



US SEC guidance on disclosure related to climate change

COMMISSION SEEKS CLARITY AND CONSISTENCY

The SEC has published guidance to public companies on its disclosure requirements regarding climate change matters. In this briefing we discuss the guidance and its possible implications for reporting companies and suggest a regime of best practice. The briefing also contains an appendix on recent developments in environmental regulation relating to climate change.

Introduction

On 2 February 2010, the US Securities and Exchange Commission (SEC) issued interpretive guidance on climate change disclosure (Guidance) in an effort to help SEC reporting companies determine what needs to be disclosed under its existing rules (available at <http://www.sec.gov/rules/interp/2010/33-9106.pdf>).

The Guidance reminds reporting companies of the principles-based nature of certain SEC rules. This permits sufficient flexibility to adapt to current developments but requires management to apply the principles to the company's particular circumstances.¹ The Guidance repeats earlier guidance on how to apply these principles (including determining materiality) and emphasises the need for adequate disclosure controls and procedures to support the materiality analysis.

The SEC gives examples of how the existing rules may require disclosure of effects related to climate change on companies in three areas:

- changing regulatory landscape;
- indirect consequences of legal, technological, political and scientific developments; and
- physical impacts.

Because the Guidance interprets existing rules, it applies immediately to periodic reports and registration statements of both US and non-US companies that are SEC reporting companies.

¹ See the Guidance at page 16 concerning disclosure required under the management's discussion and analysis requirement (Item 303 of Regulation S-K).

Background

The Guidance provides a helpful summary of the background to this SEC action. There has been mounting pressure from institutional investor groups and other stakeholders for increased disclosure and a growing web of legislative, regulatory and other initiatives (for example, the voluntary disclosure frameworks provided globally by the Carbon Disclosure Project and the Global Reporting Initiative and, in the US, by the Carbon Registry) in response to greater awareness of, and concern about, the potential impact of climate change. The US insurance industry has acted recently by proposing a requirement for certain insurance companies to disclose to their regulators the financial risks they face from climate change and the actions they are taking to deal with such risks. (For further background details please see the information set out in the *Key developments* appendix at the end of this briefing.)

The SEC adopted the Guidance by a 3-to-2 vote, which reflects the controversial nature of climate change generally. The Commissioners who did not support the Guidance variously thought that it was the wrong priority, unnecessary, apt to 'muddy the waters' (citing inherent uncertainty around reputational risk and physical impacts) and that it 'placed the imprimatur of the Commission on the agenda of the social and environmental policy lobby', which Commissioner Casey considered to be outside the SEC's investor protection

mission and expertise. The sharp dissent and general controversy also suggest that formal rule making (as opposed to interpreting existing rules) might be difficult to achieve and makes it more likely that any implications of the Guidance will be developed organically through the routine comment process.

The SEC's reminder to reporting companies about their climate change-related disclosure obligations fits with its recent regulatory action requiring US reporting companies to give enhanced risk management disclosure for executive compensation and corporate governance (www.sec.gov/rules/final/2009/33-9089.pdf).

Existing rules

The Guidance discusses the existing rules that may require climate change-related disclosure, depending on the facts and circumstances of each company. It reminds reporting companies of the overarching requirement to disclose all material information necessary to ensure disclosure is not misleading (Securities Act Rule 408(a) and Exchange Act Rule 12b-20) and of the importance of the disclosure controls and procedures that underpin compliance with that requirement.

Disclosure controls and procedures

The Sarbanes-Oxley Act of 2002 added to the federal securities laws the requirement that reporting companies must maintain disclosure controls and procedures. The rules also require that management regularly evaluates the effectiveness of these controls and procedures and discloses its conclusions in both the quarterly and annual reports for US reporting companies and the annual report for non-US reporting companies (foreign private issuers).²

The Guidance makes clear that climate change is a topic for disclosure controls and procedures. It is important to be aware that, while what is disclosed may not necessarily change, the underlying disclosure exercise may require review of a growing body of information and input from areas of the business not historically involved in the disclosure exercise – to ensure that potentially material climate change-related issues 'bubble up' to management. For example, the Guidance notes that management should ensure it has sufficient information

about the company's greenhouse gas emissions and 'other operational matters' to enable it to make an informed judgement about the likely impact of proposed legislative or regulatory changes.³

Disclosure rules

The Guidance focuses on the existing disclosure rules that may be relevant to non-financial disclosure relating to climate change (with a passing reference to those relating to financial disclosure) and discusses the SEC's established history of regulating environmental disclosure.

- Regulation S-K for US reporting companies.
 - Description of business (Item 101) includes disclosure of the material effects of complying with enacted federal, state and local environmental laws and material capital expenditures for environmental control facilities over a specified time period and beyond, where material. The requirement does not cover pending regulatory developments.
 - Legal proceedings (Item 103) requires disclosure of material, pending legal proceedings involving the company or its property. There are also specific technical requirements regarding environmental litigation.
 - Risk factors (Item 503(c)) requires tailored disclosure of how a particular risk affects a particular company. There is a similar requirement for foreign private issuers (Item 3D of Form 20-F).
 - Management's discussion and analysis (MD&A) of financial condition and results of operations (Item 303) – see discussion below on materiality. This requirement is intended to allow investors to see the company's financial condition and prospects 'through the eyes of management', including evaluating the potential impact of known trends, events and uncertainties on liquidity, capital resources and results of operations.
- Foreign private issuers are subject to requirements that are parallel though less prescriptive than those of Regulation S-K.
 - Form 20-F including the operating and financial review and prospects (OFR).
 - Forms F-1 and F-3.

² Regulation S-K Item 307 and Item 15(a) of Form 20-F.

³ Guidance at pages 18-19.

Materiality

The Guidance reminds companies of the relevant materiality principles. The standard articulated in case law⁴ provides that information is 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
- the information would substantially alter the total mix of available information.

Doubts in applying the standard should be resolved in favour of those whom the statute is designed to protect. Balance should be exercised to avoid burying the key points in a welter of information.

The materiality standard for disclosure concerning the company's liquidity, capital resources and results of operations required in the MD&A has been further developed and reiterated by SEC guidance in 1989, 1998, 2002 and 2003.⁵ The Guidance continues this tradition.

In his statement welcoming the Guidance, Commissioner Luis Aguilar said that, 'MD&A is the place to disclose the issues keeping management up at night.' In other words, management must identify and analyse known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance. The test has two steps.

- If management can determine that the known uncertainty etc is not reasonably likely to occur then no disclosure is required.
- If management cannot so determine, then it must:
 - assume the known uncertainty etc will come to fruition; and
 - objectively assess whether such known uncertainty etc is reasonably likely to have a material effect on the company's financial condition and results of operations.

The anticipated timing of the uncertainty is relevant to the materiality determination and, again, the Guidance reminds companies of the case law stating that materiality 'with respect to contingent or speculative

information or events... will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of company activity.'⁶

Three areas used as examples

By way of example, the Guidance discusses the impacts of climate change-related developments in three areas and illustrates how these impacts may trigger disclosure obligations under the existing rules.

- Impact of the changing regulatory landscape, including international accords and national legislative and regulatory developments, both those in effect and pending (for example, the European Union Emissions Trading System, which has created a market in trading greenhouse gas emissions allowances and similar proposed legislation pending in the US Congress).
- Indirect consequences of legal, technological, political and scientific developments (for example, reputational risk or additional costs being passed on by directly affected suppliers to businesses not otherwise directly affected).
- Physical impacts (for example, changes in availability or quality of water on which a business depends).

Applying existing rules to the three highlighted areas

Depending on materiality (as discussed above), the Guidance gives examples of required disclosure of negative and positive consequences.

Changing regulatory landscape

- Relevant capital expenditures (Item 101).
- Individually tailored risk factors for companies particularly sensitive to greenhouse gas emissions – for example, companies in the energy sector may face different risks to companies in the transport sector (Item 503(a)).

⁴ *TSC Industries, Inc v Northway, Inc*, 426 US 438 (1976) and *Basic Inc v Levinson*, 485 US 224 (1988).

⁵ *Release No 33-6835 (May 18, 1989); Release No 33-7558 (Jul 29, 1998); Release No 33-8056 (Jan. 22, 2002); Release No 33-8182 (Jan 28, 2003); Release No 33-8350 (Dec 19, 2003).*

⁶ *Basic at 238* quoting *Texas Gulf Sulphur*, 401 F 2d 833 (2d Cir 1968) at 849.

- In the MD&A or OFR, whether enacted climate change legislation is reasonably likely to have a material effect on financial condition or results of operations and similarly with regard to pending legislation – for example, if a federal ‘cap and trade’ system were put in place in the US and the company might benefit from selling unused emissions allowances. Business that may be materially affected by international accords should monitor the progress of such accords in order to consider disclosure as appropriate.

Indirect consequences

Several examples are given and the Guidance suggests that the disclosure would appear as risk factors or in the MD&A:

- increased demand for goods with lower emissions than competing products – for example, new compact fluorescent bulbs (rather than traditional incandescent light bulbs, which are being phased out as a result of recent regulatory change);
- increased competition to develop innovative new products;
- increased demand for generation and transmission of energy from alternative energy sources; and
- potential reputational damage as a result of the public’s reaction to publicly available data on the company’s greenhouse gas emissions.

In some cases, the Guidance indicates that indirect consequences may be sufficiently significant to warrant disclosure in the business section – for example, plans for major investment in plant and equipment so the company can reposition itself to take advantage of opportunities or manage risks associated with indirect impacts of climate change. This type of disclosure may raise competitive concerns.

Physical impacts

The Guidance focuses on businesses that are vulnerable to severe weather or climate-related risks, for example:

- increased insurance claims and liabilities for insurers;
- increased insurance premiums and reduction in the availability of cover for businesses in areas perceived to be particularly vulnerable; and
- decreased agricultural production capacity in areas affected by drought.

Suggested best practice

Although the Guidance clarifies rather than changes existing rules, we suggest the following best practice points for companies to consider when preparing their disclosure.

- Means of disclosure. Pay close attention to all climate change-related disclosures by the company, including those made voluntarily (for example, to insurers, on the company website or via any sustainability framework such as that provided by the Global Reporting Initiative) to ensure that all disclosure that is material appears in SEC filings and that disclosure is consistent across all disclosure vehicles.
- Disclosure controls and procedures. Review these to ensure that:
 - governance structures are in place to manage climate change risk;
 - relevant personnel are adequately informed and kept up to date with new developments – both concerning potential climate change impacts generally and specifically in each of the three areas singled out by the SEC – so they are able to judge what may be material to the company. For some companies, it may be appropriate to review or refresh training on the SEC requirements as they relate to climate change disclosure, particularly for drafting/reviewing the MD&A; and
 - disclosure controls and procedures operate to keep climate change disclosure under regular review. Climate change impact is a developing and controversial area. The need to build in regular review may be more pressing for non-US companies who, unlike US companies, are not required to make quarterly reports to the SEC and whose national regulatory regime may take a different approach to climate change disclosure.

Conclusion

The effect of the Guidance will probably become apparent through the routine comment process between the staff of the Division of Corporation Finance at the SEC and reporting companies on their individual filings. Comment letters from the staff are published and searchable on the SEC website (<http://www.sec.gov/answers/edgarletters.htm>).

The SEC is keeping a close eye on climate change disclosure and there may be further developments from an SEC round table with stakeholders (promised for spring 2010) and via its newly-formed Investor Advisory Committee.

Over time, the Guidance may influence disclosure in prospectuses in other jurisdictions (through the Rule 144A/Rule 10b-5 process) and may provide an impetus for regulatory change in jurisdictions with less flexible disclosure regimes.

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Appendix: Key developments in environmental regulation

International scientific consensus states that increased concentrations of carbon dioxide and certain other gases in the earth's upper atmosphere are due to human activity – and that this has caused (and will continue to cause) a rise in atmospheric temperatures and other climatic effects.¹ While the precise future consequences of climate change are still hotly debated, lawmakers in the US and around the world have begun to take steps to mitigate its causes and prepare for its effects.

A changing regulatory landscape for climate change

The most dramatic direct effects of climate change are not likely to be imminent, but changes to the regulatory landscape are underway and these can have material consequences on today's businesses. Regulatory regimes that cause businesses to pay for greenhouse gas emissions allowances can create material cost increases to those businesses whose operations directly or indirectly rely on such emissions. For businesses whose operations depend on fewer emissions, regulation can create a windfall by changing the competitive landscape or, where regulatory allowances are tradable, by allowing businesses to profit from the sale of excess emissions allowances. Furthermore, pending regulation can create the spectre of such changes.

In the US, federal and state regulations related to climate change have created material costs and may increase costs further. The US Environmental Protection Agency (EPA) has recently taken steps to regulate greenhouse gas emissions. Starting in 2010, facilities that emit over 25,000 tons of greenhouse gases annually must collect and report data with respect to their greenhouse gas emissions to the EPA² and may soon need to demonstrate that they are following best practices in reducing emissions.³

¹ See, eg, *Climate Change 2007*, the Fourth Assessment Report (AR4) of the United Nations Intergovernmental Panel on Climate Change (IPCC) (February 2007); 2007 Joint Science Academies' Statement on Growth and Responsibility: Sustainability, Energy Efficiency and Climate Protection.

² Mandatory Reporting of Greenhouse Gases, 74 Fed Reg 56, 260 (Oct 30, 2009) (to be codified at 40 CFR pt 86, 87, 89, 90 94, 98, 1033, 1039, 1042, 1045, 1048, 1051, 1054 and 1065).

³ Prevention of Significant Deterioration and Title V Greenhouse Gas Tailoring Rule, 74 Fed Reg 55, 292 (proposed Oct 27, 2009) (to be codified at 40 CFR pt 51, 52, 70 and 71).

State regulations and co-operative initiatives (such as California's Assembly Bill 32,⁴ the Regional Greenhouse Gas Initiative⁵ and the Western Climate Initiative⁶) limit emissions and create systems of tradable carbon allowances and credits. Legislation pending in the US Congress sets standards for emissions and energy efficiency, and may create a 'cap and trade' system of allowances and credits to meet these emissions standards at a national level.⁷

The National Association of Insurance Commissioners in the US, a voluntary, non-profit, non-governmental organisation of state insurance regulators, has recently developed a risk disclosure questionnaire concerning climate change and recommended that all state regulators require insurers over a certain size to complete the survey annually.⁸ The extent to which this initiative is adopted as a requirement by the various states remains to be seen.⁹

International developments are even more extensive. Since the late 1990s, the Kyoto Protocol binds the countries that have ratified it to meet emission reduction targets.¹⁰ The Kyoto Protocol also apportioned tradable allowances to ratifying countries, some of which have been sold or exchanged. In 2005, the European Union began the Emissions Trading System (EU ETS) based on the Kyoto Protocol mechanism and aimed to reduce greenhouse gas emissions through a regulated market of private emissions credits.¹¹ A recent directive expands the EU ETS and extends it through 2020.¹² At the 2009 UN Climate Change Conference in Copenhagen, 193

⁴ See, California Environmental Protection Agency Air Resources Board, Assembly Bill 32: Global Warming Solutions Act, www.arb.ca.gov/cc/ab32/ab32.htm.

⁵ Regional Greenhouse Gas Initiative, About RGGI, www.rggi.org/about.

⁶ Western Climate Initiative, Designing the Program, www.westernclimateinitiative.org/designing-the-program.

⁷ See, eg, American Clean Energy and Security Act of 2009, HR 2454, 111th Cong (2009); Clean Energy Jobs and American Power Act of 2009, S 1733, 111th Cong, 1st Sess. (2009).

⁸ See *Insurance Regulators Adopt Climate Change Risk Disclosure*, available at www.naic.org/Releases/2009_docs/climate_change_risk_disclosure_adopted.htm.

⁹ Childers, Angela, 'Debate Over NAIC Risk Disclosure Heating Up', *Risk and Insurance*, 24 Feb 2010.

¹⁰ Kyoto Protocol to the United Nations Framework Convention on Climate Change, Dec 10 1997, 37 ILM 22.

¹¹ See, European Commission, Emissions Trading System (ETS), http://ec.europa.eu/environment/climat/emission/index_en.htm.

¹² Council Directive 2009/29, 2009 OJ (L 140) 63 (EC).

nations agreed to an accord recognising the need for legally binding emissions reduction targets that will be negotiated throughout 2010.¹³

In addition to regulatory changes, the development of voluntary disclosure programmes are showing that many businesses are taking climate-related risks seriously. For example, the Carbon Disclosure Project collects and distributes climate change information on behalf of institutional investors from 66 per cent of S&P 500 companies and 80 per cent of Global 500 companies.¹⁴ Other non-profit and collaborative projects (including The Climate Registry¹⁵ and the Global Reporting Initiative¹⁶) cover thousands of companies globally and offer more information than appears to be required to be disclosed by the SEC by reporting companies, even after the Climate Guidance.

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¹³ See, press release, Frame Work Convention on Climate Change Secretariat, Copenhagen United Nations Climate Change Conference ends with political agreement to cap temperature rise, reduce emissions and raise finance (19 December, 2009), available at http://unfccc.int/files/press/news_room/press_releases_and_advisories/application/pdf/pr_cop15_20091219.pdf.

¹⁴ See, Carbon Disclosure Project, www.cdproject.net.

¹⁵ See, The Climate Registry, www.theclimateregistry.org.

¹⁶ See, The Global Reporting Initiative, www.globalreporting.org.