

SEC Issues Guidance on Climate Change Disclosures

On February 8, 2010, the Securities and Exchange Commission (SEC) published in the *Federal Register* interpretive guidance on mandatory disclosures regarding climate change risks and opportunities.¹ The guidance followed on the heels of a somewhat contentious discussion and a 3-2 vote in late January by the Commissioners, some of whom felt the push for such guidance was politically motivated and unnecessary. It came several years after a number of large institutional investors, other investor groups, and environmental organizations started petitioning the SEC to develop such guidance, and followed a high profile investigation by the New York Attorney General of five major power companies regarding the adequacy of their climate change risk disclosures. The dissenting Commissioners commented that the guidance would drag the SEC into a political debate over climate change that is beyond their purview.² In announcing the release, however, Chairman Mary Shapiro emphasized that the guidance does not reflect a position by the SEC on the science of global warming, nor does it create new or modify existing legal requirements; rather, Chairman Shapiro commented that its intent is to provide clarity and enhance consistency of climate change reporting for public companies.

The Guidance

The existing framework for environmental disclosure obligations are largely found in Regulation S-K, Items 101 (Risk Factors); 103 (Legal Proceedings) and 303 (Management's Discussion and Analysis (MD&A)), where narrative disclosures of certain non-financial, material environmental risks are required. Briefly, Item 101 requires disclosure of any material costs to comply with environmental regulations; Item 103 requires disclosure of certain governmental proceedings and material litigation and, under Item 303—the MD&A—public companies must disclose known trends, events, demands, commitments, and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance.³ Given the federal government's commitments at the recent 15th Conference of the Parties United Nations Framework Convention on Climate Change, in Copenhagen, EPA's recent "Endangerment Finding," its issuance of a final rule on GHG monitoring, and its proposed "Tailoring Rule," as well as the legislative activity on Capitol Hill, climate change-related risks appear, at a minimum, to be a known uncertainty for which investors seek the benefit of management's analysis.

The SEC affirms in the guidance that it does not change the standard of "materiality" for determining what information must be disclosed under these requirements. The Supreme Court has explained that information is "material" (and must be disclosed) if it would be important to a reasonable shareholder or investor, or if it would "significantly alter the total mix of information available."⁴

¹ 75 Fed. Reg. 6290 (February 8, 2010) <http://www.sec.gov/rules/interp/2010/33-9106fr.pdf>.

² <http://www.sec.gov/news/press/2010/2010-15.htm>.

³ For a more in-depth analysis of the existing disclosure framework please see our article at http://www.winston.com/siteFiles/Publications/ClimateRisk_ABA_MayWall.pdf.

⁴ *TSC Industries v. Northway*, 426 U.S. 438, 449 (1976).

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The guidance provides a roadmap for evaluating developments relating to the issue of climate change within the existing SEC framework for disclosure. It notes four principal ways that climate change issues may trigger disclosure obligations under existing SEC requirements: (1) impacts of current and pending legislation and regulation; (2) international accords; (3) indirect consequences of regulation or business trends; and (4) physical impacts of climate change.

Impacts of Legislation and Regulation

Existing and potential climate change legislation and regulation may have significant effects on public companies, both those with significant carbon emissions and those companies with significant carbon in their supply chain, given the potential costs to comply with emission reduction requirements or for purchasing allowances or offsets. Importantly, the SEC guidance instructs that companies should consider the potential impact (both costs and profits) on its financial results of operations by evaluating the likelihood of proposed regulations or pending legislation. While most observers are highly skeptical that an economy-wide cap and trade bill will pass this year, most believe that some form of pricing mechanism will eventually be imposed on carbon and other greenhouse gas emissions. In that regard, companies that are in the position of taking early action on emission reductions and participating in voluntary registries may want to evaluate the disclosure implications of these strategies.

International Accords

Several international climate change developments—the Kyoto Protocol, the European Union Emission Trading System, and the recent Copenhagen Accord—are likely to bear on the analysis of risk and opportunities by public companies with international operations. A number of countries have set additional emission reduction targets beyond the mandatory limits in the Kyoto Protocol in connection with the recent Copenhagen Accord. Companies in these countries should consider the potential impacts of these and other international developments and disclose any effects likely to be material.

Indirect Consequences of Regulation or Business Trends

Developments relating to climate change may also have less direct effects on public companies, which, if material, must also be disclosed. For example, public companies may experience a decreased demand for goods and services that produce significant greenhouse gas emissions, or an increased demand for goods and services that result in lower greenhouse gas emissions than

alternatives. Public companies may also suffer or benefit from public perception. For example, publicly available information relating to greenhouse gas emissions could expose a company to adverse consequences resulting from reputational damage. Some of the large investor groups pushing the SEC for this guidance have made the point that reputational impacts are something for which they want the benefit of management's analysis.

Physical Impacts of Climate Change

Finally, the physical effects of climate change—severe weather, rising sea levels, and changes in the arability of farmland and the availability of water—may also have material impacts on public companies that must be disclosed. For example, companies with facilities concentrated along coastlines should recognize and disclose any potential disruptions to operations (either directly or through supply chain interruptions), increased insurance costs, or other weather-related impacts.

The Reaction

Environmental groups and institutional investors have been petitioning the Commission to issue guidance on climate change-related disclosures since 2007. They are understandably pleased with the Commission's first economy-wide climate risk disclosure guidance. But the guidance has received significant criticism as well—both from Republican appointees on the Commission, Republican members of Congress and some in the business community. Because the guidance does not change the “materiality” standard, its critics argue, its sole effect is to have the Commission take a side in the ongoing climate-change debate. These critics have called the action “transparently political,” and at least one member introduced a bill on February 24, 2010 that would nullify SEC's interpretive guidance. Senator John Barrasso's (R-Wyoming) “Maintaining Agency Direction on Financial Fraud” (“MADOFF”) bill would also block future attempts by the SEC to issue climate-related interpretive guidance.

Regardless of the political debate, however, the SEC Division of Corporation Finance will apply the guidance when reviewing company filings. Public companies that have not mentioned climate change or greenhouse gases in their SEC disclosures—or that have not taken a rigorous approach to evaluating climate risks—should make sure they have the right governance systems in place to do a thoughtful analysis that results in informed decision-making about climate change risks and impacts on their liquidity, capital resources, and results of operations.

Briefing

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