was not about new disclosure requirements. The SEC made clear in its announcement that the relevant rules cover a company's risk factors, business description, legal proceedings, and management discussion and analysis (MD&A). "We are not opining on whether the world's climate is changing, at what pace it might be changing, or due to what causes," said Mary Schapiro. "Nothing that the Commission does today should be construed as weighing in on those topics....Today's guidance will help to ensure that our disclosure rules are consistently applied."[5]

The vote to approve was 2–2 with the chairman casting the deciding vote in favor. Also voting in favor, Commissioner Luis Aguilar spoke of climate change and his view that the earth is getting warmer in general and that investors are entitled to know what is going on regarding the effect of climate change on the companies they invest in.

Commissioner Troy Paredes, who voted in opposition, responded that it was not the right time for the decision and stated his opinion that voluntary disclosure was the path to follow as disclosure on climate change could expose companies to legal damages.

SEC — The climate change interpretive guidance

This was not a decision for commissioners or the staff of the SEC. During the open comment period, there were

four general challenges to such disclosure by issuers acknowledged in the SEC discussion:

1. the potential impact of legislation and regulation on companies;
2. the technical challenge for companies in measuring and managing their GhG emissions;
3. the difficulty in evaluating the future impact of climate change on corporate operations and finance; and
4. the cost to companies in expanded disclosure related to climate change issues.

The interpretive guidance covers the following four topic areas:

- impact of legislation and regulation (laws, including those that are pending, and regulations material);
- impact of international accords (risks or effects of international accords and treaties and their regulations);
- indirect consequences of regulations or business trends (legal, technological, political, and scientific developments regarding climate change — new opportunities or risks?); and
- physical impacts of climate change (actual or potential impact of environmental matters).[6]

Commenting on the proposed draft before the Commission, the members declared their positions on the subject.

Commissioner Troy A. Paredes

> The Release includes harm to a registrant's reputation among the "indirect risks" of climate change....A registrant may have to consider whether the public's perception of publicly available data related to GhG emissions could expose it to potential adverse consequences to its business operations or financial condition resulting from reputational damage.[7]

He voted against the measure.

Commissioner Kathleen A. Casey

> Regrettably, because [this release] is unnecessary and addresses concerns unrelated to investor protection, I am unable to support it....I question the timing of the release [in light of significant issues facing the Commission]....The disclosure regime related to environmental issues including climate change is highly developed and robust....There is undoubtedly a constituency that is interested in and has long pressed the Commission to require more extensive disclosure on the environmental issues to drive particular environmental policy objectives....The issuance of this release [at a time when the state of science, law, and policy related to climate change is in flux] makes little sense.[8]

She voted against passage.

Commissioner Elisse B. Walter

> It is not, and I cannot stress this enough, a new rule or legal obligation....It does not change disclosure obligations....It is designed to improve the quality of public company disclosures for the benefit of investors....I am concerned that many companies are providing disclosure about significant climate change related matters through mechanisms outside of the disclosure documents they file with the Commission....The requirements discussed in this interpretive guidance go to the very core of a public company's disclosure obligations.[9]

She voted for passage.

COMMENTING ON THE PROPOSED DRAFT BEFORE THE COMMISSION, THE MEMBERS DECLARED THEIR POSITIONS ON THE SUBJECT.

Commissioner Luis A. Aguilar

> Over two years ago, the Intergovernmental Panel on Climate Change concluded that it is 'unequivocal' that the Earth's climate is warming....Against the backdrop of a changing climate and changing legislative and regulatory landscapes, it is only natural that there are questions about what companies should be disclosing to investors....Today's release is an important step forward toward answering these questions....The Commission's action today is a first step in an area where [the SEC] will begin to play a more proactive role, consistent with our mandate under the National Environmental Policy Act of 1969, to consider the environment in our regulatory action.[10]

He voted yes.

Chairman Mary Schapiro

> The Commission is not making any kind of statement regarding the facts as they relate to the topic of climate change or global warming....We are not considering whether the world's climate is changing....We are not considering amending well-defined rules concerning public company reporting obligations...nor redefining long-standing interpretations of materiality....It is neither surprising or especially remarkable for us to conclude that, of course, a company must consider whether potential legislation...is likely to occur...and the company must evaluate the impact....Today's guidance will help to ensure that our disclosure rules are consistently applied, regardless of the political sensitivity of the issue at hand, so that investors get reliable information.[11]

She voted for passage, breaking the 2–2 tie.

Precedent: SEC position on corporate risk management

On December 16, 2008, the Commission adopted a final rule "to enhance the information provided to shareholders so they are better able to evaluate the leadership of public companies." Beginning in the spring 2009 annual corporate proxy voting season, the new rules took effect for corporate disclosure regarding risk, compensation, and corporate governance matters.

Among the provision of the "Proxy Disclosure Enhancements" was the following item: board leadership structure and the board's role in risk management.[12] The new rule requires companies to disclose the board's role in risk oversight, explaining if the board as a whole or a committee oversees risk, how risk is monitored, the nature of internal controls, and their risk mitigation plans.

While the rules concentrated on executive compensation and the risks attendant to that issue, the relatively small item of board risk oversight responsibilities provides an umbrella under which to emphasize board responsibilities for a range of risk factors.

WHILE THE RULES CONCENTRATED ON EXECUTIVE COMPENSATION AND THE RISKS ATTENDANT TO THAT ISSUE, THE RELATIVELY SMALL ITEM OF BOARD RISK OVERSIGHT RESPONSIBILITIES PROVIDES AN UMBRELLA UNDER WHICH TO EMPHASIZE BOARD RESPONSIBILITIES FOR A RANGE OF RISK FACTORS.

The Obama administration and climate change

The Obama administration's Executive Order 13514 was issued several months before the SEC voted. The commissioners acknowledged the work of the staff of the Division of Corporate Finance and other divisions and offices as well as the counsel of the SEC that worked on the climate change disclosure issue and drafted the release. That work occurred as the White House was focusing more intently on climate change issues.

Under the executive order, federal agencies had to submit a 2020 GhG emissions pollution reduction target within 90 days of the order in 2009 and begin efforts to increase energy efficiency, reduce fleet petroleum consumption, conserve water, reduce waste, support sustainable communities, and leverage federal purchasing power to promote environmentally responsible products and technologies.

The federal government occupies 500,000 buildings, operates 600,000 vehicle, employs 1.8 million civilians, and buys more than $500 billion each year in goods and services.

The executive order requires federal agencies to measure, manage, and reduce GhG emissions toward defined targets. Agency goals are set and reported to the president by the chairman of the CEQ, which was created under the NEPA during President Nixon's tenure.

Every federal agency must release their "scorecard" annually. (The results are available at the Office of Management and Budget's website.[13] The 2013 results should be available in May.)

Given the size of the federal government in terms of operations and purchasing power, it is the author's view that the executive order has had and will continue to have wide effects on the private and public sectors at various levels, including local communities. Finance managers will do well paying attention to the continued implementation of the executive order.

EPA addresses GhG emissions

The day after the SEC action on January 28, 2010, the EPA issued a final rule mandating the reporting of GhG emissions.[14] This required reporting GhG emissions from large sources and suppliers in the United States so that the EPA can collect accurate and timely emissions data "to inform future policy decisions."

Suppliers of fossil fuels or industrial GhG emitters, makers of vehicles and engines, and facilities emitting certain amounts of GhG emissions must submit annual reports to the EPA. GhGs include carbon dioxide (CO_2), methane (CH_4), nitrous oxide (N_2O), hydrofluorocarbons (HFC), perfluorocarbons (PFC), sulfur hexafluoride (SF_6), and other fluorinated gases, including nitrogen trifluoride (NF_3) and hydrofluorinated ethers (HFE). The rule covered 31 of 42 emission sources proposed earlier. The rule comes under the authority of the Clean Air Act.

The role of activist investors

Applauding the Commission's decision was a coalition of investors led by NGO Ceres and the network it manages, the Investor Network on Climate Risk (INCR). The INCR's 80 institutional members such as the California Public Employees' Pension Fund (CalPERS) have collective assets under management of $8 trillion. The group had petitioned the Commission in 2007, 2008, and 2009 to request that formal guidance on climate change risk be provided to public companies.

Summary

The well-settled laws and regulations concerning corporate disclosure of financial information have been in force since the 1930s and have been amended by the statutes over the years. The current environmental protection laws have been in effect for more than 50 years in some cases and provide statutory and regulatory authority to the EPA and other agencies to address air, soil, water, and other pollution issues. The moves of the SEC, the EPA, the Obama administration, and other federal agencies that focused on climate change and global warming are having a direct and indirect impact on corporate finances, strategies, and various aspects of operations.

The author will explore ways in which corporate boards and managements are or are not responding to these "enhancements" of corporate disclosure (as depicted by the SEC) in coming issues of CORPORATE FINANCE REVIEW. ■

NOTES

[1] Sarbanes–Oxley Act of 2002, P.L. 107-204, 7/30/2002. Officially titled the Public Company Accounting Reform and Investor Protection Act, sponsored by Representative Michael Oxley and Senator Paul Sarbanes. It amended sections of the SEC Act of 1934. There are 11 titles in the law. SOX created the Public Company Accounting Oversight Board (PCAOB).

[2] Dodd–Frank Act of 2010, P.L. 111-203, 7/21/2010. Officially titled the Dodd–Frank Wall Street Reform and Consumer Protection Act, including the "Volcker Rule" for banks. It was sponsored by Representative Barney Frank and Senator Chris Dodd with support from Senator Richard Shelby. Some parts amend the SEC Act of 1934, Investment Company Act of 1940, and other acts. There are 16 titles in the law. Numerous parts have not, at this writing, been enacted into rules to follow.

[3] "Federal Leadership in Environmental, Energy, and Economic Performance," Executive Order 13514 (Oct 5, 2009). Available at: https://www.fedcenter.gov/programs/eo13514/.

[4] Author's notes on open meeting, Securities and Exchange Commission meeting (Jan 27, 2010). Also see SEC agenda item: "The Commission will consider a recommendation to publish an interpretive release to provide guidance to public companies regard-

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