

Corporate Practice Client Alerts

SEC Issues Interpretive Guidance on Climate Change Disclosure

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The Securities and Exchange Commission has released interpretive guidance for public companies on existing SEC disclosure requirements as they apply to business and legal developments relating to climate change risks. You can find the full text of the interpretive release at: www.sec.gov/rules/interp/2010/33-9106.pdf. This action comes over two years after several investor groups and several state treasurers petitioned the SEC to provide further guidance on disclosures relating to climate change.¹

The new guidance is designed to complement existing SEC disclosure rules. Interpretive releases such as this one do not create new legal requirements or modify existing ones. Rather, the Commission intends for them to improve disclosure for public companies and their investors. In this regard, the Commission notes that public company disclosure at essence is, and continues to be, based on the concept of "materiality", affirming its consistently-held view that "information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make an investment decision." Public companies must disclose material information in their SEC filings such as registration statements under the Securities Act of 1933 and periodic and other reports under the Securities Exchange Act of 1934 whether pertaining to climate change or to other factors.

The interpretive release identifies and provides guidance on certain existing disclosure rules that the Commission believes are most likely to require a company to disclose the impact that developments related to climate change may have on its business. According to the Commission, the most relevant rules cover disclosure relating to a company's risk factors, business description, legal proceedings, and management discussion and analysis (or "MD&A") and apply equally to U.S. public companies as well as non-U.S. public companies meeting the SEC definition of a "foreign private issuer" (although the disclosure requirements for a foreign private issuer in most cases are derived from Exchange Act Form 20-F rather than Regulation S-K under the Securities Act).

Selected Disclosure Requirements

The Commission highlights the disclosure requirements pertaining to Securities Act registration statements and Exchange Act reports that are most likely to require climate change related disclosure, to the extent that management concludes that the impact of climate change is likely to be material.

Description of Business

Generally, Item 101 of Regulation S-K requires a public company to describe its business, including disclosure about its form of organization, principal products and services, major customers and competitive conditions. Item 101(c)(1)(xii) of Regulation S-K mandates that appropriate disclosure be made as to the material effects that compliance with federal, state and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the company. This requirement includes disclosure of any material estimated capital expenditures for environmental control facilities for a set period of time thereafter as well. In addition, Item 101(h)(4)(xi) requires disclosure of the costs and effects of compliance with federal, state and local environmental laws.

Legal Proceedings

Item 103 of Regulation S-K requires a public company to describe any material pending legal proceedings to which it is a party or to which any of its property is subject. Instruction 5 to Item 103 requires a public company to describe any material pending legal proceedings arising under any federal, state or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment. In addition, a public company may be required under Item 103 to make good-faith efforts to disclose the reasonably probable results of litigation such as a common law "public nuisance" claim against a public company that is a greenhouse gas emitter.

Risk Factors

Item 503(c) of Regulation S-K provides that, where appropriate, under the caption "Risk Factors", a public company must provide a discussion of the most significant factors that make an offering speculative or risky. Such a risk factor must not present risks that could apply to any issuer or any offering of securities, but specify how such a risk affects the issuer or the securities being offered.

MD&A

Item 303 of Regulation S-K, requiring disclosure known as "Management's Discussion and Analysis of Financial Condition and Results of Operations", or MD&A, sets forth the requirement for a public company to provide material historical and prospective disclosure in order to enable investors to assess the financial condition and results of operations of the company. In part, Item 303 mandates that management identify any known trends or any known demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in, the company's liquidity increasing or decreasing in any material way or that management reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.

Impact of Regulation

The Commission believes that the impact of existing or pending federal, state or local laws and regulations regarding climate change may trigger disclosure obligations under federal securities laws, including the disclosure items noted above. Under the Commission's guidance, when assessing potential disclosure obligations, a company should consider whether the impact of certain existing laws and regulations regarding climate change is material or is expected to be material in the future. In certain circumstances, a company should also evaluate the potential impact of pending legislation and regulation. For instance, provisions of laws or regulations relating to greenhouse gas emissions may prompt disclosure under Description of Business relating to material estimated capital expenditures for environmental control facilities. Moreover, the risk factors disclosure requirements of Item 503(c) of Regulation S-K may prompt tailored disclosure relating to risks that the company is or may be facing from the impact of existing or pending laws and regulations.

The Commission suggests that, in providing required MD&A disclosure, a public company should also evaluate whether existing or pending laws and regulations are reasonably likely to have a material effect on its financial condition or results of operation (whether positive or negative) by utilizing the following two-part test: first, if legislation is only pending, management must determine whether such pending legislation is likely to be enacted (and, unless not reasonably likely to be enacted, must proceed as if it were to be enacted), and, second, management must determine if such enacted law or regulation is reasonably likely to have a material effect (in which case disclosure is required). Examples of possible consequences of pending climate change-related legislation include: (i) costs and profits related to cap and trade systems; (ii) costs for emission reduction under regulatory regimes or to mitigate cap and trade limits; and (iii) profit or loss arising from changed demand for goods and services produced by a public company or from changed costs of goods sold.

International Accords

The Commission indicates that public companies also should consider, and disclose when material, the risks and impact on their business of international climate change treaties and accords. The release identifies two significant international accords to consider which may affect U.S. companies that have operations outside of the United States as well as non-U.S. companies: the Kyoto Protocol and the European Emissions Trading System, which is an international cap and trade system for carbon dioxide and other greenhouse gases. Other international treaties and accords also may have material effects on public companies. Similar to the analysis set forth above, a company's evaluation of the necessity of this disclosure should be made by reference to the MD&A analysis and traditional materiality principles.

Indirect Consequences of Regulation

The Commission advises companies to consider the actual or potential indirect consequences of climate change-related regulatory or business trends. Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for companies. For instance, a company may face decreased demand for goods that produce significant greenhouse gas emissions or increased demand for goods that result in lower emissions than competing products.

Examples set forth in the release of these consequences include: 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. Indirect consequences also may be more attenuated, such as whether a company should consider if the public's perception of publicly available data relating to greenhouse gas emissions could expose it to potential adverse consequences to its business operations or financial condition resulting from reputational damage.

The Commission indicates that these indirect consequences may be required to be disclosed in MD&A, or if a significant enough impact is gleaned from existing law and regulation, the business description. For instance, if a company plans to reposition itself to take advantage of potential opportunities, such as through material acquisitions of plants or equipment, it may be required to disclose this shift in plan of operation.

Physical Impacts of Climate Change

The Commission states that companies also should evaluate for disclosure purposes the actual and potential material impacts of environmental matters on their business. Climate change may affect weather, sea level, arability of farmland and water availability and quality. While companies may already routinely disclose material risk factors related to potential adverse effects of severe weather and other natural phenomenon, such as floods, hurricanes and earthquakes, in the release the Commission provides further detail regarding the assessment of such risk factors in light of climate change.

Possible consequences of climate change for companies with operations concentrated on coastlines would include property damage and disruptions to operations, including manufacturing operations or the transport of manufactured products; 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; and 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.

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It is important to note that the Commission is of the view that its guidance in the release does not modify existing disclosure or reporting requirements applicable to public companies under the Securities Act or the Exchange Act and does not add new disclosure requirements. In addition, the release does not constitute an acknowledgement by the Commission of the existence or causes of contemporary shifts in the world's climate. The Commission stated when voting to approve the release: "we are not opining on whether the world's climate is changing, at what pace it might be changing, or due to what causes." Rather, the Commission is using the release to guide public companies with respect to their disclosure obligations under the existing federal securities laws and to encourage them to consider climate change and its consequences as they prepare disclosure documents.

As a practical matter going forward, however, public companies and their counsel should expect their disclosure documents to attract greater scrutiny with regard to climate change disclosures from the Commission staff, as well as from the investing public, particularly the sections of disclosure documents that the Commission has identified in the release as likely imposing disclosure obligations related to climate change. In particular, when preparing their upcoming annual reports (which in the case of most larger public companies are due to be filed with the SEC by March 1), companies and their advisors would be well served by considering the guidance contained in this release related to the impact of climate change, especially as regards disclosure required in the Description of Business, Legal Proceedings, Risk Factors and MD&A sections of their annual reports.

If you have any questions on the release, or disclosure obligations of public companies, feel free to contact Walter Van Dorn at wvandom@sonnenschein.com or 212-768-6985, Jeff Fort at jfort@sonnenschein.com or 312-876-2380, Tom Hanley at thanley@sonnenschein.com or 202-408-9234, Mike Zolandz at mzolandz@sonnenschein.com or 202-408-9204 or Mike McNamara at mmcnamara@sonnenschein.com or 202-408-6477.

1 For a review of that petition, refer to: www.sonnenschein.com/docs/docs_climate/CCPU_10-07.pdf

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