

February 5, 2010

## Guidance on Disclosure Requirements

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### SEC Provides Guidance to Public Companies on Climate Change Disclosure

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#### SUMMARY

The SEC recently published an interpretive release to provide guidance to public companies regarding application of the SEC's existing disclosure requirements to climate change matters. The SEC is alerting registrants to the increasing importance of climate change-related regulation and the potential effects of that regulation on companies' operations and financial performance. The release points out specific areas of an annual report (such as the description of business, legal proceedings, risk factors and management's discussion and analysis) where detailed discussion of impacts of climate change would be appropriate, and reviews topics related to climate change which could trigger disclosure requirements, such as:

- Impact of significant developments in federal and state legislation and the difficulties involved in assessing the timing and effect of pending legislation, especially for registrants that are particularly sensitive to greenhouse gas regulation;
- Impact of international treaties or accords on businesses, especially for registrants with operations outside the United States that are or will soon become subject to such standards;
- Indirect consequences of legal, technological or scientific developments, such as increased demand for goods that results in lower greenhouse gas emissions or reputational damage arising from the public's perception of greenhouse gas emissions; and
- Physical impact of climate change, notably the devastating results of severe weather conditions.

Registrants will wish to take these views into account in preparing their Form 10-K's, annual reports to shareholders and other disclosure documents.

## BACKGROUND

The SEC devotes a significant part of its interpretive release<sup>1</sup> to a discussion of legislation that would result in greater regulation of greenhouse gas emissions. Legislation is pending in Congress which, if enacted, would limit greenhouse gas emissions through a “cap and trade” system of allowances and credits. In addition, the Environmental Protection Agency began, on January 1, 2010, to require large emitters of greenhouse gases to collect and report data with respect to their greenhouse gas emissions.<sup>2</sup> The international community has also taken steps to address climate change concerns. One such step was the Kyoto Protocol.<sup>3</sup> Another was the European Union Emissions Trading System (EU ETS),<sup>4</sup> which was launched as an international “cap and trade” system of allowances for emitting carbon dioxide and other greenhouse gases.

The SEC also indicates that there have been increasing requests for climate-related disclosures by shareholders of public companies. Most recently, the New York Attorney General’s Office entered into settlement agreements with three energy companies<sup>5</sup> that agreed to enhance their disclosures relating to climate change and greenhouse gas emissions in their annual reports filed with the SEC.

The SEC first addressed the question of disclosure of material environmental issues in the early 1970s and adopted rules on the topic in 1982.<sup>6</sup> Recently, the SEC reviewed its disclosure rules relating to environmental issues in connection with a review conducted by the Governmental Accountability Office.<sup>7</sup>

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## EXAMPLES OF CLIMATE CHANGE RELATED DISCLOSURES

In its release, the SEC provides a summary of current disclosure rules and points out the specific areas in a disclosure document where registrants should consider further discussion on material environmental

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<sup>1</sup> Interpretive Release: Commission Guidance Regarding Disclosure Related to Climate Change, Release No. 33-9106 (February 2, 2010), available at <http://www.sec.gov/rules/interp/2010/33-9106.pdf> (the “Release”).

<sup>2</sup> See Mandatory Reporting of Greenhouse Gases, Docket No. EPA-HQ-OAR-2008-0508, 74 FR 56260 (October 30, 2009).

<sup>3</sup> See [http://unfccc.int/kyoto\\_protocol/items/2830.php](http://unfccc.int/kyoto_protocol/items/2830.php) for more information on the Kyoto Protocol.

<sup>4</sup> See [http://ec.europa.eu/environment/climat/pdf/brochures/ets\\_en.pdf](http://ec.europa.eu/environment/climat/pdf/brochures/ets_en.pdf) for more information on the EU ETS.

<sup>5</sup> See the New York Attorney General’s Office press releases relating to: Xcel Energy, available at [http://www.oag.state.ny.us/media\\_center/2008/aug/aug27a\\_08.html](http://www.oag.state.ny.us/media_center/2008/aug/aug27a_08.html); Dynegy Inc., available at [http://www.oag.state.ny.us/media\\_center/2008/oct/oct23a\\_08.html](http://www.oag.state.ny.us/media_center/2008/oct/oct23a_08.html); and AES Corporation, available at [http://www.oag.state.ny.us/media\\_center/2009/nov/nov19a\\_09.html](http://www.oag.state.ny.us/media_center/2009/nov/nov19a_09.html).

<sup>6</sup> See Release No. 33-6383 (March 3, 1982).

<sup>7</sup> “Environmental Disclosure: SEC Should Explore Ways to Improve Tracking and Transparency of Information,” United States Government Accountability Office Report to Congressional Requesters, GAO-04-808 (July 2004).

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issues. The SEC then highlights specific matters that could be discussed by certain registrants for whom the potential impact of climate change is material.

### **Current Disclosure Rules**

Item 101 of Regulation S-K requires the registrant to describe the general development of its business. Among the required topics, Item 101 explicitly directs a registrant to disclose whether compliance with legislation regulating the discharge of materials into the environment will have material effects upon the capital expenditures, earnings and competitive position of the registrant. The registrant must disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material.

Item 103 of Regulation S-K requires a registrant to describe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to the business to which the registrant is a party or of which any of its property is the subject. Instruction 5 to Item 103 specifically requires disclosure of any proceeding brought by a governmental authority under environmental laws unless the registrant reasonably believes it will not result in sanctions of \$100,000 or more.

Item 503(c) of Regulation S-K, under the heading "Risk Factors," requires a registrant to discuss the most important factors that make an offering risky, including any risks related to climate change or regulatory actions proposed to address it.

Item 303(a) of Regulation S-K relates to management's discussion and analysis of financial condition and results of operations ("MD&A") of the registrant. Disclosure provided under Item 303(a) should communicate management's view of the company's financial condition and results of operations, and should identify and discuss known trends or uncertainties that may affect future results. In that connection, registrants need to consider all material information, including the potential consequences of any such known trend or uncertainty.

### **Examples of Disclosure**

#### **1. Impact of legislation and regulation**

As discussed above, the SEC notes that significant legislative developments regarding climate change may trigger disclosure obligations for certain registrants. Existing legislation might trigger a need to disclose material estimated capital expenditures for environmental control facilities that a registrant will be required to make. Existing or pending legislation might also trigger a need for risk factor disclosure. With respect to MD&A disclosure, in the case of a known uncertainty such as pending legislation, the SEC states that unless management determines that the legislation is not reasonably likely to be enacted, it should proceed on the assumption that it will be enacted. In that case, unless management determines that such legislation, if enacted, is not reasonably likely to have a material effect on the registrant's financial condition or operations, MD&A disclosure of the legislation and its potential impact will be

required. In addition, the registrant may also need to discuss the difficulties involved in assessing the timing and effect of such pending legislation. The SEC points out the following examples of how environmental legislation may impact the financial results of a registrant:

- Costs to purchase, or profits from sales of, allowances or credits under a “cap and trade” system;
- Costs required to improve facilities and equipment to reduce emissions in order to comply with regulatory limits or mitigate the financial consequences of a “cap and trade” regime; and
- Changes to profit or loss arising from increased or decreased demand for goods and services produced by the registrant arising directly from legislation or regulation, and indirectly from changes in costs of goods sold.

The SEC explains that registrants need to evaluate both the negative and the positive impact of potential legislation. For example, if a “cap and trade” regime is put in place, registrants may profit from sales of allowances if their emissions levels are below their emissions allotment.

If registrants have significant operations outside the United States, they may need to consider recent developments in international treaties or accords addressing climate change. The potential disclosure topics are similar to the ones discussed above in connection with U.S. legislation on climate change.

### **2. Indirect consequences of regulation**

The SEC draws registrants’ attention to the fact that technological or scientific developments regarding climate change may create new opportunities or risks for registrants and provides the following examples:

- Decreased demand for goods that produce significant greenhouse gas emissions or increased demand for goods that result in lower emissions;
- Increased competition to develop innovative products;
- Increased demand for generation and transmission of energy from alternative energy sources;
- Decreased demand for services related to carbon-based energy sources;
- Increased need for acquisitions of plant or equipment in order to take advantage of potential opportunities; and
- Impact on a registrant’s reputation due to publicly available data relating to its greenhouse gas emissions.

The SEC observes that these risks or trends may need to be disclosed as part of risk factors or in MD&A. In some cases, the developments may have significant effects on a registrant’s business which might require disclosure in its business description under Item 101.

### **3. Physical impacts of climate change**

The SEC also discusses the physical impacts of climate change. Severe weather attributable to climate change may cause difficulties in registrant’s manufacturing or distribution processes. Other significant negative effects could be property damage, indirect financial and operational impacts from disruptions to

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the operations of major customers or suppliers, and decreased agricultural capacity. The SEC points out that disasters caused by severe weather conditions may result in increased insurance claims and liabilities for the insurance and reinsurance companies, and also may cause increased insurance premiums and deductibles for registrants that have plants or operations in areas subject to such severe weather. The SEC directs registrants whose businesses may be vulnerable to severe weather conditions to disclose such material risks and their consequences.

### **Emphasis on Certain Industries**

In its release, the SEC points to certain industries whose constituents may need to devote particular attention to climate change disclosure, such as the energy sector, the utility sector and the transportation sector. The SEC asks companies in these industries to identify the specific risks that they face and to avoid generic risk factor disclosure that could apply to a wider range of industries. For example, the SEC points out that registrants in the energy sector may face different risks due to climate change legislation, compared to registrants in the transportation sector that currently rely on products emitting greenhouse gases. The SEC suggests that the insurance industry is also particularly affected, and notes that the National Association of Insurance Commissioners recently promulgated a uniform standard for mandatory disclosure by insurance companies to state regulators of financial risks due to climate change, and actions they are taking to mitigate these risks.<sup>8</sup> The SEC points out that the insurance companies are developing new actuarial models and designing new products to reshape coverage.

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<sup>8</sup> See Insurance Regulators Adopt Climate Change Risk Disclosure, available at [www.naic.org/Releases/2009\\_docs/climate\\_change\\_risk\\_disclosure\\_adopted.htm](http://www.naic.org/Releases/2009_docs/climate_change_risk_disclosure_adopted.htm).

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