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### **Roadmap for Disclosure or Recipe for Boilerplate? The SEC Issues Interpretive Guidance for Climate Change Disclosures**

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On February 2, 2010, the Securities and Exchange Commission issued Release No. 33-9106: “Commission Guidance Regarding Disclosure Related to Climate Change.” The Release describes itself as “guidance...intended to assist companies in satisfying their disclosure obligations under the federal securities laws and regulations.” Indeed, at the January 27, 2010 open meeting at which the SEC voted 3-2 to issue the Release, Chairman Mary Schapiro proclaimed that it “does not create new legal requirements or modify existing ones – it is merely intended to provide clarity and enhance consistency.” The dissenting Commissioners, on the other hand, criticized the Release as a regrettable political foray and diversion of resources from topics more relevant to most investors.

The Release adds the topic of climate change to the roster of issues that public companies must consider when drafting Forms 10-K and other disclosure documents. While companies in a few industries, notably in the energy and insurance sectors, have already devoted significant attention to climate change and ongoing environmental regulatory developments, other companies less experienced in such analysis may find climate change disclosure to be a journey beyond their management team’s normal comfort zone.

#### **Climate Change Meets the SEC’s 1989 Double Negative Gloss on the Reasonably Likely Standard: If You Can’t Prove It Won’t Happen, Then Figure It Out**

The existing management discussion and analysis (MD&A) framework depends heavily on guidance issued by the SEC over several decades. In a 1989 Release, the SEC addressed forward looking disclosure in MD&A, noting that, under its rules, a “disclosure duty exists where a trend, demand, commitment, event or uncertainty is both *presently known to management* and *reasonably likely to have material effects on the registrant’s financial condition* or results of operation” (the “1989 Release,” emphasis added). The 1989 Release went on to articulate the so-called “double negative” gloss on the “reasonably likely standard.” In evaluating trends, demands and other factors affecting business, management must consider whether such phenomena are “likely to come to fruition.” Management can avoid disclosure if it “determines that [the trend, event, etc.] is not reasonably likely to occur.” If, however, management cannot make that determination, the 1989 Release states that management must then make an objective evaluation of “the consequences of the known trend, demand, commitment, event or uncertainty, *on the assumption that it will come to fruition*” (emphasis added). After evaluating the assumption, management can only avoid disclosure if it determines “that a material effect on...financial condition or results of operations is not reasonably likely to

occur.” Over the years, some have criticized the “double negative” gloss for, in effect, rewriting the rule to require disclosure not only of what is “reasonably likely,” but of what “might happen, or might not.”

The new climate change guidance for MD&A relies repeatedly upon the double-negative gloss, which is quoted in full on page 19 of the Release. The SEC expressly states that “management must make two assessments” about climate change: Will the uncertainty come to fruition? And if so – or if it must be assumed to be so – will it have a material impact on the company? Such assessments may already be business as usual at large energy and insurance companies, but they may be burdensome and confusing to many publicly traded entities less deeply versed in climate science and the evolving legal regime. The SEC, in so many words, concedes as much: “Identifying and assessing known material trends and uncertainties generally *will require registrants to consider a substantial amount of financial and non-financial information available to them*, including information that itself may not be required to be disclosed” (emphasis added). Determining how much “non-financial information” it should evaluate – for example, the rapidly growing body of climate-change science available on the internet – may be an exercise in judgment that many management teams consider uncomfortably far afield from their traditional tasks of financial analysis, economic forecasting and claims assessment.

Performing thorough, company-specific climate-change analyses could, in the aggregate, be an expensive burden on the nation’s business and industrial sectors. The Release, however, does not estimate the cost of compliance. In addition to MD&A, the SEC notes that climate change disclosures may be triggered by other rules, including Items 101 (description of business), 103 (legal proceedings), and 503(c) (risk factors) of Regulation S-K, as well as similar disclosure requirements of Form 20-F applicable to foreign private issuers.

### **The SEC’s Recommended Roster of Climate-Change Topics to Consider and Information to Obtain**

While noting that each registered company’s duty of disclosure depends upon the particular facts and circumstances that the company faces, the SEC’s climate-change guidance offers four topics that “are some of the ways climate change may trigger disclosure required by [the SEC’s] rules and regulations.”

- *Existing and pending legislation and regulation.* Citing the 1989 Release, this new guidance states that “management must evaluate whether the pending legislation or regulation is reasonably likely to be enacted. Unless management determines that it is not reasonably likely to be enacted, it must proceed on the assumption that the legislation or regulation will be enacted.”

- *Existing and pending international treaties and accords.* The new guidance alludes to the Kyoto Protocol, the European Union's Emissions Trading System, and the recent Copenhagen Conference. Registrants "should monitor the progress of any potential agreements and consider the possible impact in satisfying their disclosure obligations...."
- *Indirect consequences of regulation or business trends.* The new guidance mentions items such as decreased demand for GHG-producing goods; increased demand for lower-emission goods; increased competition to develop innovative new products; increased demand for energy from alternative sources; and decreased demand for carbon-based energy production. The new guidance may also heighten companies' concerns about looking "green," as the SEC expressly mentions "the impact on a registrant's reputation" as a risk factor to be considered in the climate change context.
- *Physical impacts of climate change* "such as effects on the severity of weather (for example, floods or hurricanes), sea level, the arability of farmland, and water availability and quality, [which] have the potential to affect a registrant's operations and results."

In addition to listing topics that might trigger disclosure, the Release implies that a potentially substantial climate-change information-gathering effort may be necessary. As noted, fitting climate-change disclosure within what the Release considers to be acceptable MD&A practice may require management to consider "a substantial amount of ... non-financial information" about climate change and climate science. Since discussion and analysis of known material trends and uncertainties requires registrants "to consider all relevant information," management will be asking how much legislative analysis or how much climate science is enough? The Release leaves potential answers to the companies.

### **Did the SEC Sufficiently Describe the Science to be Considered, and How Should Registrants Wrestle With the Treatment of Uncertainty?**

At the January 27, 2010 open meeting, Chairman Shapiro asserted that the SEC is neutral on the facts and science of climate change and whether or not climate change itself is even occurring. She stated, "[T]he Commission is *not* making any kind of statement regarding the *facts* as they relate to the topic of 'climate change' or 'global warming.' And, we are not opining on whether the world's climate is changing; at what pace it might be changing; or due to what causes. Nothing the Commission does today should be construed as weighing in on those topics." (SEC web site, italics in original).

The Release cites an odd grab bag of sources in describing the technical foundations for climate change understanding and regulation. In keeping with the Chairman's proclamation of neutrality, the Release offers no suggestions about which information public companies should consider reliable, nor does it provide any guidance on the treatment of uncertainty by climate change experts.

For example, when discussing “physical impacts” that may trigger disclosure requirements, the Release either relies on no sources or fails to cite to some of the most fundamental technical guidance that has been published. The Release’s discussion of severe weather as a climate change impact that could affect a company’s operations cites the 2007 U.S. GAO report for the Committee on Homeland Security and Governmental Affairs. One might have expected a reference to the U.N.’s International Panel on Climate Change (IPCC), the U.S. Global Change Research Program, or the EPA Technical Support Document for the recent “Endangerment Finding.”

The “treatment of uncertainty” is also a term of art in climate change science, and it is a concept that public companies will have to confront when making judgments about disclosure. For example, a company in the lumber or paper business may own large timber reserves that are carried as a significant asset on its books. The IPCC’s 2007 Fourth Assessment Report (“AR4”) indicates that effects of temperature increases have been documented with respect to “agricultural and forestry management at Northern Hemisphere higher latitudes, such as earlier spring planting of crops, and alterations in disturbances of forests due to fires and pests.” At this point, however, such documentation has only been done with “medium confidence.” Under the IPCC’s analytical approach, that confidence level indicates a 5 out of 10 chance that the underlying data, models and analyses supporting the finding are correct. Given the state of the science, can management credibly determine that harm to its northern timber reserves “is not reasonably likely to occur?” Must it assume fruition and then make a forecast of when changes to its climate-affected reserves might begin to have a material impact on financial performance?

In a similar vein, the SEC’s climate change guidance alludes to severe weather impacts on registrants with “operations concentrated on coastlines,” and also suggests concern about “[i]ndirect financial and operational impacts from disruptions to the operations of major customers or suppliers from severe weather, such as hurricanes and floods.” The EPA’s Technical Support Document for the Endangerment Finding, however, references a 2008 Climate Change Science Panel report that confronts a management team concerned about North American coastal operations with the following conundrum: “The power and frequency of Atlantic hurricanes have increased substantially in recent decades, though North American mainland, landfalling hurricanes do not appear to have increased over the past century.” Similarly, the IPCC’s AR4 remarks that “[t]here is no clear trend in the annual numbers of tropical cyclones.” Climate change disclosures will no doubt be heavily swaddled with references to uncertainty, thereby passing along these conundrums to investors.

### **The Climate Change Release’s Potential Impacts on Registrants**

The Release poses difficult challenges in evaluating whether any of a broad range of climate risk uncertainties are material to a company’s financial condition, capital resources, operations, results or competitive position. Since the SEC signals that it will be looking for climate-oriented disclosures in its routine reviews of Forms 10-K and other periodic reports, we suspect that few companies will be

bold enough to say nothing. It seems inevitable that some kind of climate-change reference will become a standard reporting feature no matter how the tides for and against legislation, international treaties, and regulation ebb and flow. Of course, the SEC professes to disdain defensive boilerplate. It states in the Release that registrants “should consider specific risks they face as a result of climate change legislation or regulation and avoid generic risk factor disclosure that could apply to any company.”

The new guidance may spur more companies to information collection and greenhouse gas analysis, even if they fall outside the reach of the emission reporting mandates that now are becoming effective for energy companies and other significant carbon emitters. If that is one result of the Release, seasoned securities lawyers may be reminded of the Y2K interpretive release issued by the SEC in July 1998, which announced that public companies needed to devote much more attention to Y2K risks in their reporting. Some commentators credited the SEC with forcing more serious attention to the risks, while others concluded that the SEC had forced companies to devote disproportionate resources to the problem. Ironically, for those who hope that climate-change disclosure will help hasten the move away from a carbon-based economy, disclosures may become an avenue through which industry highlights the potential expense of emancipation from carbon dependency.

The only certainty amidst the uncertainty over the scope of climate change disclosure is that more “clarification” will be forthcoming. In addition to its promised review of climate change filings, the SEC plans to hold a public roundtable on climate change disclosure in the spring of 2010. Stay tuned.

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