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SEC Issues Guidance Regarding Disclosure of Climate Change Risks

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On February 2, 2010, the Securities and Exchange Commission (SEC) issued interpretive guidance on how existing risk disclosure rules apply to matters related to climate change. Companies subject to disclosure obligations who have not yet submitted their Form 10-K annual reports for fiscal year 2009 should consider the new guidance as they are preparing these reports.

The SEC's action is intended to provide clarity and lead to more consistent application of disclosure requirements; it does not change the "materiality" standard for risk disclosure in the reports of public companies filed with the agency. While in many cases the impacts of global climate change on a company's business remain speculative, issuance of the new guidance indicates the SEC's preference for more robust disclosure of climate risks and opportunities.

Background

The SEC's decision to issue its first-ever guidance on disclosure of climate change risks resulted in part from the push by a number of environmentally minded institutional investors, state treasurers and attorneys general, and activists who joined the call for companies to disclose information that enables analysis of their business risks from global warming. Investors also have been seeking information about the opportunities created by climate change and the regulation of greenhouse gases (GHGs). A company's GHG emissions potentially represent an opportunity to reduce risks, improve operations, and cut costs, as well as be seen as a leader by investors and consumers.

The guidance notes that a large number of U.S. companies are participating in voluntary disclosure initiatives and providing information about climate risks and opportunities outside of their SEC filings. On the other hand, a recent survey of nearly 6,400 annual filings by Standard & Poor's 500 companies found that 76.3% of the 2008 filings failed to mention climate change.[1]

Issuance of the guidance follows recent regulatory and legislative developments concerning climate change, which have occurred against the backdrop of evolving scientific understanding of global warming and its effects. In December 2009 the U.S. Environmental Protection Agency (EPA) issued an "endangerment finding" for GHGs under the Clean Air Act, which will compel EPA to directly regulate GHG emissions. As of January 1, 2010, EPA also is requiring large emitters of GHGs to collect and report data concerning their GHG emissions.

In addition, the U.S. House of Representatives recently approved the American Clean Energy and Security Act of 2009 (known as the Waxman-Markey bill) to establish an economy-wide cap-and-trade program, which would reduce global warming pollution by increasing the cost of emitting GHGs. The U.S. Senate is considering similar legislation. At the regional level, the northeast Regional Greenhouse Gas Initiative (RGGI), the Western Climate Initiative (WCI), and the Midwestern Greenhouse Gas Accord (MGGA) will require GHG reductions within their respective jurisdictions.

The timing of the new guidance, which was authorized on a 3-2 vote, is unusual in that it comes while many registrants are finalizing their Form 10-K annual reports for the 2009 fiscal year. The new guidance will take effect upon publication in the Federal Register, which should occur shortly.

The new guidance follows the SEC's issuance in October 2009 of Staff Legal Bulletin No. 14E, which reversed an earlier policy that was widely regarded as helping companies prevent climate change-related shareholder resolutions from coming up for a vote.[2] That policy change will not impact Form 10-K annual reports for fiscal year 2009, however.

SEC Disclosure Requirements

SEC Regulation S-K, which provides a framework for the disclosure requirements contained in the Securities Act of 1933 and the Securities Exchange Act of 1934, requires annual and quarterly filing of disclosure reports via Forms 10-K and 10-Q. Four parts of Regulation S-K are especially relevant to the disclosure of impacts of climate change regulation: Items 101, 103, 303, and 503.

Item 101 (Disclosure of Capital Expenditures) requires a company to disclose any material effect that environmental compliance costs associated with enacted or adopted laws may have on its earnings, capital expenditure, and competitive position. "Materiality" concerns whether environmental liability may affect the company's financial position, and a "material" effect is one that may "substantially alter the total mix of information" available to investors. A company must project the costs of environmental compliance for two years, or longer if believed by the company to be material.

Item 103 (Disclosure of Legal Proceedings) requires disclosure of any material pending administrative or judicial proceedings to which the company (or any of its subsidiaries) is, or may become, a party. "Material" under Item 103 has the same definition as under Item 101. Although Item 103 expressly relates to parties, companies who are not parties to a legal proceeding should still consider disclosure if resolution of the proceeding could materially affect their capital expenditures, earnings, or competitive position.

Item 303 (Management Discussion & Analysis, or "MD&A") requires a description of any "known trends … events or uncertainties" that are reasonably likely to affect the company's liquidity or capital expenditures. The intent of Item 303 is to allow investors to see the company "through the eyes of management." SEC guidance on Item 303 establishes a two-part disclosure test. First, a company must assume that a trend or uncertainty is reasonably likely to occur, unless it can determine otherwise. Second, if the trend or uncertainty is reasonably likely to occur, the company must disclose if the trend or uncertainty will have a material effect on its financial condition or operations. ("Material" has the same definition as under Items 101 and 103).

Item 503 (Risk Factors) requires a discussion of the most significant factors that make an investment in the company speculative or risky. Item 503(c) specifies that risk factor disclosure should clearly state the risk and specify how the particular risk affects the company.

The New SEC Guidance

The interpretive guidance identifies four areas where climate change may trigger disclosure requirements.

Impact of U.S. legislation and regulation. Companies with operations in regions or states with existing climate change legislation or regulation may be required to disclose under Items 101, 103, 303, and 503, especially if they are particularly sensitive to the new climate change laws, such as companies in the energy sector.

Pending and proposed legislation and regulation also may trigger disclosure obligations. The guidance states that a company must assume a proposed law will be enacted unless it determines that it is "not reasonably likely to be enacted," and that MD&A disclosure is required unless the company determines that, if the legislation is enacted, "a material effect is not reasonably likely." The guidance also emphasizes that the possible consequences of pending legislation and regulation include opportunities (not just risks), such as the potential to profit from sales of allowances or credits under a cap-and-trade program. The guidance does not explain how companies should evaluate legislative prospects, however.

Impact of treaties and international accords. The sources of disclosure obligations from the impact of treaties and international accords relating to climate change, such as the Kyoto Protocol and its yet-to-be-determined successor, are the same as from the impact of domestic legislation and regulation. Even though the United States has not ratified the Kyoto Protocol, a company may operate in one or more of the 187 signatory countries.

Indirect consequences of regulation or business trends. New indirect risks or opportunities resulting from climate change regulation or business trends may be required to be disclosed in the MD&A under Item 303 or as risk factors under Item 503. Indirect consequences include increased demand for goods that result in lower GHG emissions than competing products; decreased demand for services related to fossil fuel energy sources, such as drilling services; and increased competition to develop innovative new products. Assessing risk to supply chains may be particularly difficult.

Disclosure under Item 303 will become increasingly important as climate change regulation becomes more certain. If significant enough, consequences also may need to be disclosed under Item 101, such as when a company shifts operations through material acquisitions of plants. While this area is somewhat duplicative of the impact of domestic climate change laws, the guidance identifies reputational risk from changing business trends as a potential indirect risk that may need to be identified under Item 503.

Physical impacts of climate change. Direct physical effects of climate change, such as severe weather events, rising sea levels, and drought, may require disclosure of the risks and consequences of such events under Item 503. Many of the physical effects of global warming will occur many years in the future, making prediction of their impacts in a disclosure difficult. Disclosure of these impacts – no matter how speculative – will be most important for companies whose businesses are vulnerable to several weather or climate related events, such as those with operations concentrated on coastlines. The insurance industry will be impacted by more extreme weather events such as hurricanes, and industries involved in agriculture may be adversely affected by shifting weather patterns.

In addition, companies that are party to legal proceedings involving GHG emissions (for example, the defendants in the public nuisance lawsuits recently reinstated by the Second and Fifth Circuit Courts of

Appeal), or within the same sector as companies who are party to such proceedings, continue to be subject to disclosure under Item 103.

Importantly, the new guidance does not change the materiality requirement (i.e., climate change impacts are not per se material) or the regulatory framework for SEC disclosure; does not include any finding of inadequate disclosures to date; and does not require companies to disclose their carbon footprints or what they intend to do to reduce their GHG emissions.

Key Implications

Although it does not change the "materiality" standard for risk disclosure, the SEC's new guidance warrants careful consideration by companies subject to disclosure obligations, regardless of industry. Public companies should review their processes for assessing the materiality of climate change matters in light of the new guidance and consider the following in connection with their SEC filings:

- Ensure consistency between the climate risk and opportunity disclosures in a company's SEC filings and other public disclosures, such as in corporate sustainability and climate change reports and other documents prepared pursuant to voluntary initiatives.
- Consider disclosure of internal efforts to assess material costs that might arise from complying with regulations or regional initiatives to limit GHG emissions in jurisdictions where the company operates.
- Consider disclosure of internal efforts to assess risks of "reasonably likely" material effects of climate change with particular focus on whether the company has adopted an internal process to monitor climate change developments and undertake some long-range planning.
- Monitor legislative and regulatory developments at the state, regional, and federal levels, assess the potential consequences for the company of proposed and existing laws (both risks and opportunities), and determine whether MD&A disclosure is necessary.
- Interest groups are expected to scrutinize Form 10-K annual reports and ask the SEC to enforce climate change risk disclosures where a company is perceived to be ignoring the new guidance.

The new guidance expresses the SEC's preference for more robust disclosure of climate risks and opportunities and acknowledges that disclosures in this arena will continue to evolve. At the same time, the determination of whether and how to disclose climate change risks in SEC filings will continue to depend on a company's specific operations.

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[1] The survey results were published in a June 2009 report, *Reclaiming Transparency in a Changing Climate*, released by the Center for Energy and Environmental Security, CERES and the Environmental Defense Fund.

[2] Staff Legal Bulletin No. 14E modified agency staff's interpretation of Rule 14a-8(i)(7) under the Securities Exchange Act of 1934. The SEC now focuses on the underlying subject matter of a shareholder proposal, rather than on whether a proposal and supporting statement relate to the company engaging in an internal evaluation of risk, which the agency had viewed as relating to a company's ordinary business operations.