SEC Issues Interpretive Guidance Regarding Climate Change Disclosure

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I. Introduction

On January 27, 2010, the Securities and Exchange Commission (SEC) approved, by a 3-to-2 vote split along party lines, publication of an interpretive release providing guidance to public companies about the SEC's current disclosure requirements as they relate to matters involving climate change. The interpretive release is an outgrowth of recent regulatory and legislative developments regarding climate change matters, as well as requests for interpretive advice submitted by large institutional investors and other investor groups.

As Chairman Mary Schapiro noted during the meeting at which it was approved, the purpose of the interpretive release is not to amend current SEC rules or impose additional reporting obligations relating to climate change. Rather, the purpose is to provide additional clarity and consistency as to what does and does not need to be disclosed by public companies with respect to climate change. The dissenting Commissioners Casey and Paredes expressed concerns that the interpretive guidance in the release is unnecessary in light of current disclosure requirements and may result in burdensome disclosures by some companies with limited benefits to investors. Several members of Congress have criticized the Commission's decision to issue the interpretive release as unnecessary and inappropriately driven by political agendas.

The interpretive release took effect upon publication in the Federal Register on February 8, 2010.

II. Rules Requiring Disclosure of Climate Change Issues

The interpretive release identifies four sections of Regulation S-K that reporting companies should consider when evaluating whether disclosures relating to climate change may be required in their periodic reports and registration statements:

A. Description of Business.

Item 101 of Regulation S-K requires a company to describe its business and that of its subsidiaries. Item 101 lists a variety of topics that a company must address in its disclosure documents, including its form of organization, principal products and services, major customers, competitive conditions and certain costs of complying with environmental laws. In particular, Item 101(c)(1)(xii) expressly requires disclosure regarding the material effects that compliance with federal, state and local environmental laws and regulations may have on a company's capital expenditures, earnings and competitive position. Companies must also disclose material estimated capital expenditures for environmental control facilities for the current and succeeding fiscal years and future periods the company determines are material.

Smaller reporting companies are permitted, in accordance with Item 101(h), to disclose instead their "costs and effects of compliance with environmental laws (federal, state and local)." The disclosure requirements of Item 101 apply to the company and, in many cases, each reportable segment about which financial information is presented in the financial statements. If the information is material to individual segments of the business, a company must identify the affected segments.

B. Legal Proceedings.

Item 103 of Regulation S-K requires a company to briefly describe any material pending legal proceeding to which it or any of its subsidiaries is a party, any material pending legal actions in which its property is the subject of the litigation and, if it is aware of similar actions contemplated by governmental authorities, those contemplated actions as well. Companies are not required to describe "ordinary routine litigation incidental to the business." However, Instruction 5 to Item 103 deems administrative or judicial proceedings "arising under any Federal, State or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primary [*sic*] for the purpose of protecting the environment" not to be ordinary routine litigation if the proceeding is material to the company's business or financial condition; involves a claim for damages or potential sanctions, capital expenditures, deferred charges or charges to income in excess of 10% of the company's consolidated current assets; or, where a governmental authority is party to the proceeding, involves potential monetary sanctions, unless the company reasonably believes the proceeding will result in sanctions of less than $100,000.

C. Risk Factors.

Item 503(c) of Regulation S-K requires companies, other than smaller reporting companies, to discuss the most significant factors that make an investment in the company speculative or risky. Item 503(c) specifies that risk factor disclosure should clearly state the risk and specify how the particular risk affects the particular company—companies should not present risks that could apply to any issuer or any offering.

D. Management's Discussion and Analysis.

Item 303 of Regulation S-K includes disclosure requirements for a company's Management's Discussion and Analysis of Financial Condition and Results of Operations, or MD&A. As described in the interpretive release, a company's MD&A should:

- provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management;
- enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
- provide information about the quality of, and potential variability of, a company's earnings and cash flow so that investors can ascertain the likelihood that past performance is indicative of future performance.

The disclosure should be both historical and prospective with a particular emphasis on the company's future prospects.

Item 303 identifies a broad range of disclosure items addressing the company's liquidity, capital resources and results of operations, some of which are specific disclosure requirements and others of which are general principles that must be considered in the context of the company's specific situation. These general disclosure requirements include identifying and disclosing known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on the company's financial condition or operating performance. The nature of these more general disclosure requirements places particular importance on a company's assessment of whether trends and uncertainties will have, or are reasonably likely to have, a material impact on the company's liquidity, capital resources or results of operations. The interpretive release reminds companies that Item 303 does not include specific time periods that must be considered in assessing the impact of known trends, events or uncertainties and that the necessary time period will depend on the company's particular circumstances.

E. Foreign Private Issuers.

The interpretive release reminds foreign private issuers that their disclosure obligations are governed principally by Form 20-F, which includes disclosure requirements parallel to most of those described above, although in less prescriptive form. Specifically, Form 20-F requires disclosure concerning material climate change matters under the following items:

- Item 3.D, disclosure of material risks;
- Item 4.B.8, disclosure of the material effects of government regulation and identification of the particular regulatory body;
- Item 4.D, description of environmental issues that may affect the company's utilization of its assets;
- Item 5, management's explanation of factors that have affected the company's financial condition and results of operations for the periods covered by the financial statements and management's assessment of factors and trends anticipated to have a material effect on the company's financial condition and results of operations in future periods; and

- Item 8.A.7, information on legal or arbitration proceedings which may have or have had in the recent past, significant effects on the company's financial position or profitability.

Forms F-1 and F-3 also require foreign private issuers to include Item 503 risk factor disclosure.

III. Climate Change-Related Disclosures

The interpretive release addresses four topics that companies should consider when evaluating the need for, and appropriate level of, disclosure related to climate change matters:

A. Impact of Legislation and Regulation.

Companies should consider the impact of legislation and regulation regarding climate change, including the potential impact of pending legislation. Developments in legislation and regulation may trigger disclosure obligations under Items 101, 103, 503(c) and 303 of Regulation S-K. For example, Item 101 requires disclosure of any material estimated capital expenditures for environmental control facilities for the remainder of a company's current fiscal year and its succeeding fiscal year and for such further periods as the company may deem material. Item 503(c) may require risk factor disclosure regarding existing or pending legislation or regulation that relates to climate change. Item 303 requires companies to assess whether any climate change legislation or regulation is reasonably likely to have a material effect on the company's financial condition or results of operation and to make disclosures if it is. In the case of pending legislation or regulation, this assessment requires companies to evaluate both whether the legislation is reasonably likely to be enacted or the regulation is reasonably likely to be adopted, and, if so, whether it is reasonably likely to have a material effect.

Examples of consequences of legislation and regulation that could trigger disclosures include:

- costs to purchase credits under a "cap and trade" emissions allowance system;
- costs to improve facilities and equipment to reduce emission to comply with regulatory limits; and
- changes to profit or loss from increased or decreased demand for goods and services produced by the company arising directly from legislation or regulation and indirectly from changes in costs of goods sold.

The interpretive release notes that companies should not limit their evaluation of disclosure of a proposed law only to negative consequences. Changes in the law or in the business practices of some companies in response to the law may provide new opportunities for companies, such as potential investment opportunities from "cap and trade" systems for emissions allowances.

B. International Accords.

Companies should consider, and disclose when material, the impact on their business of treaties or international accords relating to climate change. The interpretive release notes as examples both the Kyoto Protocol, to which the United States is not a signatory but which may nevertheless affect companies with global operations, and the European Union Emissions Trading System. Companies whose businesses are reasonably likely to be affected by such agreements should monitor the progress of any potential agreements and consider the possible impact in satisfying their disclosure obligations based on MD&A and materiality principles.

C. Indirect Consequences of Regulation or Business Trends.

Companies should consider whether legal, technological, political and scientific developments regarding climate change will create new opportunities or risks. Possible risks or opportunities may 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 relating to carbon- based energy sources, such as drilling services or equipment maintenance services. In addition, the interpretive release specifically notes that impact on a company's reputation or the public's perception of its climate change-related activities, such as greenhouse gas emissions, may be an indirect risk that must be disclosed. These business trends or risks may be required to be disclosed as risk factors or in MD&A and, in some cases, could have a significant impact on a company's business to a degree such that disclosure may be required under Item 101.

D. Physical Impacts of Climate Change.

Companies should evaluate the actual and potential material impacts of the physical effects of climate change on their business, such as the effects of severe weather, sea levels, arability of farmland and water availability and quality. Possible consequences of severe weather for companies with operations concentrated on coastlines, for example, could 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; 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.

IV. Conclusion

As discussed above, this interpretive release does not change existing disclosure rules, but is intended to remind companies of their obligations under existing federal securities laws and regulations and to consider climate change and its consequences as they prepare disclosure documents to be filed with the SEC and provided to investors.

The full text of the release can be found here.

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