SEC Publishes Interpretive Release on Disclosure Relating to Climate Change

On February 2, 2010, the Securities and Exchange Commission ("SEC" or "Commission") published an interpretive release discussing how existing disclosure requirements apply to matters of climate change.[1] The release is intended to remind companies to consider climate change and its consequences (both positive and negative) under the existing federal securities laws and regulations. It was published in light of increased investor interest in, and rapidly growing regulatory focus on, climate risks, particularly on controlling emissions of greenhouse gases (GHGs).[2] The Commission stressed, however, that this release does not create any new legal obligations nor does it modify existing ones. According to SEC Chairman Mary Shapiro, the release "is merely intended to provide clarity and consistency . . . regardless of the political sensitivity of the issue at hand, so that investors get reliable information."[3]

The interpretive release was proposed and approved by a 3-2 vote of the Commission at an open meeting held on January 27, 2010.[4]

I. BACKGROUND

The SEC's disclosure requirements under the Securities Act of 1933 ("Securities Act") and the Securities and Exchange Act of 1934 ("Exchange Act") instruct public companies to report any information that is material. 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.[5] In addition to what is expressly

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1 *See* SEC Interpretive Release 33-9106, "Commission Guidance Regarding Disclosure Related to Climate Change" (2010), available at: http://www.sec.gov/rules/interp/2010/33-9106.pdf.

2 *See* Interpretive Release 33-9106. at 2.

3 *See* Speech by SEC Chairman Schapiro at the Open Meeting, U.S. Securities and Exchange Commission, Washington, D.C. January 27, 2010. Video footage of the SEC open meeting is archived at: http://www.connectlive.com/events/secopenmeetings/. Text of the Chairman's opening statement is available at: http://www.sec.gov/news/speech/2010/spch012710mls-climate.htm.

4 *Id*. Commissioners Casey and Paredes objected to the proposal based on the belief that current disclosure requirements were clear and that existing guidance relating to disclosure was adequate.

5 If the information would alter the total mix of available information, it is considered material. *See* Basic Inc. v. Levinson, 485 U.S. 244 (1988) at 231, quoting TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) at 449.

required by the Commission, Securities Act Rule 408 and Exchange Act Rule 12b-20 require public companies to disclose any "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."[6]

In the last few years, the SEC has received petitions submitted by large institutional investors, e.g., California Public Employees' Retirement System, other asset managers, environmental groups and public officials for interpretive guidance relating to climate change disclosure.[7] This push for guidance is attributed to the accelerating pace and array of international, national and local legislative and other governmental actions aimed at addressing climate risks by controlling GHGs. For example, recently the U.S. Environmental Protection Agency ("EPA") has: (i) issued a requirement for large sources of GHGs to report GHGs annually to EPA commencing in March 2011; (ii) issued an "endangerment" finding that GHGs threaten both the public health and the public welfare; and (iii) proposed to regulate large sources of GHGs under various permitting programs pursuant to the Clean Air Act. Congress is considering comprehensive legislation to regulate and reduce GHG emissions in part under a "cap and trade" system. Certain states either on their own or in regional alliances have, or are considering adoption of, "cap and trade" programs. Litigation is also looming as a risk. The New York State Attorney General has recently entered into settlement agreements with three energy companies resulting in enhanced disclosure to the Commission of matters relating to climate change and greenhouse gas emissions.[8] Also, recently the U.S. Court of Appeals for the Second Circuit and the U.S. Court of Appeals of the Fifth Circuit have ruled that certain public and private parties can pursue claims that GHG emissions constitute a public nuisance and seek to recover alleged related damages.[9] Further, the Kyoto Protocol and the European Union Emissions Trading System (EU ETS) have international relevancy to registrants with business operations outside of the U.S. that are subject to those standards.

While some information relating to climate change is now disclosed in SEC filings, information outside SEC public disclosure documents is increasingly available as a result of voluntary initiatives and other regulatory obligations.[10]

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6 17 C.F.R. 230.408 and 17 C.F.R. 240.12b-20.

7 *See* Note 20 of Interpretive Release 33-9106.

8 *See* Note 21 of Interpretive Release 33-9106.

9 *See* Connecticut v. American Electric Power Service Corp., 582 F.3d 309 (2d Cir. 2009) and Comer v. Murphy Oil USA, 585 F.3d 855 (5th Cir. 2009).

10 Some voluntary disclosure initiatives include The Climate Registry, which provides public access to greenhouse gas emissions reports (available at: http://www.theclimateregistry.org/resources/climate-registry-information-system-cris/public-reports/.); the Carbon Disclosure Project, which provides both quantitative and qualitative carbon emissions data on behalf of institutional investors (available at: www.cdproject.net); and the Global Reporting Initiative, which provides a reporting framework that

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II. CURRENT DISCLOSURE REQUIREMENTS

The SEC's disclosure requirements can be found in Regulation S-K[11] and those with particular relevance to the SEC's guidance regarding climate change disclsoures are noted below.

A. ITEM 101: DESCRIPTION OF BUSINESS

Item 101 of Regulation S-K requires registrants to provide a description of their business and the business of their subsidiaries. This includes any material information particular to the registrant's business including a plan of operation and any anticipated material acquisition of plant and equipment and the capacity thereof. This description must include information about its form of organization, principal products and services, major customers and competitive conditions. In particular, Item 101(c)(1)(xii) expressly requires disclosure of the material effects of environmental compliance on "capital expenditures, earnings and competitive position of the registrant and its subsidiaries."[12]

B. ITEM 303: LEGAL PROCEEDINGS

Item 103 of Regulation S-K requires a registrant to disclose material pending legal proceedings, including specific disclosure of certain environmental litigation.[13]

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organizations can use to keep track of their "economical, environmental and social performance" relating to climate change (available at: www.globalreporting.org).

11 In addition to Regulation S-K, Form 20-F contains the Exchange Act disclosure requirements of foreign private issuers. However, Items 3.D, 4.B, 4.D, 5, and 8.A.7 of Form 20-F contain similar disclosure obligations to those found in Items 101, 103, 503, and 303 of Regulation S-K. 17 C.F.R. 249.220f.

12 17 C.F.R. 299.101(c)(1)(xii).

13 Instruction 5 to Item 103 states: "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

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C. ITEM 503(C): RISK FACTORS

Item 503(c) of Regulation S-K requires registrants to provide, under the heading "Risk Factors," a discussion of the most significant factors that make an investment in the registrant speculative or risky. Risk factor disclosure should be registrant-specific; registrants need not present risks that could apply in any offering or to any issuer.[14]

D. ITEM 303: MD&A

Item 303 of Regulation S-K requires a Management's Discussion and Analysis of Financial Condition and Results of Operations, or MD&A, which has three objectives:

- To provide a narrative explanation of a registrant's financial statements that enables investors to see the registrant through the eyes of management;
- To enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
- to provide information about the quality of, and potential variability of, a registrant's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.[15]

MD&A disclosure also requires discussion of "known trends or uncertainties" that a company believes will result, or are reasonably likely to result, in a material impact on the company's liquidity, capital resources, revenues and income from continuing operations.[16] The Commission has not specified a future time

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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."

[14] 17 C.F.R. 229.503(c).

[15] 17 C.F.R. 229.303; *See* Interpretive Release 33-9106, citing 2003 SEC Release.

[16] See Interpretive Release 33-9106, citing SEC Div. of Corp. Fin., "Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies", February 23, 2003, available at: www.sec.gov/divisions/corpfin/fortune500rep.htm.

period to consider in determining the impact of any trend or uncertainty; the relevant period "will depend on a registrant's particular circumstances and the particular trend, event or uncertainty under consideration."[17]

III. Guidance from the Interpretive Release

The Commission's interpretive guidance focuses on four areas where climate change may trigger disclosure under the noted Regulation S-K requirements, depending on the facts and circumstances of a particular registrant.

A. Legislation & Regulation

Recent developments in legislation and regulation regarding climate change may trigger disclosure obligations. Under Item 101, registrants should disclose any material estimated capital expenditures relating to compliance with developing environmental legislation. Item 503 may require disclosure of risk factors relating to climate change, if a particular registrant's operations-- such as energy or transportation -- face specific risks related to existing or pending legislation or regulation addressing GHGs. Item 303's MD&A requires a two-step analysis of a known uncertainty such as pending legislation or regulation where management must:

- evaluate whether pending legislation or regulation is reasonably likely to be enacted and then
- determine whether the legislation or regulation is reasonably likely to have a material effect on the registrant, its financial condition or results of operations.[18]

Also, the registrant needs to disclose, if material, any difficulties in determining the timing and effect of the actions under consideration.

MD&A disclosure is required unless management determines that a material effect is not reasonably likely. The release provides that a registrant should disclose possible opportunities as well as any negative consequences of proposed legislation or regulation. For example, the Commission highlights the following possible consequences of pending legislation:

- 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

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[17] *See* Interpretative Release 33-9106 at 17.

[18] *See* Interpretive Release 33-9106 at 23.

- 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.[19]

B. International Accords

The release suggests that registrants consider and disclose material impact on their business of treaties or international accords relating to climate change. These include any material affects on a registrant's business from, for example, the Kyoto Protocol as well as subsequent agreements reached in the related UN climate change negotiations, and the "cap and trade" system of allowances for carbon dioxide emissions set in the EU ETS. Registrants who are reasonably likely to be affected by such international agreements should monitor their compliance and consider disclosing the possible impact of any similar international accords under Item 303.

C. Indirect Consequence of Regulation or Business Trends

Certain developments regarding climate change may create opportunities or risks for registrants that create a demand for new products or services or decrease demand for those that exist. While the Commission stresses that each registrant consider its own facts and circumstances to determine materiality, it suggests that the following indirect opportunities or consequences may lead to material effects requiring disclosure:

- 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 related to carbon based energy sources, such as drilling services or equipment maintenance services.[20]

The release also notes a need to consider any potential effects on business or financial conditions from the impact on a registrant's reputation resulting from publicly available data on its GHG emissions.[21]

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[19] *See* Interpretive Release 33-9106 at 24.

[20] *See* Interpretive Release 33-9106 at 25.

[21] *See* Interpretive Release 33-9106 at 26.

D. PHYSICAL IMPACTS OF CLIMATE CHANGE

Under Item 101, registrants should consider their ability to temper the effects of severe weather (e.g., floods, hurricanes), or "sea levels, the arability of farmland, and water availability and quality" on their operations and results. The release points to a 2007 Government Accountability Office report highlighting the negative effect severe weather can have on the financial condition of affected businesses. The SEC recommends that registrants whose businesses may be particularly susceptible to severe weather or other "climate events" should consider disclosing that susceptibility as a material risk.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Robert M. Hallman at 212.701.3680 or rhallman@cahill.com; Jon Mark at 212.701.3100, jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com.; Mary Holst at 212.701.3672 or mholst@cahill.com.

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