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Monday, February 08, 2010

CONTA

SEC Adopts Guidance on Climate Change Disclosures

On February 2, 2010, the Securities and Exchange Commission (“SEC”) issued an interpretative release (the “Release”) seeking to clarify public companies’ obligations to disclose potential impacts of climate change on their businesses.¹ The SEC’s new guidelines were adopted through an unusually partisan vote, split three to two between Commissioners appointed by the Obama and Bush Administrations, respectively.

In announcing the issuance of the Release, SEC Chairman Schapiro emphasized that the Release does not amend any disclosure regulations or materiality standards, nor does it redefine existing SEC or judicial interpretations of those regulations or standards. Chairman Schapiro also explained that the SEC is not “opining on whether the world’s climate *is* changing, at what pace it might be changing, or due to what causes.”² Rather, the purpose of the Release, according to Chairman Schapiro, is to facilitate clarity and consistency in disclosures within the existing SEC disclosure framework.

Notwithstanding this statement of benign intent, the issuance of the Release immediately spawned controversy. Two Commissioners took the unusual step of criticizing the Release as unnecessary and unlikely to improve the quality of information available to investors. Republican members of Congress also voiced their displeasure. Representative Spencer Bachus (R-AL), ranking Member of the House Financial Services Committee, sent a pointed letter to Chairman Schapiro calling the Release “ill-advised.”

Key Implications of the Release

Central to the SEC’s new guidance is a determination that climate change issues – proposed and existing legislation, new trading markets for emissions credits, changing costs and demands for products and services, and potential impacts of changing weather patterns on existing infrastructure – may have a material impact now, or constitute a known trend that is reasonably likely to have a material effect in the future. In support of that determination, the SEC cited to multiple pending petitions by environmental and investor groups seeking new climate change disclosure guidance, actions by the New York Attorney General to compel energy-producing companies to enhance their climate change disclosures, the U.S. Environmental Protection Agency’s (“EPA’s”) “endangerment finding” for greenhouse gases (“GHGs”) under the Clean Air Act, and regional, national, and international initiatives to reduce GHG emissions.

The Release states that the mere existence of proposed climate change legislation or regulations may require analysis and disclosure, even if it is not yet known whether such proposals ultimately will be adopted. In her speech discussing the Release, Chairman Schapiro stated “It is neither surprising nor especially remarkable for us to conclude that *of course* a company must consider whether potential legislation – whether that legislation concerns climate change or new licensing requirements – is likely

occur. If so, then under our traditional framework the company must then evaluate the impact it would have on the company's liquidity, capital resources, or results of operations, and disclose to shareholders when that potential impact will be material."³

Although the Release purports not to change existing materiality standards, its focus on potential impacts of laws yet to be enacted and climate events yet to occur calls that into question. So does emphasis in the Release on subjective measures of materiality, such as potential "reputational" damage associated with the public's perception of a company's environmental performance.

Whether the Release will improve the quality of information available to investors remains to be seen. The Release suggests that whether climate change matters may have a material impact, or constitute a known trend reasonably likely to have a material impact, on specific business operations is a question to be answered based on each registrant's unique circumstances. The Release also acknowledges previous studies by CERES and the Environmental Defense Fund showing widely disparate disclosure practices among apparently similarly situated public companies.⁴

Regulatory Basis for Disclosure of Climate Change Risks

The Release highlights four SEC regulations that may trigger climate change-related disclosure obligations:

- *Item 101 of Regulation S-K*, which requires a company to disclose material effects of compliance with environmental laws that have been "enacted or adopted."⁵
- *Item 103 of Regulation S-K*, which requires a description of "any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party."⁶
- *Item 303 of Regulation S-K*, entitled Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), which requires disclosure of "known trends, events, demands, commitments, and uncertainties" that are reasonably likely to have a material effect on a company's "financial condition or operating performance."⁷ Item 303 requires companies to assess the likely *future* impacts, whether favorable or unfavorable, of known trends and uncertainties on company operations. Under Item 303, disclosure is required if management cannot determine that (i) the trend or event is not reasonably likely to occur; and (ii) such trend or event is not reasonably likely to be material.⁸
- *Item 503(c) of Regulation S-K*, which requires a company to discuss "the most significant factors," specific to the company, that make an investment in the company "speculative or risky."⁹

Whether a company is required to make disclosures in its SEC reports, particularly under Item 101 and in the MD&A, continues to hinge on whether climate change related risks are considered "material." Generally, an item is material if there is a substantial likelihood that its disclosure would be viewed by a "reasonable investor" as having significantly altered the "total mix" of information based on which he or she determines whether to invest.¹⁰

Inherent in the question of whether a prospective environmental cost or loss contingency will have sufficient impact on a company's operations or financial condition to be material are the further questions of whether and when it is likely to happen at all. Given the uncertainty associated with both the science of climate change, and whether, and in what manner, GHG emissions will be regulated, a materiality determination in the context of climate change may be particularly vexing. Both the U.S. Supreme Court and the SEC have stated that doubts about materiality should be resolved in favor of disclosing the information, however,¹¹ and the Release reiterates this point.¹² Moreover, the Release states that, in making materiality determinations, companies "should not limit the information that management considers" and are "expected to consider all relevant information even if that information is not required to be disclosed," including the vast amount of financial and non-financial information companies now have at their disposal.¹³

Climate Change Issues Subject to Disclosure

The Release lists four climate change-related "topics" that a company "may need to consider" in preparing its disclosures: (i) the "impact of legislation and regulation"; (ii) "international accords"; (iii) "indirect consequences of regulation or business trends"; and (iv) "physical impacts of climate change."¹⁴

Impact of Legislation and Regulation

That laws and regulations that already have been enacted may have a material impact and therefore require disclosure is not news. The introductory sections of the Release note a number of existing regulatory programs related to climate change, including GHG emissions restrictions in California, the Regional Greenhouse Gas Initiative establishing a cap-and-trade system for GHG emissions from electric generators in Northeast and Mid-Atlantic states, and the United States EPA's promulgation of GHG reporting requirements for large sources.¹⁵ According to the Release, disclosures of "any material estimated capital expenditure for environmental control facilities" in connection with "existing federal, state, and local provisions which relate to [GHG] emission would be required under Item 101, much as they would in connection with other environmental laws."¹⁶ Likewise, there may be material risk factors for companies in sectors already affected by existing GHG requirements, such as energy and transportation that warrant disclosure under Item 503(c).

The much thornier issue is whether "pending" legislation and regulations may be material. The Release acknowledges the many different federal bills and regulations that are now pending.¹⁷ The Release states that pending legislation or regulations must be evaluated to see if they are "reasonably likely to be enacted."¹⁸ *According to the Release, unless management can determine that such proposals are not reasonably likely to be enacted, "it must proceed on the assumption that the legislation or regulation will be enacted."*¹⁹ A company should then determine, if enacted, whether the legislation or regulation is "reasonably likely to have a material effect on the [company], its financial condition or results of operations."²⁰ If so, "MD&A disclosure is required."²¹

The Release focuses on the possible effects of cap-and-trade legislation in particular, including the costs of emissions allowance and credits, the capital costs of reducing emissions at company facilities, and changes to demands for goods and services.²² The Release also counsels companies to ascertain the potential positive impacts of a proposed law, such as profits from the sale of carbon allowances or offsets.²³

To allow companies to make an evaluation of the impacts of legislation or regulation, the Release states that companies should "ensure" that they have enough information regarding their GHG emissions and other operational matters to assess "the likelihood of a material effect arising from the subject legislation or regulation."²⁴ In this regard, the Release appears intended to spur companies to perfect procedures for collecting data regarding their GHG emissions and other climate change-related information even if federal or state regulations do not require companies to do so. As chief executive officers and financial officers are required to certify that their companies' protocols regarding collection and reporting of company data to management are appropriate to ensure proper disclosure of information, the Release suggests that collection and reporting of GHG emissions data should be of concern to companies' top-level managers.

International Accords

The Release also discusses the potential impacts to companies' operations under various international accords and treaties that relate to climate change, including the Kyoto Protocol, which was never ratified by the United States but may nevertheless apply to companies with international businesses, and the European Union Trading System, which implements Kyoto through a cap-and-trade system limiting GHG emissions in a number of European nations.²⁵ The Release also mentions the possibility of future treaties that may emerge from ongoing international climate change dialogue, such as the recent United Nations Climate Change Conference in Copenhagen, Denmark.²⁶

The Release directs companies to evaluate the impacts of international accords and treaties relating to climate change in the same manner that they evaluate domestic legislation and regulations, including "pending" efforts.²⁷ The Release urges companies to "monitor" the progress of international negotiations on climate change issues to determine whether they may warrant discussion in SEC reports.²⁸ Significantly, the Release suggests that companies need to evaluate not only the direct effects of existing and future international accords on their operations, but also the effects of such accords on other companies up the supply chain or with whom they have other contractual relationships.

Indirect Consequences of Regulation or Business Trends

Indirect consequences of "business trends or risks" related to climate change, the Release states, also should be evaluated and may require disclosure.²⁹ Although the Release focuses on potential changes in demand for goods and services as a result of climate legislation and regulations, such as increased demand for renewable non-carbon-based energy and decreased demand for services related to carbon-based energy sources, the Release broadly describes "legal, technological, political, and scientific developmen

regarding climate change” as potentially requiring disclosure as risk factors or in the MD&A.³⁰ The Release also calls attention to potential “reputational” damage associated with the public’s perception of a company’s emissions performance.³¹

Physical Impacts of Climate Change

Although Chairman Schapiro stated that the SEC takes no position on the science of climate change, the Release does discuss a number of potential “physical effects” of climate change, including increased severity of weather, rising sea levels, declines in the availability of farmland, and diminished water availability and quantity.³² These physical risks may be material, the Release says, to companies with coastal or agricultural operations, and to insurers and reinsurers.³³

Challenges in Preparing Climate Change Disclosures

The Release leaves public companies with very few concrete guidelines for preparing disclosures on the climate change issues identified in the Release, other than the message that the SEC believes that companies should give these issues careful consideration. The Release presents a number of challenges for companies in preparing disclosures:

- The Release does not announce *per se* rules or other mandatory requirements in favor of disclosure, but suggests that companies should consider climate change in preparing disclosures. While, as noted above, materiality continues to be the touchstone of SEC disclosure requirements, the Release provides little, if any, guidance for companies in evaluating, for example, whether pending GHG legislation or speculative future physical impacts of climate change may be material to a company’s operations.
- With respect to the evaluation of “pending” legislation and regulations, the Release says that public companies should assess separately and on a continual basis, whether climate change legislation will be enacted. The legislative process associated with climate change bills currently before Congress highlights the difficulties associated with making such an assessment. Climate change legislation has passed the House but has languished in the Senate, with the President signaling in his FY2011 budget and in public remarks that he thinks the likelihood of a cap-and-trade program passing the Senate this year is very low. The contents of the final legislation, even if it were to pass, are also highly uncertain, with the fundamental details of the legislation differing depending on the bill. It will be difficult, at best, for companies to undertake a meaningful evaluation of the risks associated with proposed legislation.
- Similarly, the SEC appears to be inviting companies to speculate on how the public will value its efforts to reduce GHGs, even such reductions are not currently required by law. SEC Commissioner Paredes, who voted against issuance of the Release, expressly criticized the SEC for focusing on a factor as speculative as “reputational damage.”³⁴
- Finally, assessing whether the physical impacts of climate change will have material effects on a company’s business will be difficult, if not impossible, for most companies. It is one thing to predict that climate change will have impacts on a global level but quite another to predict economic impacts on a local level. There is, in fact, significant scientific uncertainty regarding how climate change will affect the weather or environmental conditions in a particular location, including, for example, the amount and timing of any sea level rise.

Consistent with its assertion that it is not making any changes to companies’ disclosure obligations, the SEC made no statement to how, and to what degree, it will enforce its new climate change guidance. Prior to the SEC’s announcement, the New York Attorney General instituted his own State enforcement actions, and investors brought dozens of shareholder resolutions seeking detailed climate disclosures. Now that the SEC has to some extent aligned itself with these efforts, and is planning to convene a climate change “roundtable” this spring, it would be prudent for every public company to take a fresh look at its own internal compliance programs for identifying, measuring, and reporting potential impacts of climate change matters on their business operations.

¹ Commission Guidance Regarding Disclosure Related to Climate Change, SEC Interpretative Release No. 33-9106.

² See Chairman Schapiro’s Statement Before the Open Commission Meeting on Disclosure Related to Business or Legislative Events on the Issue of Climate Change

³ *Id.*

⁴ Release at 7 n.20.

⁵ See Release at 12-13; 17 C.F.R. § 229.101(c)(1)(xii).

⁶ See Release at 13-14; 17 C.F.R. § 229.103, Instruction 5. Although the Release does not specifically discuss GHG litigation or enforcement actions, the petitions to the SEC requesting the Release cited as examples *Connecticut v. AEP Co.*, a public nuisance action by several states and environmental groups against five major electric generating companies, now pending in the Second Circuit, and *Comer v. Murphy*, an action against coal, oil, and chemical companies for damages caused by Hurricane Katrina, which plaintiffs allege were exacerbated by the companies' GHG emissions, now pending in the Fifth Circuit.

⁷ Release at 16-17. See 17 C.F.R. § 229.303(a)(3)(ii); Interpretative Release No. 33-8350 (Dec. 19, 2003).

⁸ See Release at 19.

⁹ See Release at 15; 17 C.F.R. § 229.503(c).

¹⁰ *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1979).

¹¹ *Id.* at 448.

¹² Release at 11.

¹³ See Release at 18-19.

¹⁴ Release at 22-27.

¹⁵ Release at 3.

¹⁶ Release at 22. According to the Release, the company must disclose such expenditures anticipated through the next fiscal year and "for such further periods as the [company] may deem material." *Id.*

¹⁷ Release at 3-4.

¹⁸ Release at 23.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² Release at 23-24.

²³ *Id.*

²⁴ See Release at 23 n.71.

²⁵ See Release at 4.

²⁶ *Id.*

²⁷ Release at 24.

²⁸ *Id.*

²⁹ Release at 25-26.

³⁰ *Id.*

³¹ Release at 26.

³² Release at 6-7; 26.

³³ See Release at 27.

³⁴ See Commissioner Paredes' Statement Regarding Commission Guidance Regarding Disclosure Related to Climate Change

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