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Climate Change Disclosure: SEC Seeks To Bring Clarity To Reporting "Known Uncertainties"

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July 2010

The author thanks Eric E. Freedman, Kristy T. Harlan, Sean M. Jones and Holly K. Vance, with whom he has collaborated in the firm's climate change disclosure initiative.

Introduction

Uncertainty seems to pervade almost any discussion of climate change and its consequences. This is especially true when discussing climate change legislation and regulation. Notwithstanding, the Securities and Exchange Commission (SEC) in January sought to bring some clarity to the question of whether climate change and its consequences, including pending legislative and regulatory proposals, are appropriate matters of disclosure for public companies. In its detailed interpretive release, the SEC sets forth the analytical framework and process for a public company to follow in determining whether climate change and its consequences are to be disclosed in the company's public filings.

The SEC's Interpretive Release

By a 3-to-2 vote on January 27, 2010, the SEC approved the interpretive release, *Commission Guidance Regarding Disclosure Related to Climate Change*, which was effective on February 8, 2010. As an interpretive release, the SEC's guidance does not create new legal requirements or modify existing ones. Instead, as SEC Chair Mary Schapiro indicated in her comments when introducing the release: "[It] is merely intended to provide clarity and enhance consistency."

Specifically, the SEC intends the release to assist public companies in determining what climate change-related disclosures need to be made pursuant to existing disclosure rules governing a company's risk factors, business description, legal proceedings, and management's discussion and analysis (MD&A). However, the SEC's issuance of the release, and its thoroughness and tenor, indicate that the SEC expects companies generally to give greater attention to evaluating climate change risks and opportunities and, based on these evaluations, to make appropriate disclosures when these risks or opportunities are material. Even those companies previously making climate change disclosures will likely need to reevaluate their disclosures in light of the SEC's guidance.

The interpretive release provides a comprehensive analysis of the SEC's view of the obligations of public companies, and the process to be undertaken by them, regarding climate change-related disclosure. In its interpretive release, the SEC highlighted the following areas as examples of situations when climate change and its consequences may trigger disclosure requirements:

- *Impact of Legislation and Regulation:* A company should consider whether the impact of existing laws and regulations regarding climate change is material to it and its business. A company should also evaluate the potential impact of ***pending*** legislation and regulation related to climate change. The SEC noted that certain companies, such as those in the energy sector, "are particularly sensitive to greenhouse gas legislation or regulation" and "may face significantly different risks" than some other companies. In what is clearly an understatement, the SEC "reiterate[d] that climate change regulation is a rapidly developing area [and companies] need to regularly assess their potential disclosure obligations given new developments."
- *Impact of International Accords:* A company should consider, and disclose when material, the risks or effects on its business of international accords and treaties relating to climate change.
- *Indirect Consequences of Regulation or Business Trends:* Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for companies. For instance, a company could face decreased demand for goods that produce significant greenhouse gas emissions or increased demand for goods that result in lower emissions than competing products. As such, a company should consider, for disclosure purposes, the actual or potential indirect consequences it may face due to climate change related regulatory or business trends.
- *Physical Impacts of Climate Change:* A company should also evaluate for disclosure purposes the actual and potential impact of significant physical effects of climate change on its business. These physical effects could include matters such as increased severity of floods or hurricanes, rising sea levels or decreased availability and lower quality of drinking water.

Focus on MD&A and "Known Trends and Uncertainties"

Much of the SEC's focus in its interpretive release related to reviewing past guidance regarding disclosures required in a company's MD&A, which is governed by Item 303 of Regulation S-K. The SEC noted that the MD&A should (a) provide a narrative explanation of a company's financial statements to enable investors to view the company through management's eyes and (b) provide information about the quality and potential variability of a company's earnings and cash flow so that investors can ascertain the likelihood that the company's past performance is indicative of its future performance. The SEC then focused particularly on the need to provide information to allow investors to assess the trends and uncertainties facing a company, and how this guidance should be applied in the context of evaluating climate change disclosure. The SEC emphasized the requirement that a public company disclose in its MD&A any known trends or uncertainties, such as pending climate change legislation or regulation, that are reasonably likely to have a material effect on the company's financial condition or operating performance. In determining what trends or uncertainties should be disclosed, the SEC said that a company should undertake the following analysis:

- consider financial, operational and other information known to the company;
- based on this information, identify known trends and uncertainties; and
- assess 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 said that there was no prescribed time horizon for determining by when such a trend or uncertainty must occur. A company instead should consider its particular circumstances and the specific trend or uncertainty in question. The company should then apply the general standard for determining the materiality of contingent or speculative information or events, which requires that the probability of the event occurring be weighed against its anticipated magnitude.

Determining Materiality of Known Trends and Uncertainties

The touchstone for determining whether disclosure is required under SEC rules is materiality—whether there is a substantial likelihood that a reasonable investor would consider the information important in deciding how to vote his or her securities or in making an investment decision. Whether omitted information is material is determined on the basis of whether there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the "total mix" of information available.

The SEC described in its release the two-step assessment to be undertaken by a public company in determining whether a particular known trend or uncertainty should be considered material and therefore disclosed:

- First, a public company must assess whether the trend or uncertainty is reasonably likely to come to fruition. The SEC cautioned in its release that "reasonably likely" is a lower disclosure threshold than "more likely than not." If the company can determine that the trend or uncertainty is not reasonably likely to come to fruition, no disclosure is required.
- Second, if the company cannot make this determination, it must evaluate objectively whether the consequences of the trend or uncertainty would be material assuming that the trend or uncertainty comes to fruition. Disclosure is then required, the SEC said, unless the company determines that a material effect on the company's financial condition or results of operations is not reasonably likely to occur.

It is worth noting that requiring disclosure as described in the second step above would be consistent with the SEC's admonition earlier in its release that when the materiality of a particular disclosure is in doubt, "it is appropriate that these doubts be resolved in favor of those the statute is designed to protect."

When making a disclosure regarding a trend or uncertainty, the SEC said that a company should also consider disclosing, if material, the difficulties involved in assessing the timing and effect of the trend or uncertainty. The SEC also cautioned that a company should not limit its disclosure evaluation to the negative consequence of a trend or uncertainty but should also consider whether it may provide new opportunities for the company, a topic that frequently has not been addressed in many climate change disclosures.

In preparing its MD&A, the SEC noted, a company must balance including all information that is material with eliminating immaterial information and duplicative or uninformative disclosure that may obscure material information. The SEC cautioned, however, that while materiality determinations may limit what is disclosed, they should not limit the information to be considered in making these determinations. The SEC took special note of the significant increase in financial and non-financial information now available due to technology and communications improvements, and it stressed that all relevant information, even information that is not material or required to be disclosed, should be evaluated.

Disclosure Controls and Procedures

The SEC also cautioned that public companies should have sufficient disclosure controls and procedures to collect and process this body of information in order to make appropriate climate change disclosure determinations. As the SEC noted, pursuant to Securities Exchange Act of 1934 (Exchange Act) Rules 13a-15 and 15d-15, a company's principal executive officer and principal financial officer must make certifications regarding the maintenance and effectiveness of the company's disclosure controls and procedures. These rules define "disclosure controls and procedures" as those controls and procedures designed to ensure that information required to be disclosed by the company in its SEC reports is:

- recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms, and
- accumulated and communicated to the company's management as appropriate to allow timely decisions regarding required disclosure.

The SEC emphasized that 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 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 Exchange Act Rule 12b-20's admonition to include in filings with the SEC material information in addition to the required information such that the required information is not misleading.

Ongoing Monitoring and Potential for Additional Guidance or Regulations

The SEC stated that as part of its ongoing disclosure review program, it will be monitoring the effect of its interpretive release on company filings. The SEC indicated that it would be conducting a public roundtable on climate change disclosure, although the Spring 2010 timeframe for holding the roundtable has apparently been delayed. The SEC said that based on the results of its review program, the information from this public roundtable and the advice and recommendations from its Investor Advisory Committee, it would determine whether further guidance or rulemaking was warranted.

The Investor Advisory Committee has established an Investor as Owner subcommittee which has begun reviewing environmental, social and governance (ESG) disclosure, including those related to climate change and sustainability. This subcommittee has held several meetings on ESG disclosure and will hold a late summer public hearing, after which it is expected to propose recommendations to the full Investor Advisory Committee which could form the basis for the recommendations from the Committee to the SEC on climate change disclosure.

Other SEC Disclosure Requirements

Registration statements filed under the Securities Act of 1933 (Securities Act) and proxy statements and periodic reports filed under the Exchange Act must disclose all information required by the applicable disclosure forms. In addition, Securities Act Rule 408 and Exchange Act Rule 12b-20 require a company to disclose, in addition to the information expressly required by the forms, "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." Finally, Exchange Act Rule 10b-5 provides that it is unlawful to make an untrue statement of material fact or to omit to state a material fact necessary to make the statements, in light of the circumstances under which they are being made, not misleading in connection with the purchase or sale of a security.

The provisions of Regulation S-K more specifically prescribe the subject matter of certain items required to be disclosed in a company's SEC filings. In addition to Item 303, which governs a company's MD&A and is discussed above, other Regulation S-K items as noted by the SEC may apply to a company as it considers climate change disclosures. These include the following:

- Item 101(c)(1)(x) requires a company to disclose competitive conditions in its business. For some companies, sustainability performance may have a material impact on competitive conditions, and therefore require disclosure.

- Item 101(c)(1)(xii) requires a company to disclose the material effects of environmental compliance associated with enacted laws. The cost of complying with any adopted greenhouse gas emissions regulations is a type of cost, if material, required to be disclosed by this item.
- Item 103 requires disclosure of any material pending administrative or judicial proceeding to which a company is a party. Any such proceeding arising under any laws regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment must be described if it falls within certain parameters specified in Item 103. In addition, a company should focus not only on any proceeding to which it is a party but on any third party proceedings if the outcome could materially affect the company's financial condition or competitive position. Significant court decisions regarding greenhouse gas emissions were issued in 2009, including the decision of the U.S. Court of Appeals for the Second Circuit in *Connecticut v. American Electric Power*, which allowed claimants to pursue federal common law public nuisance claims that the greenhouse gas emissions by the five defendant power companies had contributed to global warming.
- Item 503(c) requires a discussion of the most significant risk factors that apply to a company. Companies with businesses that may be impacted by climate change or climate change-related regulation will need to consider including appropriate disclosure addressing these risks and their potential effect on the company.

Related SEC Rules

In December 2009, the SEC adopted new Item 407(h) of Regulation S-K, which requires companies to "disclose the extent of the board's role in the risk oversight . . . such as how the board administers its oversight function and the effect that this has on the board's leadership structure." In conducting this oversight responsibility, a board should be satisfied that management has an appropriate process in place for identifying, evaluating, monitoring, mitigating and reporting to the board material risks to the company, including any material risks related to climate change and climate-change regulation.

In addition, Regulation FD prohibits certain selective disclosures of material nonpublic information. Consequently, disclosure of material climate change information to third parties may violate Regulation FD if not also disclosed to the general public in a manner that complies with Regulation FD. Any company reporting, for example, to the Carbon Disclosure Project or another climate-change-reporting organization should ensure that it is not selectively disclosing material information about climate change in violation of Regulation FD. This same concern about "selective disclosure" can arise from information on a company's website, in its marketing or press materials, reports to investors and analysts, participation in surveys and even filings made with other governmental agencies. If such public disclosures in non-SEC venues are considered to be material, their omission in the company's SEC filings would highlight defects in these filings and possibly violate regulations prohibiting selective disclosure.

Given the current uncertainty regarding climate change and its consequences, many disclosures regarding climate change will be "forward-looking statements". As a result, public companies should consider the "safe harbor" for forward-looking statements provided under the federal securities laws when making these disclosures. The safe harbor protects a company from liability in private lawsuits for certain "forward-looking statements". The safe harbor requires, among other things, that any forward-looking statements be identified and accompanied by meaningful cautionary statements identifying important factors that could cause the actual results to differ materially from those described in the disclosure.

Finally, a public company should be aware of the action taken last fall by the SEC staff regarding shareholder proposals to be made at annual shareholder meetings. The SEC staff, in a reversal of its prior position, issued a bulletin on October 27, 2009, that facilitated and encouraged shareholder proposals to require companies to provide greater disclosure about their climate change risks. According to Ceres, a coalition of investors, environmental groups and other public interest groups, this change resulted in a 40% increase in the climate change proposals filed in the recently completed proxy season. Ceres reported that as of May 18, 2010, a total of 102 resolutions had been filed with 89 U.S. and Canadian companies, including coal companies, electric power and oil producers, homebuilders, big box retailers and financial institutions. According to Ceres, shareholders filing such resolutions had successfully negotiated 48 withdrawals of their resolutions in exchange for specific commitments by the respective companies.

Observations on the Process for Determining Disclosure

The SEC's interpretive release lays out broad general guidelines to be applied by a public company to its specific circumstances in determining what climate change disclosures may be appropriate. In the end, of course, the specific process and the determination of what climate change consequences are material (and must therefore be disclosed) will be based on a company's particular circumstances and on the then relevant information in what is a very dynamic field.

One of the key first steps in this process for a company, as underscored by the SEC, is to ensure that the appropriate disclosure controls and procedures are in place to collect and review the relevant information to make disclosure determinations. Coordination within the company will often be critical since input from different offices within the corporation on a variety of subjects will be needed. In some cases, either the company's disclosure committee or a special management committee may be advisable to serve as the central collection, review and dissemination point. Many corporations, especially energy companies, will need to determine the appropriate level of involvement by its board of directors, especially in light of the board's risk oversight responsibility.

Among the information to be collected will be the estimated levels of greenhouse gas emissions, direct and indirect, by the company and its operations, which will necessitate both consistency in reporting and familiarity with current and proposed emission reporting methodologies. The company also will need to stay abreast of existing and proposed relevant legislative and regulatory measures, as well as judicial actions and decisions. The legislative and regulatory measures will include federal, state and local initiatives and those of general applicability as well as initiatives focused on a specific industry or sector. While Congress and the EPA have proposed or adopted a number of significant measures, many states also have significant regulatory requirements or regimes. Companies with international operations will need to consider international actions that may result from negotiations for a successor to the Kyoto Protocol. These would include actions by individual countries independently or in anticipation of, or pursuant to, any international agreements including the Copenhagen Accord. Companies will need to bear in mind that, as the SEC noted, "climate change regulation is a rapidly developing area".

The appropriate officers reviewing climate change information must also consider what information has been filed or distributed by the company regarding climate change that is not reflected in the company's SEC reports. For example, this could include information filed with certain federal or state agencies or available on the company's website. This information would not only be relevant to assessing climate change disclosures, but would need to be reviewed to assure consistency and to avoid "selective disclosure" contrary to Regulation FD's prohibitions.

After collecting and reviewing the relevant information, the appropriate officers and committees will need to identify known trends and uncertainties and then assess whether these trends and uncertainties will have, or are likely to have, a material impact on the company and its financial condition or results. Below are examples of some possible impacts, including those described by the SEC:

- Costs or profits from the purchase or sale of allowances or credits under a "carbon cap" regime.
- Costs to improve facilities or equipment to reduce emissions due to regulatory limits or to mitigate the costs of a "carbon cap", "carbon tax" or similar regime.
- Increased operating costs due to modified operations to comply with regulatory requirements.
- Profitability changes due to increased or reduced demand for goods or services. This change in demand could be positive or negative and could result directly from legislation or regulation or indirectly from changes in the costs of goods sold.
- The impact from the physical or climatic effects of climate change on a company's key locations or its key suppliers or customers. Locations vulnerable to climate change events, such as flooding or hurricanes, may have potential additional risks and costs, including higher insurance costs and local taxes.
- Reputational risks and favorable or adverse public perception of the company and its products or services.

An important impact highlighted by the SEC in its release is the potential for opportunities that may arise from climate change. While this obviously applies to renewable energy companies, natural gas is increasingly discussed as a potential beneficiary of climate change legislation, depending on the actual terms of such legislation. This arises, in part, from the potential roles of natural gas as a "bridge" fuel until the deployment in the future of lower carbon options; as a "backup" fuel for intermittent renewable fuels, such as solar and wind; and in a larger, longer-term role in the event lower carbon options are not broadly deployed due to technological, economic or other factors.

However, as The Brattle Group points out in its March 2010 Discussion Paper, *Prospects for Natural Gas Under Climate Policy Legislation*, the role that natural gas will play "is far from clear, even over the next five to ten years." Brattle's report notes that natural gas demand may decline despite the argument for natural gas to play a greater role in an era of concern about carbon emissions. The report notes however that there are likely to be regional differences in natural gas demand due to regional differences in the fuel mix of various electric generation fleets.

In light of these regional differences and other factors, such as the specific terms of any enacted legislation and the extent of the continuing fluidity of climate change policy formulations, climate change legislation may offer potential material opportunities for certain natural gas companies, either in the near future or the longer term. As with all disclosures about possible future trends, disclosures of potential climate change opportunities should be appropriately qualified. To the extent these disclosures constitute "forward-looking statements", companies should take advantage of the SEC's safe harbor for forward-looking statements by identifying them as such and accompanying them with appropriate cautionary statements about the important factors that could delay or prevent the company from taking advantage of such opportunities.

Finally, companies must be alert to and vigilant about pending climate change developments. As many companies, especially those in the energy sector, are aware, this entire area is one that has been rapidly evolving and frequently changing. Not only is climate change regulation a rapidly developing area, as the SEC noted, but many other policy formulations related to climate change have continued to emerge or change. These now include the SEC's actions in 2009 and 2010, which indicate a heightened attention by the SEC to climate change disclosure. Moreover, the SEC has indicated that in the near future it may be providing further advice or directives on this subject.

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