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Alerts

SEC Issues Guidance Regarding Disclosures Related to Climate Change

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Corporate / Financial Institutions Alert

On February 2, 2010, the United States Securities and Exchange Commission (SEC) released its interpretive guidance regarding the application of its existing disclosure requirements concerning climate change matters. The SEC made it clear in the guidance that a company should establish a process for assessing to what extent climate change matters are material to it. If a particular matter is material, the company must include appropriate disclosures in its SEC filings. Calendar-year companies will be filing their Form 10-Ks shortly and must be prepared to address the climate change issues raised by this guidance.

Materiality
When a company makes a filing with the SEC, it will have to comply with the disclosure requirements of Regulations S-K and S-X. These rules require that the disclosures focus on material information. Materiality determinations may limit what is actually disclosed, but they should not limit the information that management considers in making its determinations.

In addition to the information expressly required by these SEC regulations, Securities Act Rule 408 and Exchange Act Rule 12b-20 require a company to disclose "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."

Therefore, whether a company is required to make disclosures in its SEC reports will depend upon whether climate change issues are "material." A climate change risk would be deemed material if there is a substantial likelihood that its disclosure would be viewed by a "reasonable investor" as having significantly altered the "total mix" of information based on which he or she determines whether to invest.

Part of the problem in determining whether a prospective environmental cost or loss contingency is material is whether it is likely to occur if at all and, if so, when it will happen. There is much uncertainty regarding climate change science as well as whether, and how, greenhouse gas emissions will be regulated. As a consequence, a materiality determination related to climate change matters may be difficult. However, the prevailing rule under existing case law and securities regulations is that any doubt about materiality should be resolved in favor of disclosing the information. If a company cannot determine that a climate change risk is not material, it should disclose the risk.

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Furthermore, the SEC stated in the interpretive guidance that when making materiality determinations, a company “should not limit the information that management considers” and is “expected to consider all relevant information even if that information is not required to be disclosed,” including financial and non-financial information.

Further compounding the problems inherent in a materiality determination is the fact that the interpretive release does not set forth specific disclosure requirements. There are no per se rules or other requirements mandating disclosure. Instead the guidance directs companies to conduct their own materiality analysis, evaluating both the likelihood that a risk or opportunity, or a known trend or uncertainty, related to climate change will occur, as well as the material effect to the company of that risk, opportunity, trend or uncertainty, if it does occur.

Overview of Rules Requiring Disclosure of Climate Change Issues
The SEC staff cited the following provisions of Regulation S-K where climate change may require disclosures.

Description of Business -- Item 101 of Regulation S-K
A company must describe its business and that of its subsidiaries as required by Item 101, which provides a variety of topics that must be addressed, including disclosure about a company’s principal products and services, major customers and competitive conditions. Furthermore, Item 101(c)(1)(xii) expressly requires disclosure regarding certain costs of complying with environmental laws, stating:

Appropriate disclosure also shall 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 registrant and its subsidiaries. **The registrant shall 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. [emphasis added]**

Legal Proceedings -- Item 103 of Regulation S-K
A company must briefly describe any material pending legal proceeding to which it or any of its subsidiaries is a party, including material pending legal actions to which its property is subject. If it is aware of similar actions contemplated by governmental authorities, Item 103 of Regulation S-K directs a company to disclose these proceedings as well. Moreover, Instruction 5 to Item 103 provides some specific requirements that apply to disclosure of certain environmental litigation:

Notwithstanding the foregoing, an administrative or judicial proceeding (including, for purposes of A and B of this Instruction, proceedings which present in large degree the same issues) arising under any Federal, State or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primary for the purpose of protecting the environment shall not be deemed "ordinary routine litigation incidental to the business" and shall be described if:

(A) Such proceeding is material to the business or financial condition of the registrant;

(B) Such proceeding involves primarily a claim for damages, or involves potential monetary sanctions, capital expenditures, deferred charges or charges to income and the amount involved, exclusive of interest and costs, exceeds 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis; or

(C) A governmental authority is a party to such proceeding and such proceeding involves potential monetary sanctions, unless the registrant reasonably believes that such proceeding will result in no monetary sanctions, or in monetary sanctions, exclusive of interest and costs, of less than $100,000; provided, however, that such proceedings which are similar in nature may be grouped and described generically.

Risk Factors -- Item 503(c) of Regulation S-K
When appropriate, a company must provide (as instructed by Item 503(c) of Regulation S-K) a discussion of the most

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significant factors that make an investment in the company speculative or risky; this disclosure must be made under the heading "Risk Factors." The risk factor disclosure should clearly state the risk and specify how it affects the company.

Management's Discussion and Analysis -- Item 303 of Regulation S-K

The Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) requirements (Item 303 of Regulation S-K) are intended to satisfy three principal objectives:

- provide a narrative explanation of a company's financial statements that enables investors to see it 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.

When drafting MD&A disclosure, a company should focus on material information and eliminate immaterial information that does not promote an understanding of the company's financial condition, liquidity and capital resources, changes in financial condition and results of operations. These determinations may limit what is actually disclosed, but they should not curb the information that management considers in making its determinations. In identifying, discussing and analyzing known material trends and uncertainties, a company is expected to consider all relevant information even if it is not required to be disclosed.

A company must also consider whether it has sufficient disclosure controls and procedures in place to process this information. "Disclosure controls and procedures" are defined as those controls and procedures that are designed to ensure that information which is required to be disclosed by the company in the reports that it files or submits under the Exchange Act is (i) "recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms," and (ii) "accumulated and communicated to the company's management . . . as appropriate to allow timely decisions regarding required disclosure." A company's disclosure controls and procedures should not be limited to disclosure specifically required, but should also ensure timely collection and evaluation of "information potentially subject to [required] disclosure," "information that is relevant to an assessment of the need to disclose developments and risks that pertain to the [company's] businesses," and "information that must be evaluated in the context of the disclosure requirement of Exchange Act Rule 12b-20." A company's chief executive officer and chief financial officer must provide certification regarding the maintenance and effectiveness of disclosure controls and procedures in a company's 10-K.

Item 303 requires a company to identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on its financial condition or operating performance. "Reasonably likely" is a lower disclosure standard than "more likely than not." Issues that are reasonably likely to cause reported financial information not to be necessarily indicative of future operating performance or of future financial condition should be highlighted in the disclosure. Disclosure decisions concerning trends, demands, commitments, events and uncertainties generally should involve the:

- consideration of financial, operational and other information known to the company;
- identification, based on this information, of known trends and uncertainties; and
- assessment of whether these 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 SEC has not quantified a specific future time period that must be considered in assessing the impact of a known trend, event or uncertainty that is reasonably likely to occur. The necessary time period will depend on a company's particular circumstances and the specific trend, event or uncertainty under consideration. Furthermore, the time horizon may be relevant to a company's assessment of the materiality of the matter and whether the impact is reasonably likely. Materiality "with respect to contingent or speculative information or events . . . 'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'"

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Companies may experience difficulties in analyzing the materiality of known trends, events or uncertainties. When conducting such an analysis, management, according to the SEC, must assess:

- 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.
- 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.

A company, when identifying and assessing known material trends, will have to consider a substantial amount of financial and non-financial information available to it, including information that may not be required to be disclosed.

Furthermore, a company should also address, when material, the difficulties involved in assessing the effect of the amount and timing of uncertain events, and provide an indication of the time periods in which resolution of the uncertainties is anticipated.

Climate Change-Related Disclosures
In the interpretive guidance, the SEC suggested that the following topics are some ways by which climate change may trigger disclosure required by these rules.

Impact of Legislation and Regulation
The impact of existing and pending climate change laws and regulations should be considered when assessing potential disclosure obligations. If material, the difficulties of assessing the timing and effect of the pending legislation and regulation should also be considered and discussed. In the guidance, the SEC suggested several regulatory, legislative and other matters that a company might consider in assessing the impact of such legislation and regulations, including:

- U.S. federal and state legislation;
- U.S. Environmental Protection Agency (EPA) requirements to collect and report greenhouse gas emissions and the EPA's recent greenhouse gas endangerment finding;
- The Kyoto Protocol, the United Nations (UN) Climate Change Conference in Copenhagen and the European Union's Emissions Trading Systems (EUETS), which launched an international cap and trade system based on the Kyoto Protocol; and The 2009 standards of the National Association of Insurance Commissioners requiring insurance companies with annual premiums in excess of $500 million to disclose to state regulators the financial risks related to climate change.

Both the positive and negative consequences of actual or pending legislation or regulatory actions should be considered. Possible consequences of pending climate change legislation and regulation include:

- 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 to 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 company arising directly from legislation or regulation, and indirectly from changes in costs of goods sold.

The recent developments in federal and state legislation and regulation regarding climate change may trigger disclosure obligations under SEC rules and regulations, such as the provisions of Regulation S-K discussed above. Financial statement implications of climate change issues must be considered in accordance with applicable accounting standards, including Financial Accounting Standards Board (FASB), Accounting Standards Codification Topic 450, Contingencies, and FASB Accounting Standards Codification Topic 275, Risks and Uncertainties.

When reviewing the impact of existing federal, state and local provisions which relate to greenhouse gas emissions, a

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company should remember that as indicated previously, Item 101 of Regulation S-K 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.

Furthermore, risk factor disclosure regarding existing or pending legislation or regulation that relates to climate change may be required by Item 503(c) of Regulation S-K. The risk factor must focus on specific risks as a result of climate change legislation or regulation and avoid generic risk factor disclosure that could apply to any company. For example, a company in an energy providing business (such as a power plant) may face significantly different risks from climate change legislation or regulation compared to a company that provides services and does not own or operate large greenhouse gas emitting facilities.

Item 303 of Regulation S-K requires registrants to determine whether any enacted climate change legislation or regulation is reasonably likely to have a material effect on the company's financial condition or results of operation. In cases involving pending legislation or regulation, the analysis as to whether disclosure is required in MD&A consists of two steps:

- First, management must evaluate whether the pending legislation or regulation is reasonably likely to be enacted. Unless management determines that it is not reasonably likely to be enacted, it must proceed on the assumption that the legislation or regulation will be enacted.
- Second, management must determine whether the legislation or regulation, if enacted, is reasonably likely to have a material effect on the registrant, its financial condition or results of operations.

If a company cannot determine that a material effect is not reasonably likely, a disclosure is required in the company's MD&A. Companies should remember that "reasonably likely" is a lower disclosure standard than "more likely than not."

In addition to disclosing the potential effect of pending legislation or regulation, a company would also have to consider disclosure, if material, of the difficulties involved in assessing the timing and effect of the pending legislation or regulation. In conducting this analysis, management should make sure that it has sufficient information regarding the company's greenhouse gas emissions and other operational matters to evaluate the likelihood of a material effect arising from the subject legislation or regulation. Because carbon dioxide is a natural byproduct of combustion of fuels, government regulation of emissions can translate into government involvement in a company's means and methods of energy consumption and product production.

The SEC has directed companies to assess, separately and on a continual basis, whether climate change legislation will be enacted. However, such assessment will not be easy. For example, major climate change legislation has passed in the House but not yet in the Senate. Moreover, President Obama has indicated that the likelihood of a cap-and-trade program passing the Senate this year is very low. With the details of the legislation differing depending on the bill, the contents of the final legislation, even if it were to pass, are also highly uncertain. As a consequence, companies will face difficult challenges when attempting to undertake a meaningful evaluation of the risks associated with proposed legislation.

An additional question is whether Clean Air Act permitting will have to take carbon dioxide emissions into account. If so, then a company desiring to expand its facilities or build new ones may face a slower and more costly permitting process.

International Accords

A company should consider the impact on its business of treaties or international accords relating to climate change. If the impact is material, the company should provide the relevant disclosure. The Kyoto Protocol, the EUETS and other international activities in connection with climate change remediation should be reviewed. Even though such policies may not be applicable in the U.S., an American company's overseas operation(s) may be subject to such policies.

The potential sources of disclosure obligations related to international accords are the same as those discussed above for U.S. climate change regulation. A company whose business is reasonably likely to be affected by such agreements should monitor the progress of any potential agreements and consider the possible impact in satisfying its disclosure obligations based on the MD&A and materiality principles discussed above.

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Indirect Consequences of Regulation or Business Trends
New opportunities or risks could be presented by developments regarding climate change, including legal, technological, political and scientific developments. Possible indirect consequences 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 (such as solar and wind power);
- decreased demand for services related to carbon based energy sources, such as drilling services or equipment maintenance services;
- plans to increase the acquisition of material plants or equipment to take advantage of potential opportunities related to climate change; and
- if a company's business is sensitive to public opinion, risks arising from reputational damage related to climate change, such as possible negative public reaction to data on the company's greenhouse gas emissions levels.

A company must consider its own particular facts and circumstances in evaluating the materiality of these opportunities and obligations.

Physical Impacts of Climate Change
While it is plausible that the guidance was motivated by a belief that carbon dioxide and other anthropogenic greenhouse gas emissions pose a significant threat of climate change, SEC Chairman Mary Schapiro expressly stated that "the Commission is not making any kind of statement regarding the facts as they relate to the topic of 'climate change' or 'global warming.' And, we are not opining on whether the world's climate is changing; at what pace it might be changing; or due to what causes. Nothing that the Commission does today should be construed as weighing in on those topics."

Because the SEC does not specifically define what is or is not "climate change," and as there is scientific controversy on the subject of climate change causation, a company may reasonably decline to take a position on what climate changes will occur and whether they are primarily man-made. Instead it would seem reasonable to address whether there would be a material effect on the business if projected climate changes, such as those described by the UN's Intergovernmental Panel on Climate Change (IPCC) Fourth Assessment, were to occur. It is also legitimate to note that not all scientists agree with the IPCC, and that the finding of the EPA Administrator that greenhouse gases pose a significant environmental and human health threat is undergoing judicial review.

The IPCC projections of climate change are detailed in 976-page discussion entitled "Climate Change 2007: Impacts, Adaptation and Vulnerability, Contribution of Working Group II to the Fourth Assessment Report of the Intergovernmental Panel on Climate Change." Because that report breaks down the subject of predicted worldwide impacts geographically and by type and degree, it provides a means of objectively asking whether a given projected impact is significant for a given company, based upon the company's processes, locations and markets. Businesses seeking a reference to "balance" or illustrate that there are views contrary to the IPCC might also refer to sources such as "Climate Change Reconsidered: The 2009 Report of the Nongovernmental International Panel on Climate Change (NIPCC)," coauthors Dr. S. Fred Singer and Dr. Craig Idso (Heartland, 2009).

Significant weather events are asserted by the IPCC as likely to be physical effects of climate change. Examples include severe weather events such as floods or hurricanes. Long-term rising sea levels, changes in the arability and productivity of farmland, and water availability and quality, also are attributed by the IPCC to climate change and could have the potential to affect a company's operations and results.

Clearly, weather can be a risk; accordingly, it should likely be treated as such within the intent of the SEC guidance. For example, severe weather can cause catastrophic harm to physical plants and facilities and can disrupt manufacturing and distribution processes. A 2007 Government Accountability Office report states that 88 percent of all property losses paid by insurers between 1980 and 2005 were weather-related. Although there is dispute as to the question, the GAO report

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cites a number of sources to support the view that severe weather scenarios will increase as a result of climate change brought on by an overabundance of greenhouse gases.

Possible consequences of severe weather could include:

- property damage and disruptions to operations, including manufacturing operations or the transport of manufactured products, especially for facilities located along coast lines or in areas subject to severe weather;
- 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 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;
- the impact on a company's employees, physical assets, supply chain and distribution chain of changes in weather patterns, such as the effects of increases in storm intensity, sea-level rise, melting of permafrost and temperature extremes on facilities or operations;
- changes in the availability or quality of water, or other natural resources on which the company's business depends;
- financial risks if the company's suppliers are impacted by climate change, such as if a company purchases agricultural products from farms hurt by floods or drought; and
- decreased consumer demand for products or services, such as if warmer temperatures reduce demand for residential and commercial heating fuels, service and equipment.

In short, irrespective of whether climate change is due primarily to greenhouse gas emissions, changes in weather patterns may accompany climate change. Similarly, the effects of water shortage or increased rainfall can have impacts on a company. Given the requirement that the risks of climate change be discussed if material, a company whose business may be vulnerable to severe weather, water supply changes or other climate related events should consider disclosing material risks of, or consequences from, such events in its publicly filed disclosure documents.

SEC Monitoring

Companies in the midst of preparing their annual reports on Form 10-K should review their disclosures in light of this interpretive release. The SEC intends to monitor the impact of this interpretive release on company filings as part of its ongoing disclosure review program. In addition, the SEC's Investor Advisory Committee is considering climate change disclosure issues as part of its overall mandate to provide advice and recommendations to the SEC, and the agency is planning to hold a public roundtable on disclosure regarding climate change matters in the spring of 2010.

The SEC has not made any statement as to how, and to what degree, it will enforce its new climate change guidance. However, because the SEC has issued its guidance and is planning to convene a climate change "roundtable" this spring, it make sense for SEC-reporting companies to take a fresh look at their own internal compliance programs for identifying, measuring, and reporting potential impacts of climate change on their business operations.

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