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SEC Issues Guidance on Disclosure Related to Climate Change

On February 2, 2010, the Securities and Exchange Commission issued an interpretive release[1] designed to provide guidance to public companies on disclosures regarding the effects of climate change on their businesses. The interpretive release does not create new disclosure requirements or amend existing requirements, but rather expresses the SEC's views on the application of ***existing*** disclosure requirements to climate change matters. This alert discusses the issues that the SEC suggested should be covered in the climate change disclosures as well as rules applicable to such disclosures.

Topics for Climate Change Disclosures Suggested by the SEC

The interpretive release, as well as the speech of the SEC Commissioner Luis A. Aguilar[2], provided some practical guidance regarding issues that may prompt climate change disclosures.

Companies should discuss in their SEC filings:

- the direct effect of environmental legislation, regulation and international treaties;
- the indirect consequences of climate change; and
- the impact of physical changes to our planet caused by the climate change (for example, rising seas, stronger storms, and increased drought affecting the distribution and production of goods and damaging property, plant and equipment).

Impact of Legislation, Regulation and International Treaties

Recent developments in federal and state legislation and regulation regarding climate change may trigger disclosures in the description of the company's business, risk factors and management's discussion and analysis of financial condition and results of operations ("MD&A"). See "SEC Existing Rules Requiring Climate Change Disclosures" below for a summary of applicable disclosures. In addition, a public company should assess, and disclose when material, the impact on its business of treaties or international accords relating to climate change[3]. A public company that may be affected by such accords should monitor the progress of any proposed agreements and the materiality of their potential impact on its business and operations.

The SEC included in its interpretative release the following examples of possible consequences of legislation, regulation or international treaties related to climate change:

- 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.

1. *See* SEC Release No. 33-9106, *Commission Guidance Regarding Disclosure Related to Climate Change* (February 2, 2010), which is available at http://www.sec.gov/rules/interp/2010/33-9106.pdf

2. *See Speech by SEC Commissioner: Responding to Investors' Requests for SEC Guidance on Disclosures of Risks Related to Climate Change* (January 27, 2010), which is available at http://www.sec.gov/news/speech/2010/spch012710laa-climate.htm

3. In recent years, the Kyoto Protocol and the European Union Emissions Trading System have impacted public companies with operations outside of the United States. The Kyoto Protocol was adopted in Kyoto, Japan, on December 11, 1997 and became effective on February 16, 2005. The European Union Emissions Trading System, launched in 2005 as an international "cap and trade" system of allowances for emitting carbon dioxide and other greenhouse gases, was built on the mechanisms set up under the Kyoto Protocol. The United Nations Climate Conference may lead to future international treaties focused on remediating environmental damage caused by greenhouse gases.

In order to comply with the applicable disclosure requirements, public companies need to evaluate whether they have an effective system for collecting information about their emissions. Information about the company's emissions and other operational matters will enable it to make a decision as to whether the climate change is going to have a material impact on its business.

Indirect Consequences of Climate Change

Developments related to climate change may create new opportunities or risks for public companies. These business trends or risks should be described as a risk factor or in the MD&A, and if they have a significant impact on the public company's business, could affect the description of the company's business. The SEC provided some examples of indirect consequences or opportunities of climate change:

- decreased demand for goods that produce greenhouse gas emissions;
- increased demand for goods with lower emissions;
- increased competition to develop new products;
- increased demand for alternative energy sources; and
- decreased demand for services related to carbon-based energy sources (for example, drilling services or equipment maintenance services).

Indirect consequences of climate change may also include the impact on the company's reputation. For example, the company may consider whether the public's perception of data related to the company's emissions could lead to potential adverse consequences to its business operations or financial condition due to the reputational damage.

Physical Impacts of Climate Change

In the release, the SEC noted that severe physical effects of climate change, such as severe weather conditions (floods or hurricanes), changes in sea levels, arability of farmland and water quality and availability could affect the company's results of operations. Public companies whose businesses are susceptible to these types of events should consider disclosing the material risks or consequences of such events.

The interpretive release provided a list of the following possible consequences of severe weather conditions:

- property damage and disruptions to operations, including manufacturing operations or the transportation of manufactured products (especially for companies with operations concentrated on coastlines);
- 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.

SEC Existing Rules Requiring Climate Change Disclosures

In the interpretive release, the SEC reviewed its rules which could require disclosure related to climate change. The SEC noted that Rule 408 under the Securities Act of 1933, as amended, and Rule 12b-20 under the Securities Exchange Act of 1934, as amended, require a public company to disclose, in addition to any explicitly required information, "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances in which they are made, not misleading."

The release suggests that a company should make climate change disclosure if the climate change has a material effect on the company's business and operations. Generally, under the securities laws, information is considered 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, or if the information would alter the total mix of information available to the investor. The SEC recognizes that companies may have doubts as to materiality of information related to the climate change. However, the SEC believes that it is appropriate that these doubts be resolved in favor of disclosure to investors.

The SEC rules also contain specific requirements related to the climate change disclosures in the business, legal proceedings, risk factor and MD&A sections of the applicable SEC filings.

Description of Business

A public company must describe its business and the business of its subsidiaries, including the material effects of compliance with environmental laws on the company's capital expenditures, earnings and competitive position. The company should also disclose its 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 company may deem material[4].

Legal Proceedings

Generally, a public company must describe any material legal proceedings and actions contemplated by governmental agencies, to which it or any of its subsidiaries is a party, or in which its property is the subject of the litigation or governmental action. Subject to certain conditions, a public company must disclose environmental administrative or judicial proceedings that are material to the company's business or financial condition[5].

4. *See* Item 101(c)(1)(xii) of Regulation S-K and Item 4.B.8 of Form 20-F.

5. *See* Item 103 of Regulation S-K and Item 8.A.7 of Form 20-F.

Risk Factors

A public company must discuss its most significant risk factors that make an investment in the company speculative or risky[6]. For example, a risk factor regarding existing or pending legislation or regulation relating to climate change. Public companies should consider the specific risks they face as a result of climate change and avoid generic disclosure. For example, companies in the energy sector may face different risks related to climate change than companies in the transportation sector.

MD&A

A public company must include a detailed MD&A section designed to provide material historical and prospective information enabling investors to assess the financial condition and results of operations of the company[7]. The MD&A requirements place particular emphasis on disclosure regarding trends, commitments and uncertainties that will have, or are reasonably likely to have, a material impact on the company's liquidity, capital resources or results of operations. Depending on the business of the company, trends or uncertainties related to climate change issues may materially affect its business operations. The company should address, if material, the difficulties involved in assessing the effect of uncertain events and provide an indication of the time frame in which the company anticipates to resolve such uncertainties.

6. *See* Item 503(c) of Regulation S-K and Item 3.D of Form 20-F.

7. *See* Item 303 of Regulation S-K and Items 4.D and 5 of Form 20-F.

For example, public companies should assess whether enacted or pending climate change legislation or regulation is reasonably likely to have a material effect, positive or negative, on the company's financial condition or results of operations. In the case of a known uncertainty related to such legislation, the company is required to analyze (i) whether the pending legislation or regulation is reasonably likely to be enacted, and (ii) whether, if enacted, the legislation or regulation is reasonably likely to have a material effect on the company. In addition to disclosing the potential effects of any pending legislation or regulation, the company would also disclose any material difficulties in assessing the timing and effect of such pending legislation or regulation.

Conclusion

In light of the SEC guidance, a public company, including a foreign private issuer, that is in the process of preparing its annual report or registration statement should:

- review its disclosures related to the business description, legal proceedings that the company is involved in, risk factors and MD&A; and
- evaluate whether additional or revised disclosure is necessary to reflect the risks or opportunities created for the company by the climate change. ■

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