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#### **A Publication of Pepper Hamilton LLP** **Sustainability, CleanTech and Climate Change Alert**

Another Climate Change Shoe Drops: The SEC Climate Change Disclosure Guidance

*Tuesday, February 23, 2010*

On February 2, 2010, the Securities and Exchange Commission (SEC) issued controversial guidance on what types of disclosures public companies should make concerning the potential future impact of climate change (guidance).<sup>1</sup> In essence, the SEC has concluded that disclosure<sup>2</sup> is necessary because current and potential future regulatory, legislative and other developments relating to climate change could have significant effects on operating and financial decisions of companies. Such effects on companies can be direct effects (i.e., requiring them to purchase greenhouse gas (GHG) emission allowances for each ton of GHG emissions from their facilities). Effects also can be indirect, e.g., from changing prices for the companies' goods or services (due to increased costs to the companies for energy or raw materials that may be produced by a process that emits GHGs) or from damage to companies' reputations caused by their producing disfavored products or services. Thus, climate change disclosures in prior SEC filings may no longer be good models or precedent, since it is their perceived inadequacy that appears to have driven the SEC to force a change by issuing this guidance.

#### **How the SEC Uses Its Guidance**

The principle that regulatory developments that may have a material effect on a company's financial condition should be disclosed is well established, although until now, that principle has applied only to existing – as opposed to potential – legislative or regulatory requirements. This guidance is described as interpretive rather than as imposing new regulatory mandates and, as with all guidance, it does not have the force and effect of law. Nevertheless, the SEC is the arbiter of first resort as to whether a company has provided adequate disclosures in compliance with federal securities regulations, and as such, a company ignores the SEC's guidance at its peril.

#### **Potential Problems in Applying the Guidance**

The question at this point is not whether disclosure of material environmental liabilities is appropriate, but whether this guidance facilitates appropriate disclosure or further confuses matters. The guidance creates a number of dilemmas for companies because it directs them to predict what statutory or regulatory requirements may be adopted in the future and then "inform" investors about potential effects that may never occur or could be mitigated based on the final provisions that are enacted or promulgated.

#### *Predicting Future Statutory and Regulatory Requirements*

As a threshold matter, a company must determine whether federal, state or local climate change legislation or regulation<sup>3</sup> is "not reasonably likely to be enacted." Unless this is a defensible conclusion, the guidance directs companies to *assume* the legislation or regulation will be enacted and registrants should consider "specific risks they face as a result of climate change pending legislation or regulation." This convoluted phrasing seems intended to create a presumption that climate change legislation or regulation will be adopted.

At first glance, this appears to be in line with long-standing SEC policy, dating back at least to the SEC's 1989 Interpretive Release on Management's Discussion and Analysis of Financial Condition and Results of Operations,<sup>4</sup> in which the SEC laid out the now well-established disclosure standard for MD&A. According to that standard, "where a trend, demand, commitment, event or uncertainty is known, management must make two assessments:

- (1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
- (2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur."<sup>5</sup>

Under this standard, the question becomes whether enactment of climate change legislation should be considered to be "reasonably likely to occur." If that determination cannot be made, then the company must disclose the consequences of climate change legislation unless management is able to determine that such legislation will not have a material effect on the company.

Thus, the first dilemma that a company faces is whether it is able to determine whether the enactment or promulgation of a climate change statute regulation is "reasonably likely to occur."<sup>6</sup> The House of Representatives has passed a climate change bill and the Senate Committee on the Environment and Public Works has voted for a similar, but not identical, bill that has not moved to the full Senate. One of the primary authors of the Senate committee bill has publicly announced that he is seeking to negotiate a bipartisan compromise bill, a strong indication that the previous bill cannot win the necessary votes for passage. Based on these facts, the only certainty is that the final bill, if there is one, will *not* be identical to either the House or the Senate Committee bills.<sup>7</sup> So, viewed literally, both the House and the Senate Committee bills are "not reasonably likely to be enacted."

Similarly, EPA has *proposed* a Clean Air Act (CAA) GHG Prevention of Significant Deterioration (PSD) "Tailoring Rule" (i.e., it tailors the existing CAA rule to apply to GHGs). This rule has not been promulgated in final form. It will be challenged in court, and congressional proponents have made it clear they will propose legislation to withdraw EPA's authority to regulate GHG emissions. EPA officials have indicated that, even if the rule is

finalized, they will only require energy efficiency measures at most facilities. Accordingly, at this point, it is impossible to predict what, if any, regulations will be imposed.

#### *The Difficulty in Predicting What Will Be in a Future Statute or Regulation*

If a company is unable to determine whether climate change legislation is reasonably likely to be adopted, the challenge then is predicting what will be in the assumed statute or regulation in order to consider the “specific risks they face as a result of climate change pending legislation or regulation.” Therefore, the second dilemma is whether to assess the “specific risks” using the provisions of the House bill, the Senate committee bill, the company’s own assessment of what might be in a final bill, or all three of these options. Alternatively, a registrant could simply state that the House and Senate committee bills are unlikely to pass in their current form, but, in the interest of full disclosure, report the company’s GHG emissions and some general effects from a generic carbon reduction regime, such as the likelihood of having to buy GHG emission allowances if a cap and trade scheme is enacted. This approach, however, may be inconsistent with the guidance’s admonition to “avoid generic risk factor disclosure that could apply to any company” as opposed to identifying specific effects (since it is difficult to predict which companies will find themselves in need of GHG allowances without knowing how many will be allocated and what industry sectors may be granted free allowances and for how long). Unless a company can identify specific factors that would appear to make it particularly sensitive to climate change factors, such as agricultural enterprises in areas subject to drought where climate change is expected to worsen the situation, it is difficult to visualize the kind of individualized effects the guidance references, especially within the time period likely to be relevant to investors.<sup>8</sup>

Beyond this conundrum, if the SEC staff apply the interpretation in the guidance strictly, companies could face a Hobson’s choice of guessing wrong on what bill might pass. Any disclosure prepared at this stage would need to identify the assumptions made concerning the final form of any legislation that may eventually be enacted, and the materiality of any such qualified disclosure becomes questionable.<sup>9</sup>

#### *The Relevance of International Accords*

The guidance also directs registrants to assess the “impact of international accords,” which also is difficult to apply. As a matter of law, international accords have no legally binding effect in the United States unless implemented by domestic legislation. Even the principal example provided – the Kyoto protocol – has never been ratified by the United States, as the guidance acknowledges. Thus, this section is perhaps interesting background for domestic companies, but has no legal consequence. Companies with operations outside the United States face a similar dilemma to the one described above concerning predicting domestic legislation and regulation, except that predicting the outcome and effectiveness of international agreements is even less certain.

#### *Some Indirect Consequences of Regulation or Business Trends Are Easier to Predict Than Others*

In another section, the guidance notes that companies must disclose the “indirect consequences of regulation or business trends,” including:

- decreased demand for goods that produce significant greenhouse gas emissions
- increased demand for goods that result in lower emissions than competing products
- 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.

Although aspects of these assessments are subjective and can be difficult to divine, some existing SEC disclosures and annual reports have generally touched on these issues, albeit not with the level of detail suggested by the new SEC guidance. This is particularly the case in situations in which climate change opens up new markets. In addition, disclosing increased demand for goods that result in lower emissions than competing products will be easier for some companies because some retailers are already requiring disclosure from their suppliers.<sup>10</sup>

In view of the new focus on this area, a company that has a public report or even a “confidential” planning assessment that addresses one or more of these indirect effects (e.g., projected declining sales of a product that is energy inefficient) should ensure that its SEC disclosure is consistent with the internal assessment. (Similarly, it is important that companies, when drafting their disclosures, consider the views that the company has taken publicly on the passage of the climate change statute or regulation, to avoid discrepancies that could be an issue for shareholders.)

#### *Predicting the Physical Impacts of Climate Change at Specific Locations is Beyond the Reach of Current Science, Although Some Aggregate, General Trends Can Be Discussed*

Perhaps the most troublesome recommendation in the guidance is that companies must disclose the “physical impacts of climate change,” including:

- the property damage and disruptions to operations, including manufacturing operations or the transport of manufactured products, for companies with operations concentrated on coastlines
- indirect financial and operational impacts from disruptions to the operations of major customers or suppliers from severe weather, such as hurricanes or floods
- increased insurance claims and liabilities for insurance and reinsurance companies
- decreased agricultural production capacity in areas affected by drought or other weather-related changes
- increased insurance premiums and deductibles, or a decrease in the availability of coverage, for companies with plants or operations in areas subject to severe weather, and
- the material risks of, or consequences from, companies whose businesses may be vulnerable to severe weather or climate-related events.

For a few companies (e.g., insurance companies), this recommendation may not add significant burdens compared to the company’s current practices. By definition, insurance companies are in the business of predicting future claims so that they can set their premiums. There is robust insurance literature on the effect of climate change. Additionally, in 2009, the National Association of Insurance Commissioners voted to require insurers to submit annual “climate-risk” reports. However, these predictions are actuarial (i.e., they do *not* predict specific effects at specific facilities, such as is suggested by the guidance).

In contrast, plant-specific predictions of climate change effects are, as a practical matter, impossible based on the current state of the science.<sup>11</sup> While the examples noted in the guidance (e.g., the dangers to coastal facilities from hurricanes or floods or decreased agricultural output in areas subject to drought) may be true at a large-scale level, it is difficult to see how reasonably accurate individualized predictions can be made.

## **Conclusion**

In summary, the SEC has jumped head-first into the climate change debate. It remains to be seen whether the pool was sufficiently filled prior to this leap. In any case, companies subject to SEC disclosure requirements should re-evaluate their past practices and make a good faith effort to comply with this guidance, despite the serious problems presented by the interpretations provided in the guidance.

#### Endnotes

1 Release No. 33-6835 (May 18, 1989) [54 FR 22427]

2 Id.

3 SEC, Commission Guidance Regarding Disclosure Related to Climate Change, available at <http://www.sec.gov/rules/interp/2010/33-9106.pdf>. For background on the prior SEC climate change disclosure requirements see the Pepper Hamilton LLP *Energy Update*, "SEC Climate Change Reporting Requirements and Developments" (October 08, 2007), available at [http://www.pepperlaw.com/publications\\_update.aspx?ArticleKey=1000](http://www.pepperlaw.com/publications_update.aspx?ArticleKey=1000).

4 Disclosure may be required:

(a) by Item 101(c)(1)(xii) of Regulation S-K (17 CFR § 229.101(c)(1)(xii)), which requires disclosure of any "material estimated capital expenditures" for climate change control facilities required by federal, state, and local laws or regulations during the current fiscal year, the succeeding fiscal year and for such further periods as the registrant may deem material

(b) by Item 103 of Regulation S-K (17 CFR § 229.103), which requires disclosure of any material pending legal proceeding to which it or any of its subsidiaries is a party

(c) by Item 503(c) of Regulation S-K46 (17 CFR § 229.503(c) (known as the Risk Factors), which requires a discussion of the most significant factors that make an investment in the registrant speculative or risky, and

(d) by Item 303 of Regulation S-K48 (17 CFR § 229.303) (known as the Management's Discussion and Analysis of Financial Condition and Results of Operations, or MD&A), which requires disclosure of material historical and prospective textual disclosure enabling investors to assess the financial condition and results of operations of the registrant, and

(e) by Form 20-F (17 CFR 249.220f) (the obligation of foreign private issuers), which requires disclosure of, among other things, material risks, environmental issues that may affect use of assets, factors and trends that may have a material effect on a company's financial condition and results of operation in the future, and any legal or arbitration proceedings, including governmental proceedings, that are anticipated to have a material effect on the final conditions and operations.

5 See the Pepper Hamilton LLP *Energy Update*, "State and Local Governments Forge Ahead with Climate Change Legislation" (September 03, 2008) available at [http://www.pepperlaw.com/publications\\_update.aspx?ArticleKey=1229](http://www.pepperlaw.com/publications_update.aspx?ArticleKey=1229).

6 The Environmental Protection Agency promulgated a GHG emission reporting rule that became effective on December 29, 2009. It requires reporting of 2010 emissions (either based from generic emission factors (i.e., nonplant specific methods that allow the companies in an industry to calculate the "average" emissions) or by measuring actual emissions, which is more expensive. The rule does *not* require control of GHG, rather it mandates only that sources above certain threshold levels monitor and report emissions.

7 For example, a bill could have a cap and trade structure or not. If it has a cap and trade scheme, it could require annual purchases of GHG emission allowances equal to the prior year's GHG emissions, or issue free greenhouse gas emission allowances (generally or for a fixed period of time). In fact, the consensus of political commentators is that significant bipartisan compromise will be needed in order to pass a bill and many senators oppose a cap and trade provision. For example, Sen. John Kerry (D-Mass.), one of the cosponsors of the Senate climate bill; Sen. Joe Lieberman (I-Conn.); and Sen. Lindsey Graham (R-S.C.) are working on a compromise. Sen. Bingaman (D-N.M.) and Sens. Maria Cantwell (D-Wash.)/Sen. Susan Collins (R-Maine) have energy bills without cap and trade.

8 The guidance offers the example of energy sector companies, which it suggests are particularly sensitive to GHG legislation or regulation, compared to registrants in the transportation sector, which are less so.

9 For example, the guidance states that "if a 'cap and trade' type system is put in place, registrants may be able to profit from the sale of allowances if their emissions levels end up being below their emissions allotment." Guidance at 23. Neither the House nor Senate bills provide an allotment. A covered company must hold GHG allowances equal to the number of tons that it actually emitted from its facilities the prior year and such allowances must be purchased from the government or on the GHG allowance exchange. Certain industrial companies will obtain full "free" allowances through 2026. Whether a company generates a net profit or simply minimizes the overall cost of compliance will depend on the specific circumstances. Except for carbon trading brokers (and similar entities), most companies are unlikely to make a net profit from climate change trading. The allotment language quoted above from the guidance more reflects the European Union's cap and trade scheme.

10 For example, the Carbon Disclosure Project (<https://www.cdproject.net/en-US/Pages/HomePage.aspx>) seeks to get companies to measure and disclose their greenhouse gas emissions and climate change strategies. It also provides this information to allow other companies up the product chain to make decisions based on a disclosing company's carbon emissions. The goal of the Carbon Disclosure Project is to put "this information at the heart of financial and policy decision-making." Companies like Wal-Mart are requesting disclosures from suppliers throughout their supply chains.

11 The existing modeling results may give general information on effects regionally, but not at the plant level. There are serious and substantial uncertainties in the projections, which does not seem to be taken into account in the guidance.

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