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Climate Change

SEC Issues Guidance on Disclosure Related to Climate Change

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On February 2, 2010, the U.S. Securities and Exchange Commission (SEC) issued an interpretative release to provide guidance to public companies regarding the applicability of the SEC's existing disclosure requirements to "climate change" issues ("the Guidance"). See the complete SEC guidance here. The Guidance does not make new law or modify existing law but rather serves to "remind" public companies of their obligation under existing SEC requirements to consider the relevance of climate change issues and, as necessary, disclose any material risks posed by those issues with respect to the company's financial condition and results of operations. Notably, however, the SEC suggests that a company should consider the actual physical impacts of climate change on the company's operations and results, including impacts from severe weather events that may be the result of climate change caused by greenhouse gases.

The practical effect of the Guidance is that it represents a first-of-its-kind touchstone — a conspicuous standard by which the SEC, shareholders, and the public will measure a company's disclosure with respect to climate change matters. The SEC announced that it plans to monitor the effect of the Guidance on future filings made by public companies. The SEC also announced that it intends to hold a public roundtable on climate change related disclosure matters in the spring of 2010. Based on its review and information gathered from the roundtable, the SEC will consider whether further guidance or rulemaking on this issue is appropriate.

Setting the Stage: Responses to Climate Change and Existing SEC Rules that May Require Disclosure of Climate Change Matters

In setting the stage for its guidance, the SEC acknowledges the heightened public interest in climate change and briefly mentions legislative, regulatory, and other developments taking place in the United States and internationally in response to perceived threats from climate change. The Guidance briefly comments on ways in which these developments could have a significant effect on operating and financial decisions of public companies that may be required to reduce emissions of greenhouse gases, purchase allowances (in a "cap-and-trade" system), or adjust to indirect consequences such as increased prices for certain goods or services. The SEC also cites to potentially significant physical environmental impacts of climate change that have the potential to have a material effect on a public company, including changes in weather patterns or changes in availability or quality of water.

The Guidance highlights specific, existing SEC requirements that the SEC believes may trigger a public company's obligation to consider and evaluate climate change issues. The Guidance describes the most pertinent, non-financial statement disclosure rules that may require disclosure related to climate change, specifically:

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(i) Regulation S-K, Item 101, which requires a registrant to describe its business and that of its subsidiaries;

(ii) Regulation S-K, Item 103, which requires a registrant to briefly describe any material pending legal proceeding to which it or any of its subsidiaries is a party and any material pending legal actions in which its property is the subject of the litigation;

(iii) Regulation S-K, Item 503(c), which requires a registrant to provide a discussion of the most significant factors that make an investment in the registrant speculative or risky;

(iv) Regulation S-K, Item 303, which requires disclosure known as the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A); and

(v) Form 20-Fs, which imposes SEC disclosure obligations on foreign private issuers.

The Heart of the Guidance: SEC's Interpretation of Its Existing Rules in the Context of Climate Change Issues

At the very heart of the Guidance is the SEC's interpretation of its existing rules with respect to climate change issues. The Guidance makes clear that disclosure of climate change issues is dependent on the facts and circumstances related to a particular registrant. The Guidance then provides interpretative analyses on ways in which certain climate change issues may trigger disclosure under the existing rules, including:

Impact of Legislation and Regulation

The Guidance suggests that significant recent developments in federal and state legislation and regulation regarding climate change may trigger disclosure obligations under Item 101, 103, 503(c), and 303 of Regulation S-K. The Guidance notes that, with respect to legal requirements relating to greenhouse gas emissions, Item 101 requires disclosure of any material estimated capital expenditures for environmental control facilities for this fiscal year, next fiscal year, and for such future periods as the registrant may deem material.

In addition, Item 503(c) requires consideration of risk factors regarding existing or pending legislation or regulation relating to climate change. The Guidance notes that risks specific to the registrant should be considered as opposed to generic risks. For instance, the Guidance specifically notes that registrants in the energy sector may face significantly different risks as compared to registrants in the transportation sector that are reliant on products that emit greenhouse gases.

The Guidance notes that Item 303 requires consideration of whether any enacted climate change legislation or regulation is reasonably likely to have a material effect on the registrant's financial condition, or results of operations. In the case of a known uncertainty, such as pending legislation or regulation, the Guidance states that the analysis

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of whether disclosure is required is a two-step process: (i) management must evaluate whether the pending legislation or regulation is reasonably likely to be enacted (and unless management determines that it is not reasonably likely to be enacted, it must proceed on the assumption that the measure will be enacted); and (ii) 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 operation (and unless management determines that a material effect is not reasonably likely, the SEC notes that MD&A disclosure is required). In addition, a registrant should consider the difficulties involved in assessing the timing and effect of the pending legislation or regulation in assessing whether or how to disclose the potential impact of any proposed legislation or regulation.

The Guidance importantly notes that a registrant should not limit its evaluation of proposed legislation or regulation only to negative consequences but also should consider potential new opportunities. As an example, the Guidance states that if a “cap-and-trade” system of regulating greenhouses gases is established, registrants could profit from the sale of emission allowances.

The Guidance provides examples of possible consequences of pending legislation and regulation related to climate change, including:

- 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 limits or to mitigate financial consequences of a “cap-and-trade” system; and

- Changes to profit or loss arising from increased or decreased demand for goods and services produced from the registrant arising directly from legislation or regulation, and indirectly from changes in costs of goods sold.

Finally, the Guidance makes clear that climate change regulation is essentially a “moving target,” subject to rapid change, and thus registrants should regularly assess their potential disclosure obligations given new developments.

International Accords

With regard to the international arena, the Guidance directs registrants to consider, and disclose if material, the impact on their business of treaties and international accords relating to climate change. The Guidance also suggests that registrants who may be affected by such agreements should monitor the progress of such treaties and accords.

Indirect Consequences of Regulation or Business Trends

The Guidance notes that with the advent of new legal, technological, political, and scientific developments regarding climate change, there may be indirect consequences resulting in corresponding new risks or opportunities. For instance, there may be new or increased demand for certain products and services or decreased demand for other products or services. The Guidance provides several examples of indirect consequences or opportunities, including:

- Decreased demand for goods producing significant greenhouse gas emissions;
- Increased demand for goods that result in lower emissions than competing products;
- Increased competition to develop innovative 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.

The Guidance further notes that the impact to a registrant's reputation could be another potential indirect risk or consequence, depending on the nature of the registrant's business and its sensitivity to public opinion.

Physical Impacts of Climate Change

The final topic addressed by the Guidance may be its most controversial. The SEC accepts as a premise that there are significant physical effects of climate change, such as effects on the severity of weather (e.g., floods, hurricanes), sea levels, arability of farmland, and water availability and quality. The Guidance goes farther and cites a 2007 Government Accountability Office report for the proposition that severe weather scenarios will increase as a result of climate change caused by an overabundance of greenhouse gases. The Guidance notes that significant physical effects of climate change have the potential to affect a registrant's operations and results. The Guidance provides examples of several potential consequences of severe weather, including:

- For registrants with operations along coastlines, property damage and disruptions to operations, including manufacturing operations and transportation of products;
- Indirect financial and operational impacts from disruptions to the operations of major customers or suppliers due to severe weather such as hurricanes and 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 registrants with operations in areas subject to severe weather.

The Guidance suggests that registrants whose business may be vulnerable to severe weather or climate-related events should consider disclosing material risks of, or consequences from, such events.

Potential Effects of the Guidance: Companies Should Pay Careful Attention

Notwithstanding the fact that the Guidance is not a legally enforceable rule or regulation, the Guidance will be looked to as setting a standard for disclosure of climate change issues. Not only will it be used by the SEC to gauge the effectiveness of a company's disclosure of climate change matters, it likely will be used by shareholder activists and environmental groups as a basis for claims that disclosures are inadequate and as a means to try to force companies to limit their emissions of greenhouse gases. The Guidance throws a somewhat new twist in the climate change disclosure arena in that it calls for consideration of the impacts of climate-change related weather events, specifically impacts to companies with operations located along coastlines and companies who work with such coastal-based operations. Companies with coastal-based facilities or that supply or procure from such companies should pay careful attention to this part of the Guidance.

Public companies also should consider documenting their consideration of the Guidance prior to SEC filings in order to best position themselves for any challenge to their climate change disclosures (or lack thereof). Companies also should evaluate their need to conduct internal greenhouse gas emissions inventories to fully assess the need to disclose effects of climate change issues on company financial conditions or results of operations. Finally, companies interested in providing feedback to the SEC on the Guidance should follow the progress of the planned public roundtable.

Perhaps the most remarkable aspect of the SEC's Guidance is that it assumes that climate change is occurring, is attributable to anthropogenic emissions of greenhouse gases, and is a proximate cause of severe weather events. While many may question this assumption, public companies would be well advised to pay heed to the Guidance in their future filings with the agency.

For more information regarding the Guidance or with respect to other climate change and environmental issues, please contact Vinson & Elkins lawyers Larry Nettles, Larry Pechacek, or Kristie Tice. Please visit our website to learn more about our Climate Change practice and our Environmental practice groups.