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SEC Issues Interpretive Guidance Concerning Climate Change Disclosure

On February 2, 2010, the U.S. Securities and Exchange Commission (“SEC”) published an interpretive release to provide guidance to public companies on the application of existing SEC disclosure requirements to climate change matters (the “Climate Change Guidance”).¹ The Climate Change Guidance responds to heightened public awareness of climate change issues and calls from certain sectors of the investment community for either guidance on the application of existing SEC rules or the issuance of new rules mandating increased climate change disclosure. In a press release that preceded the issuance of the Climate Change Guidance,² the SEC emphasized that the interpretive guidance does not create new legal requirements or modify existing ones, but is intended to provide clarity and consistency in the application of existing disclosure requirements.³

Existing SEC Disclosure Rules

The Climate Change Guidance summarizes a number of SEC disclosure regulations that need to be considered by public companies in deciding how much climate change disclosure is appropriate under the federal securities laws, including:

- Item 101 of Regulation S-K, which requires a registrant to describe its business, including the material effects that compliance with environmental laws may have upon capital expenditures, earnings and competitive position, including material capital expenditures for environmental

¹ Interpretive Release, Commission Guidance Regarding Disclosure Related to Climate Change, Release Nos. 33-9106 and 34-61469 (Feb. 2, 2010) [75 Fed. Reg. 6290], available at <http://www.sec.gov/rules/interp/2010/33-9106.pdf>.

² SEC Press Release, “SEC Issues Interpretive Guidance on Disclosure Related to Business or Legal Developments Regarding Climate Change” (Jan. 27, 2010).

³ Interpretive releases such as the Climate Change Guidance are generally considered to be non-binding authority. See, e.g., *Berkeley Investment Group, Ltd. v. Colkitt*, 455 F.3d 195, 221 n.24 (3d Cir. 2006) (explaining that an SEC interpretive release is “an interpretive rule [that] is not binding on a court”); *Ontario Teachers’ Pension Plan Board v. IG Holdings, Inc.*, 2000 U.S. Dist. LEXIS 12591, at *21 (S.D.N.Y. Aug. 28, 2000) (even though defendant did not follow the recommendations set forth in an SEC interpretive release on disclosure in a mini-tender offer, the court granted defendant’s motion to dismiss fraud claims because defendant took alternative steps that “provided sufficient warning and put potential sellers on notice that it would be prudent to investigate”). Nevertheless, a registrant should consider the Climate Change Guidance in its future SEC disclosures since courts tend to defer to the SEC’s expertise on matters of securities law set forth in interpretive releases. See, e.g., *United States v. Elliott*, 62 F.3d 1304, 1309-11 (11th Cir. 1995) (noting that SEC interpretive releases are “entitled to great weight” and relying on criteria set forth in such a release in upholding fraud convictions under the Investment Advisers Act); *SEC v. Simpson Capital Management*, 586 F.Supp.2d 196, 203 (S.D.N.Y. 2008) (denying defendant’s motion to dismiss an SEC enforcement action because guidance set forth in an applicable interpretive release warranted deference).

control facilities for its current and succeeding fiscal years and such further periods as a registrant may deem material;

- Item 103 of Regulation S-K, which requires a registrant to disclose any material pending legal proceeding to which it is a party or in which its property is the subject of the litigation and, pursuant to Instruction 5 of Item 103, certain other environmental proceedings, including proceedings by governmental authorities seeking monetary sanctions, unless the registrant reasonably believes the sanctions will be less than \$100,000;
- Item 303 of Regulation S-K, which requires disclosure of management's discussion and analysis ("MD&A") of a registrant's financial condition, including significant capital or liquidity requirements, as well as disclosure of "known trends or uncertainties" that are reasonably likely to have a material effect on financial condition or operating performance;
- Item 503(c) of Regulation S-K, which requires a registrant to discuss the most significant factors that make an investment in the registrant speculative or risky for a particular investor; and
- Form 20-F for Foreign Private Issuers, which requires disclosure of material risks, material effects of government regulation, environmental issues that may affect the registrant's utilization of its assets, management's assessment of factors and trends that are anticipated to have a material effect on the registrant's financial condition, results of operations and legal proceedings that may have, or have had in the recent past, significant effects on a registrant's financial position or profitability.

The Climate Change Guidance also notes that Securities Act Rule 408 and Exchange Act Rule 12b-20 require disclosure of all material information necessary to make a registrant's disclosure not materially false or misleading. The Climate Change Guidance does not purport to change the traditional standard of "materiality," which requires disclosure of information if there is a substantial likelihood that disclosure would be viewed by a reasonable investor as altering the total mix of available information.⁴ The Climate Change Guidance emphasizes that doubts regarding whether information is material should be resolved in favor of disclosure.

Four Climate Change Risks that May Trigger Disclosure Requirements

The Climate Change Guidance describes four principal ways in which climate change risks may trigger disclosure obligations under existing SEC rules.

1. Impact of Legislation and Regulation

The Climate Change Guidance notes a number of significant developments in federal, regional and state legislation and regulation regarding climate change, including:

- Proposed federal climate change legislation that, if enacted, would establish a "cap and trade" system of allowances to reduce greenhouse gas emissions;
- Regional, state and local climate change laws and regulations;

⁴ See *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

- The U.S. Environmental Protection Agency's (the "EPA") rule requiring reporting of greenhouse gases by large emitters beginning with the time period starting on January 1, 2010; and
- The EPA's December 2009 endangerment finding for greenhouse gases under the federal Clean Air Act, which will allow the EPA to promulgate rules directly regulating greenhouse gas emissions.

Possible consequences of enacted and pending climate change legislation and regulation, both negative and positive, that should be considered by registrants include:

- Costs to purchase, or profits from sales of, allowances or credits under a "cap and trade" system;
- Costs to improve facilities and equipment in order to reduce emissions to comply with regulatory limits or mitigate the financial impact of a "cap and trade" system; and
- Changes to profit or loss resulting from increased or decreased demand for goods or services produced or provided by a registrant arising either directly from climate change legislation or regulation or indirectly from changes in the cost of goods sold.

The Climate Change Guidance provides a number of examples of how enacted and pending climate change legislation and regulation and their possible impact on a registrant may trigger disclosure obligations under existing SEC disclosure rules:

- Item 101: Item 101 requires disclosure of any material estimated capital expenditures for environmental control facilities (which would include any control facilities to reduce or sequester greenhouse gas emissions) for a registrant's current and succeeding fiscal years and for such further periods as a registrant may deem material.
- Item 303: Item 303 requires a registrant to assess whether any enacted climate change legislation or regulation is reasonably likely to have a material effect on a registrant's financial condition or results of operation, including the potential for increased costs. In addition, with respect to a known uncertainty, such as pending climate change legislation or regulation, management must (i) evaluate whether any pending legislation or regulation is reasonably likely to be enacted, and (ii) unless management can determine that any pending legislation is not reasonably likely to be enacted, management must determine whether any pending legislation or regulation, if enacted, is reasonably likely to have a material effect on a registrant, its financial condition or results of operations. Unless management determines that a material effect is not reasonably likely, MD&A disclosure is required. Moreover, a registrant must consider disclosure, if material, of "the difficulties involved in assessing the timing and effect of the pending legislation or regulation."⁵
- Item 503(c): Item 503(c) requires risk factor disclosure of existing or pending climate change legislation or regulation that make an investment in a registrant speculative or risky. The Climate

⁵ Release No. 33-8350 (Dec. 19, 2003) [68 Fed. Reg. 75055].

Change Guidance notes that a registrant should consider specific risks it faces as a result of climate change legislation or regulation and avoid generic risk factor disclosure that could apply to any company. As an example, the Climate Change Guidance notes that registrants in the energy sector face significantly different risks from climate change legislation and regulation than registrants in the transportation sector.

Emphasizing that climate change regulation is a “rapidly developing area,” the Climate Change Guidance encourages a registrant to regularly assess its potential climate change disclosure obligations in light of new developments. In addition, the guidance specifically states that management “should ensure that it has sufficient information regarding the registrant’s greenhouse gas emissions and other operational matters to evaluate the likelihood of a material effect” arising from climate change legislation or regulation. To do so, a registrant must have adequate “disclosure controls and procedures” in place to process information required to be disclosed or potentially subject to required disclosure.⁶

2. International Accords

The Climate Change Guidance acknowledges international efforts to address climate change concerns on a global basis, such as the Kyoto Protocol, the European Union Emission Trading System and the United Nations Climate Conference in Copenhagen. The potential sources of SEC disclosure obligations with respect to such international climate change accords are the same as discussed above with respect to U.S. climate change legislation and regulation. Thus, the Climate Change Guidance encourages a registrant whose business is reasonably likely to be affected by such international climate change agreements to monitor the progress of any such agreements and disclose material impacts on its business.

3. Indirect Consequences of Regulation or Business Trends

The Climate Change Guidance lists a number of possible indirect risks or opportunities for a registrant resulting from legal, technological, political and scientific developments relating to climate change that may affect the competitive landscape for goods and services in the markets in which a registrant participates, including:

- Decreased demand for goods that produce significant greenhouse gas emissions and a corresponding increased demand for goods that result in lower greenhouse gas emissions;
- Increased competition to develop innovative new products;
- Increased demand for generation and transmission of energy from alternative energy sources; and
- Decreased demand for services related to carbon-based energy sources, such as drilling services or equipment maintenance services.

The Climate Change Guidance provides a number of examples as to how these indirect consequences may trigger disclosure obligations under existing SEC disclosure rules:

⁶ Release No. 33-8124 (Aug. 28, 2002) [67 Fed. Reg. 57276].

- Item 101: Disclosure may be required in a registrant's business description under Item 101(a)(1) if climate change business trends have a significant enough impact on a registrant's business to result in a shift in operation (e.g., if a registrant plans to reposition itself through material acquisitions of plants or equipment in order to take advantage of potential climate change opportunities).
- Item 303: MD&A disclosure may be required if business trends resulting from such indirect consequences are reasonably likely to have a material effect on a registrant's financial condition or results of operation.
- Item 503(c): Disclosure of significant indirect risks from climate change may be required, including the impact on a registrant's reputation. The Climate Change Guidance encourages a registrant to assess whether the public's perception of any publicly available data relating to its greenhouse gas emissions could expose it to potential adverse consequences to its business operations or financial condition resulting from reputational damage.

4. Physical Impacts of Climate Change

Finally, the Climate Change Guidance notes that significant physical effects of climate change have the potential to affect a registrant's operations and results, and that a registrant whose business may be vulnerable to severe weather or climate related events should consider disclosing material risks of, or consequences from, such events. The guidance enumerates the following possible consequences of severe weather:

- Property damage and disruptions to operations on coastlines;
- Indirect financial and operational impacts from disruptions to operations of major customers or suppliers from severe weather;
- Decreased agricultural production in areas affected by weather-related changes, such as drought;
- Increased insurance claims and liabilities for insurance and reinsurance companies; and
- Increased insurance premiums and deductibles, or a decrease in availability of coverage, for a registrant with facilities in areas subject to severe weather.

Conclusion

Although the Climate Change Guidance states that it does not intend to alter the basic tenets of existing SEC disclosure obligations, the tenor of the Climate Change Guidance sends a clear signal that the SEC expects public companies to pay closer attention to the evaluation of both climate change risks and opportunities when determining whether, how much and what kind of disclosure is warranted. In particular, the SEC's discussion of the need for a registrant to consider disclosure of both the indirect consequences of climate change, as well as its physical impacts, are likely to elicit new and more comprehensive disclosures of the potential for material impacts by companies already disclosing the risks associated with climate change.

The Climate Change Guidance became effective on February 8, 2010, and should, therefore, be considered carefully by public companies, including disclosure committees and the persons in charge of

crafting disclosures, in connection with the preparation of their Form 10K annual reports and other public filings for the fiscal year ending December 31, 2009.

The Climate Change Guidance may not be the SEC's last word on the application of SEC disclosure requirements to climate change matters. The SEC plans to monitor the impact of the Climate Change Guidance on public filings as part of its ongoing disclosure review program and to hold a public roundtable on climate change disclosure issues in the spring of 2010. In addition, the SEC's Investor Advisory Committee is considering climate change disclosure in connection with its overall mandate to provide advice and recommendations to the SEC. Based on the results of its information gathering, the SEC may consider whether further guidance or rulemaking relating to climate change disclosure is necessary or appropriate in the future.

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