

KEEPING IT GREEN: THE SECURITIES AND EXCHANGE COMMISSION ISSUES

An Interpretative Release to Provide Guidance on Climate Change Disclosures for Public Companies

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Abstract

On February 2, 2010, the Securities and Exchange Commission (“SEC”) issued an Interpretative Releaseⁱ (“Release”) to provide guidance for public companies on existing SEC disclosure requirements as applied to global climate change. Under the new Release, public companies must disclose to investors any serious risks that global warming might pose to their businesses. More importantly, if these risks are both probable and reasonably estimable then such risks must be recorded on the company’s books as a liability. The guidance is an interpretative release and not a formal rule; therefore it is possible that it is effective immediately. The Release is intended to provide clarity and lead to more consistent application of climate change-related disclosures, it does not change the materiality standard for risk disclosure in the reports of public companies filed with the SEC. Although the SEC insists that the guidance does not modify or create new disclosure rules, it is likely that scrutiny by the SEC for disclosure or lack of disclosure relating to the effects of climate change will increase. Public companies subject to disclosure obligations who have not yet submitted their 2009 SEC reports should consider the guidance as they prepare these reports.

This article summarizes the Release and examines recent climate change developments, together with the affect on corporate disclosure practices. The article also provides practical considerations for companies developing and implementing appropriate climate change disclosure practices.

Introduction

The first ever guidance on disclosure of climate change risk comes on the heels of an Environmental Protection Agency’s (“EPA”) endangerment finding that current and projected levels of greenhouse gases in the atmosphere endanger public health and welfare.ⁱⁱ This finding, combined with the extensive media coverage of the United Nations Climate Change Conference held in Copenhagen in December of 2009, have resulted in an increased focus on global climate change and the likelihood of government action. These developments present challenges for public companies, as they must now consider the Release in analyzing the potential affect of global climate change on their financial statements. Since companies are required to provide additional information necessary to make the financial statements not misleading they should also consider any financial statement implications of climate change issues in accordance with applicable accounting standards such as Financial Accounting Standards on Contingencies, risks, and uncertainties.ⁱⁱⁱ Some energy and utility companies with a stake in the climate change debate have voluntarily started reporting the effect of climate change on their businesses outside of their

SEC filings, but the majority of companies have not. In a recent survey of 6,400 annual filings by Standard and Poor's 500 companies, 76.3% of the 2008 SEC filings failed to mention climate change.^{iv} The EPA, as well as other groups advocating for corporate environmental responsibility have already announced their intention to seek SEC intervention in cases where they believe companies have not adequately disclosed climate change risks.

Summary of the Interpretative Release

The Release first identifies existing SEC disclosure laws and regulations that may require disclosure related to climate change for domestic companies. The release specifically identifies potential disclosure requirements arising under the following:

- **Business Description**
Item 101(c)(1)(xii) of Regulation S-K requires appropriate disclosure of the material effects that compliance with federal, state, and local provisions regulating the discharge of materials into the environment as well as the disclosure of material estimated expenditures for environmental control facilities may have upon the financial position of the company;
- **Legal Proceedings**
Item 103 of Regulation S-K requires a company to disclose material legal proceedings. Under Item 103, proceedings arising under environmental laws are not routine if they are material;
- **Risk Factors**
Item 503(c) of Regulation S-K requires companies to provide disclosure of the most significant factors that may make an investment in the company speculative or risky. The risk factors are to be specific, and companies should avoid generic risk factors that do not apply to their particular situation;
- **Management Discussion and Analysis ("MD&A")**
Item 303 of Regulation S-K mandates the disclosure requirements in the MD&A section of the SEC reports; and includes disclosure of items that pertain to a company's liquidity, capital resources, and results of operations. Companies are to discuss "known trends, events, demands, commitments and uncertainties" that are reasonably likely to have a material impact on financial condition. It should be noted that reasonably likely is a lower disclosure standard than "more likely than not;"
- **Additional Disclosure**
Rule 408 under the Securities Act of 1933 and Rule 12-b20 under the Securities Exchange Act of 1934 require companies to provide additional information necessary to make the financial statements not misleading;
- **Foreign Private Issuers**
under Form 20-F, foreign private issuers may also be required to provide disclosure concerning climate change matters material to their companies.

There have been significant developments in federal and state climate change laws and regulations;^v the Release highlights four main areas where climate change-related issues may trigger disclosure requirements under existing federal securities laws and regulations for registered companies.

Impact of Existing and Pending Laws and Regulations

When companies conduct business in a state that has enacted climate change laws, such companies will be required to disclose information pursuant to Items 101, 103, 503, and 303 as noted above. For example, Item 101, which requires disclosure of material estimated capital expenditures for environmental control facilities, is of particular importance when companies are highly sensitive to the new climate change laws. Companies are encouraged not to list “generic risk factors,” because companies that are “particularly sensitive to greenhouse gas legislation” such as companies in the energy sector, may “face significantly different risks from climate change legislation or regulation compared to companies that currently are reliant on products that emit greenhouse gases, such as companies in the transportation sector.”^{vi}

Under the Release, pending and proposed legislation^{vii} may also trigger disclosure requirements for companies; if companies determine that legislation is reasonably likely to be enacted and that legislation will have a material effect on those companies, additional MD&A disclosure is required^{viii}. Companies should also consider the positive effects of a proposed law as changes in legislation or in the business practices of some companies in response to the law may provide new opportunities such as sale of allowances under a “cap and trade” type system.^{ix}

Impact of International Accords and Treaties

The potential sources of disclosure requirements related to international accords and treaties are the same as those for US climate change legislation, the Release states that companies “whose businesses are reasonably likely to be affected by such agreements should monitor the progress of any potential agreements and consider the possible impact in satisfying their disclosure obligations based on MD&A and materiality principles.”^x The Release requires companies to consider the impact of international climate change-related accords and treaties such as the Kyoto Protocol and the European Union Greenhouse Gas Emission Trading System. The impact of international accords and treaties is of particular importance to multi-national companies that are or will soon become subject to such standards.

Indirect Consequences of Regulation or Business Trends

Indirect consequences of regulation or business trends including legal, technological, political and scientific developments regarding climate change may create new risks or opportunities for companies, such as decreased demand for goods that produce significant greenhouse emissions or increased demand for goods that result in lower emissions than competing products.^{xi} Companies should look at their facts and circumstances and determine the materiality of these risks and opportunities for disclosure purposes.

Physical Impacts of Climate Change

The physical effects of climate change, such as the severity and frequency of floods and hurricanes, rising sea levels, and drought could affect companies' operations and results. For example, severe weather can cause catastrophic harm to physical plants and facilities and can disrupt manufacturing and distribution processes. A 2007 Government study found that 88% of all property losses paid by insurers between 1980 and 2005 were weather related.^{xii} Companies whose businesses may be vulnerable to severe weather or climate related events should consider disclosure of the material risks and consequences of such events under Item 503.

Practical Considerations

The Release warrants careful consideration by companies subject to climate change disclosure requirements, regardless of industry public companies may wish to consider the following steps relating to their possible disclosure of climate change-related information and risks:

- look closely at the four main areas identified in the release where climate change-related issues may trigger disclosure requirements under existing federal securities laws and regulations for registered companies;
- maintain consistency between climate risk and opportunity disclosures in all SEC filings and other public disclosures;
- ensure that senior management of companies includes climate change issues as part of their strategic planning process. If climate change issues are material, they should be disclosed;
- consider voluntary disclosure of internal efforts to determine costs arising from compliance with climate change disclosure requirements;
- determine risk factors and MD&A disclosures. Companies may wish to review their filings made with the EPA to help with this process;
- compare companies' public disclosures regarding climate change, such as media releases or speeches by senior management and internet webpage disclosures with official disclosures made to the SEC and ensure that they are consistent;
- prepare a committee including members of senior management if climate-change issues are presently or expected to become material to companies;
- look at comparable companies in the industry and see if they have a similar approach to disclosure;
- institute a frequent review of legislative and regulatory developments that may affect companies' businesses;

- determine if companies' potential stakeholders, shareholders, and labor unions have taken similar positions with respect to climate-change and ascertain whether employees of companies that interact with investors are fully aware of companies' policies on climate-change.

Recent Developments

Climate change legislation is currently pending in Congress, the House of Representatives has approved the first version of the American Clean Energy and Security Act of 2009 and the Clean Energy Jobs and American Power Act of 2009 was introduced to the Senate. If the legislation is finalized, it will limit and reduce greenhouse gases through a cap and trade system. The SEC intends to monitor the impact of the Release on companies' filings as part of its ongoing disclosure program. Furthermore, the SEC's Investor Advisory Committee, which was formed on June 3, 2009 to advise the Commission on matters of concern to investors in the securities market, is considering climate change disclosure issues as part of its overall mandate.^{xiii}

Conclusion

Although the cost of reporting more data may be expensive, it may be more costly to ignore the risks posed by climate change. Since so few companies were voluntarily providing climate change risk information to investors the SEC almost had to step in and issue a ruling. There is still uncertainty as to the future impact of climate change and the SEC's response to such change. However, the increased focus on climate change risk as well as the likelihood of more government action impacting a large number of companies in many different industries, is enough reason for public companies to begin considering climate change risks and the related disclosure practices more closely.

References

ⁱ SEC 17 CFR PARTS 211, 231 AND 241 [Release Nos. 33-99106; 34-61469; FR-82] Commission Guidance Regarding Disclosure Related to Climate Change <http://www.sec.gov/rules/interp/20/10/33-9106.pdf>.

ⁱⁱ See Current and Near Term Greenhouse Gas Reduction Initiatives, available at <http://www.epa.gov/climatechange/policy/neartermghgreduction.html>

ⁱⁱⁱ See Financial Accounting Standards Codification Topic 450, Contingencies, and Topic 275, Risks and Uncertainties.

^{iv} The survey results were published in a June 2009 report, *Reclaiming Transparency in a Changing Climate*, released by the Center for Energy and Environmental Security, CERES and the Environmental Defense Fund.

^v For a listing of State and Federal laws in and regulations in this field see <http://www.epa.gov/climatechange/wycd/stateandlocalgov/index.html>. See also American Clean

Energy and Security Act of 2009, H.R.2454, 111th Cong., 1st Sess. (2009), passed by the House of Representatives on June 26, 2009.

^{vi} See Release, Page 22, Paragraph 1.

^{vii} See American Clean Energy and Security Act of 2009 and the Clean Energy Jobs and American Power Act of 2009

^{viii} Companies should ensure that they have sufficient information regarding their greenhouse gas emissions and other operational matters to evaluate the likelihood of a material effect arising from the subject legislation or regulation.

^{ix} Cap and trade is an environmental policy tool that delivers results with a mandatory cap on emissions while providing sources flexibility in how they comply. Successful cap and trade programs reward innovation, efficiency, and early action and provide strict environmental accountability without inhibiting economic growth.

^x Release, Page 24, Paragraph 2.

^{xi} For example, recent legislation will ultimately phase out most traditional incandescent light bulbs. This has resulted in the acceleration of the development and marketing of compact fluorescent light bulbs. See Energy Independence Security Act of 2007, Pub. L. No. 110-140, 121 Stat. 1492 (2007).

^{xii} See “Climate Change: Financial Risks to Federal and Private Issuers in Coming Decades Are Potentially Significant: U.S. Government Accountability Office Report to the Committee on Homeland Security and Governmental Affairs, U.S. Senate,” GAO-07-285 (March 2007)

^{xiii} See Press Release No 2009-126, “SEC Announces Creation of Investor Advisory Committee,” available at <http://sec.gov/news/press/2009/2009-126.htm>.)