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Business Alert

Securities and Exchange Commission Publishes Its Interpretive Release on Climate Change Related Disclosures

Written by Seth D. Jaffe

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In early February, the Securities and Exchange Commission published an interpretive release (Release Nos. 33-9106 and 34-61469) about public company disclosures related to climate change. The Commission has previously stated that it is not making new law, nor is it taking a position on any aspect of the debate concerning climate change. Instead, the release summarizes the current state of that debate, reminds companies of the existing regulatory scheme requiring disclosures concerning environmental and climate matters, and then — in what is clearly the most helpful part of this fairly short release — enumerates and describes the kinds of disclosures that the Commission believes would be, and should be, captured by the current regulatory system.

Despite the Commission's protests about the "neutral" nature of the release, it was approved by a 3 to 2 vote of the Commissioners and engendered controversy about whether it was, in fact, a political statement issued in response to political pressures.

Potential Impacts of Climate Change Related Matters on Public Companies

The Commission notes that pending and effective regulatory, legislative and other developments can have a significant effect on operating and financial decisions of public companies, such as those involving capital expenditures to reduce emissions and, for companies that may become subject to "cap and trade" laws, the expense of purchasing allowances, or the cost of penalties when target reductions cannot be achieved. In the latter part of the release, the Commission develops this theme at length, as discussed below.

Similarly, the release observes that the physical effects of climate change may potentially have a material effect on a company's business, citing possible effects on personnel, physical assets, and supply and distribution chains. Such effects may also be secondary, such as increases in insurance costs or the unavailability of insurance for physical plants in areas hard hit by adverse climate changes.

The Existing Scheme of Rules and Regulations Requiring Disclosure of Climate Change Issues

There are four key areas within existing Commission rules that call for the types of disclosures that are the subject of the interpretive release: (1) description of the business, (2) legal proceedings, (3) risk factors, and (4) management's discussion and analysis of financial condition and results of operations (usually referred to as MD&A).

1. Description of the Business.

In addition to the expected disclosures about a company's business and organization, there is a specific regulation calling for current and anticipated costs of complying with environmental laws.

2. Legal Proceedings.

In general, companies must disclose material pending legal proceedings to which they or any of their subsidiaries is a party, except for "ordinary routine litigation incidental to the business." However, special disclosure is required (and such matters are not considered "ordinary routine litigation") in case of an administrative or judicial proceeding arising under federal, state or local laws covering the discharge of materials into the environment, or protecting the environment, if the matter is material, if the monetary damages may exceed 10% of the company's current assets, or if a government authority is a party to the proceeding and the matter involves $100,000 or more of potential monetary sanctions.

3. Risk Factors.

Commission regulations require companies to provide in certain filings, under the heading "Risk Factors," a discussion of the most significant factors that make an investment in the company speculative or risky.

4. Management's Discussion and Analysis.

The Commission continues to stress that it wants companies to evaluate known trends and uncertainties and their potential effects on the business and financial condition of the company. As the interpretive release notes, "disclosure should highlight issues that are reasonably likely to cause reported financial information not to be necessarily indicative of future operating performance or of future financial condition."

Identified Climate Change Related Disclosures

In what is undoubtedly the most helpful part of the interpretive release, the Commission discusses the types of environmentally related disclosures that are called for under its existing rules within four broad categories: (1) impact of legislation and regulation, (2) international accords, (3) indirect consequences of regulation or business trends, and (4) physical impacts of climate change.

1. Impact of Legislation and Regulation.

With respect to laws and regulations relating to greenhouse gases, companies should disclose any material estimated capital expenditures for environmental control facilities for the current and succeeding fiscal years and for such further periods as the company might consider material.

Companies in the energy sector should be particularly sensitive to the risks associated with greenhouse gas legislation or regulation. Management must evaluate in MD&A whether pending legislation or regulation is reasonably likely to be enacted, and then determine whether, if enacted, the legislation or regulation is reasonably likely to have a material effect on the company or its financial condition or results of operations.

Companies should also consider whether new legislation will provide opportunities, such as profiting from the sale of allowances if a "cap and trade" system is put in place.

Examples of possible consequences of pending legislation in this area cited by the Commission therefore include:

- Costs to purchase, or profits from the sale 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 regulations or to mitigate "cap and trade" consequences
- Changes to profit or loss arising from increased or decreased demand for goods and services produced by the company arising directly from pending legislation, and indirectly from changes in costs of goods sold

2. International Accords.

Where companies have businesses reasonably likely to be affected by agreements such as the Kyoto Protocol or the European Union Emissions Trading System (EU ETS), they should monitor the progress of any potential agreements and consider the possible impact of them in satisfying their disclosure requirements based on the MD&A and other materiality principles developed in the interpretive release.

3. Indirect Consequences of Regulation or Business Trends.

In this category, the Commission comments that developments regarding climate change may create new opportunities as well as risks, citing the following possible examples of both:

- 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
- Decreased demand for services related to carbon based energy sources, such as drilling services or equipment maintenance services

Interestingly, the Commission also suggests as a possible risk factor the impact of public opinion. "Depending on the nature of a [company's] business and its sensitivity to public opinion, a [company] may have to consider whether the public's perception of any ... data relating to its greenhouse gas emissions could expose it to potential adverse consequences to its business operations or financial condition resulting from reputational damage."

4. Physical Impacts of Climate Change.

The interpretive release concludes by noting that significant physical effects of climate change, such as effects on severity of weather, sea levels, arability of farmland, and water availability and quality can significantly impact some companies. Other possible consequences of severe weather could include these:

- For companies with operations concentrated on coastlines, property damage and disruption to operations, including both manufacturing processes and the transport of materials and goods
- Indirect financial and operational impacts from disruptions to the operations of major suppliers or customers from severe weather
- Increased insurance claims and liabilities for insurance and reinsurance companies
- Decreased agricultural production capacity in areas affected by drought or other adverse weather-related changes

Conclusion

In June 2009, the Commission formed an Investor Advisory Committee to address improvements to disclosure, include climate change related disclosure. In the spring of 2010, the Commission is planning to hold a public roundtable on disclosure regarding climate change matters. We intend to monitor Commission positions that may be changed due to the work of that Committee or from public input.
