The Review of Securities & Commodities Regulation
"The SEC Interpretive Release
on Climate Change Disclosure"
April 7, 2010

Cravath, Swaine & Moore llp

THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 43 No. 7 April 7, 2010

THE SEC INTERPRETIVE RELEASE ON CLIMATE CHANGE DISCLOSURE

The SEC's new guidance on this complex subject covers legislative and regulatory developments, material litigation, MD&A disclosure of known trends and uncertainties, and physical risks to the registrant and other commercially related entities. Its most immediate and lasting consequence may be to bring climate change disclosure directly under the umbrella of the SEC's integrated disclosure requirements found in Regulation S-K.

By Jeffrey A. Smith, Matthew Morreale, and Kimberley Drexler *

On January 27, 2010, the U.S. Securities and Exchange Commission voted three-to-two to issue an Interpretive Release on disclosure requirements relating to climate change. The decision ended a two-year stalemate on the issue at the SEC and revealed some sharp divisions among the commissioners on whether such a Release was appropriate or necessary.[1]

The Release itself was published on February 2, 2010 and highlights four possible sources of the consequences of climate change that may require disclosure by registrants:

- existing and pending legislation and regulation in the U.S., such as the costs to purchase allowances under a "cap and trade" system or for facility improvements to reduce emissions;
- international climate change accords and agreements;
- the indirect consequences of climate change regulation and resulting business trends, such as

[1] The Release is *available at* www.sec.gov/rules/interp/2010/33-9106.pdf. It became effective on February 8, 2010, when it was published in the Federal Register. 75 Fed. Reg. No. 25 at 6290.

* *JEFFREY A. SMITH is the Partner in charge of the environmental law practice at Cravath, Swaine & Moore LLP and the past Chairman of the Committee on Environmental Disclosure of the American Bar Association's Section on Environment, Energy and Resources. His e-mail address is jsmith@cravath.com. MATTHEW MORREALE is a senior member of Cravath's environmental practice group and KIMBERLEY DREXLER is a senior attorney in Cravath's corporate department. Their e-mail addresses are, respectively, mmorreale@cravath.com and kdrexler@cravath.com. Olivia Katz and Steven Engler, who are paralegals in Cravath's environmental group, provided valuable research assistance for this article.*

IN THIS ISSUE

RSCR Publications LLC Published 22 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $1,197 per year in U.S., Canada, and Mexico; $1,262 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (866) 425-1171 or visit our Web site at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@hotmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 0884-2426.

decreased consumer demand for carbon-intensive goods or the impact on a registrant's reputation; and

- the physical consequences of climate change, such as the direct impacts to a registrant's facilities (*e.g.*, on coastal sites as a result of rising sea levels) and the indirect operational and financial impacts to its operations (*e.g.*, as a result of drought and shifts in weather patterns).

In September 2007, Ceres, in conjunction with a coalition of U.S. institutional investors, the New York Attorney General, various state treasurers, comptrollers and chief financial officers, and several asset management firms, had filed a petition asking that the SEC issue formal guidance on the circumstances when public companies should disclose risks related to climate change under existing law.[2] The petition sought to require issuers to make disclosure about the physical risks associated with climate change; the financial risks associated with present or probable regulation of greenhouse gas ("GHG") emissions; and legal proceedings relating to climate change. The first two of these topics, in particular, would have required analysis of other matters as well, such as management's strategic plan for dealing with climate issues.

The fact that the petition sought guidance rather than rule-making turned out to be significant from both a procedural and a substantive standpoint. Procedurally, it allowed the SEC to issue the Release without engaging in notice-and-comment rulemaking. Substantively, it allowed the SEC to position the Release as a clarification of long-standing case law and regulations that establish well-recognized standards for materiality, while confirming that some elements of Regulation S-K could be applicable to the climate change arena.

THE LEGAL FRAMEWORK

The Release specifies four items of Regulation S-K that set forth most of the potential scope of climate change disclosure.[3]

- Item 101, the Description of Business, requires disclosure of the material effects of compliance with federal, state, and local laws relating to the protection of the environment on capital expenditures, earnings, and competitive position. Item 101 also requires the disclosure of contingent effects.[4]

Thus, in the climate change context, Item 101 requires ongoing attention to both legislative developments and to the possible technical and financial consequences of various regulatory outcomes. Material contingent capital plans should be disclosed. For example, a multinational company with facilities in both the U.S. and Europe is currently required to determine whether disclosure is required concerning capital expenditures undertaken as an alternative to purchasing credits in the E.U. emissions trading scheme.[5] The element of the Release dealing with international treaties

[2] Petition for Interpretive Guidance on Climate Risk Disclosure, Sept. 18, 2007, *available at* www.sec.gov/rules/petitions/2007/petn4-547.pdf. In November 2009, the group filed a Supplemental Petition citing new developments, including the mandatory EPA greenhouse gas reporting requirement and the introduction of climate legislation in the U.S. Congress, *available at* www.sec.gov/rules/petitions/2009/petn4-547-supp.pdf. The group had also filed an earlier Supplemental Petition on June 12, 2008, to update the Commission on then-current developments. That petition is *available at* www.sec.gov/rules/petitions/2008/petn4-547-supp.pdf.

[3] As noted in the Release, the Securities Act and Exchange Act disclosure obligations of foreign private issuers are governed principally by Form 20-F and not by Regulation S-K. At the same time, the SEC notes in the Release that the Regulation S-K items that pertain to climate change have parallels under Form 20-F, although the requirements are not exactly the same, and 20-F is not as prescriptive in some respects as the provisions applicable to U.S. domestic issuers.

[4] 17 C.F.R.§229.101 (2005).

[5] The SEC had previously determined that "to the extent any foreign [environmental] provisions may have a material impact upon the company's financial condition or business, … such matters should be disclosed." *Arthur M. Wharton Air Products and Chemicals, Inc.*, 1973 WL 11973 (S.E.C. No-Action Letter July 11, 1973) (interpreting precursor to Item 101(c)(xii)).

and compacts also draws on this well-established approach. The logic of the Release strongly suggests that similar analysis – and disclosure for each region in which the results are material – will now be required, if differing state and regional regulatory regimes remain the dominant source of GHG emission reduction mandates in the U.S. in the absence of preemptive federal legislation.

- Item 103 requires a company to disclose material legal proceedings and administrative enforcement actions in which the issuer, its property, or its subsidiaries are involved.[6]

The sources and objectives of climate change litigation have rapidly diversified and expanded in recent years. They now range from the introduction of climate issues into traditional facility-permitting hearings, to constitutional challenges to a court's jurisdiction to hear damage claims, to issues of a party's standing to bring a claim.[7] In this way, climate litigation has rapidly joined the mainstream of environmental litigation. The Release makes clear that these cases will need to be analyzed and disclosed accordingly.

A recent flurry of judicial decisions on key questions demonstrates the speed at which the landscape can change, and poses some immediate disclosure issues for both the litigants and for other similarly situated companies that could become defendants in the pending cases or be affected by any verdict. In September 2009, the United States Court of Appeals for the Second Circuit handed down a lengthy and much-anticipated opinion in which it reversed the District Court for the Southern District of New York and allowed claims against six major power generators for their contributions to global warming to go forward on a theory of public nuisance.[8] While the Second Circuit's opinion may prove to be influential, it was not the last word. Within less than a month, two other courts handed down decisions involving very similar questions.[9] The court in each of these three cases (1) decided whether remedies for climate change raise issues that are proper for courts to decide – that is, are they justiciable – or are they best left for the executive or legislative branches of government because they raise political questions; and (2) determined who, if anyone, should have standing to bring such cases.[10] The ramifications of these decisions may become more profound if a split among the circuits leads to Supreme Court review, or if the holding of any one of the cases prompts additional litigants to bring claims.

- Item 303, Management's Discussion and Analysis (MD&A), requires a company to disclose known trends and uncertainties that are expected to have a material effect on its liquidity, capital resources, net sales or revenues, or income from ongoing operations.

The SEC has long seen MD&A disclosure as an opportunity to give investors "a look at the company through the eyes of management."[11] This is particularly significant and complex in the rapidly changing, multifaceted regulatory environment surrounding climate change. To that end, the Release highlights the need for registrants to assess any related disclosure

---

[6] 17 C.F.R. § 229.103.

[7] Smith, *Climate Change in the U.S. Courts*, 6 Env. Liability 211 (2006).

[8] *Connecticut v AEP*, 2009 U.S. App. Lexis 20873 (2nd Cir. Sept. 19, 2009), *petition for rehearing filed* (Nov. 5, 2009). It is noteworthy that the matter had been argued over three years before it was decided.

[9] *Comer v Murphy Oil*, 2009 U.S. App. Lexis 22774 (5th Cir Oct.16, 2009) *petition for rehearing en banc granted* (Feb. 26, 2010) (Plaintiffs had standing to assert their public and private

footnote continued from previous column…

nuisance, trespass, and negligence claims, and those claims were not political questions; dismissal of those claims was reversed, and those claims were remanded. The unjust enrichment, fraudulent misrepresentation, and civil conspiracy claims were seen as generalized grievances, rather than particularized injuries, as to which plaintiffs failed to satisfy prudential standing requirements. The dismissal of those claims was affirmed.); *Kivalina v ExxonMobil Corp.*, 663 F. Supp 2d 863 (N.D. Cal. Sept. 30, 2009) (Plaintiffs alleged that defendants contributed to the global warming that was causing the loss of sea ice and resulting destruction of the coastline that would require relocation of plaintiffs' residences. The court held that plaintiffs' claim for nuisance under federal common law was barred by the political question doctrine and, in any event, that plaintiffs lacked standing to bring them.)

[10] Thus far, the three federal district courts in which these cases have been filed have maintained the view that they raise political, rather than judicial, questions, while the two circuit courts that have heard the appeals of the dismissals have allowed the cases to proceed, granting standing to a wide range of plaintiffs, including private property owners, land trusts and state attorneys general.

[11] Commissioner Richard Y. Roberts, *Update on Environmental Disclosure*, Address at the Colorado Bar Ass'n (Sept. 28, 1991).

obligations regularly.[12] Thus, the interplay between these disclosure requirements and the evolution of climate regulations appears to be the most dynamic area for most issuers in the near-term future, and consequently an important subject for MD&A.

Item 303 has been interpreted to require two distinct inquiries. First, management must determine whether an uncertainty is reasonably likely to occur, and unless management can conclude that the event is not reasonably likely to occur, management must assume that it will occur.[13] Second, the trend or event must be disclosed, unless management can determine that its occurrence is not reasonably likely to have a material effect on the company.[14] Disclosure is optional when management is merely anticipating "a future trend or event, or anticipating a less predictable impact of a known trend, event, or uncertainty."[15] To attempt to capture this balance, Item 303 requires the disclosure of "known uncertainties"[16] – knowable possibilities that are less than trends but that could result in material consequences. Historically, the SEC has also required disclosure of trends that are "currently known" and "reasonably expected to have material effects."[17] The predictability of the event at issue has as much significance for disclosure purposes as the size of its potential consequences.[18]

- Item 503, Risk Factors, mandates disclosure of specific, significant factors that may make an investment in the issuer speculative or risky.

Physical risk to facilities or operations is a well-established element of most public companies' disclosure, irrespective of the cause. A major plant that may have to curtail operations because of a dwindling supply of process water should be the subject of disclosure, irrespective of whether climate change is causally related to the condition. The Ceres petition had asked that the SEC require registrants to evaluate the physical impacts of climate change on their operations, as well as on their supply chain, distribution chain, and personnel, and to disclose the physical risks of climate change for entities other than the registrant itself, if they are material to financial performance. The petition posed the example of increased credit risks for banks with borrowers located in at-risk areas or the effect of physical damage to suppliers' infrastructure or disruption of deliveries as a result of the deleterious effects of climate change. Examples of such physical effects include (i) the impact of weather patterns, such as storm intensity, sea-level rise, and melting of the permafrost; (ii) effects of climate change upon land; (iii) damage to facilities or decreased efficiency of equipment; and (iv) effects of changes of temperature on the health of the workforce.

Broad-based risk analyses are a familiar protocol for most issuers. Despite the fact that the Release reiterates that registrants should avoid "generic risk factor disclosure that could apply to any company,"[19] this aspect of the Release may prompt detailed, self-protective disclosure of conditions that obscure, rather than illuminate, important consequences of climate change. Commissioner Paredes emphasized this potential outcome in his remarks in support of his no vote.[20]

The two commissioners who voted against issuing the Release also found it significant that the SEC staff had not attempted to demonstrate that climate change disclosure to date had been inadequate. They noted that disclosure on matters such as the physical effects of climate change might either lead to investor uncertainty, because there are no ready benchmarks for evaluating the likelihood or severity of the actual consequences, or risk flooding the market with trivial, non-material

[12] Release at pp. 19 and 24 (reiterating the need for registrants to assess their potential disclosure regularly).

[13] Sec. Act Rel. No. 6835, 54 Fed. Reg. 22,427, at 22,430 (May 24, 1989).

[14] *Id.*

[15] *Id.* The SEC has expressly rejected as "inapposite to Item 303 disclosure" the probability/magnitude balancing test for disclosure of contingent events set forth by the Supreme Court in *Basic v Levinson*. Sec. Act Rel. No. 6835, 54 Fed. Reg. 22,427, at 22,430 n.27. In other words, it is neither necessary nor proper to disclose the remote possibility of a catastrophic event.

[16] 17 C.F.R. § 229.303(a)(1) (2005).

[17] Sec. Act Rel. No. 6711, 52 Fed. Reg. 13715 (April 24, 1987).

[18] The instructions to Item 303 state that the information provided in the MD&A "need only include that which is available to the registrant without undue effort or expense and which does not clearly appear in the registrant's financial statements." 17 C.F.R. § 229.303 (2005) (Instruction 2); s*ee also* Sec. Act Rel. No. 6835, *supra* note 13 (stating that MD&A requires quantification of potential liability "to the extent reasonably practicable").

[19] Release at 22.

[20] Statements at SEC Open Meeting - Disclosure Related to Climate Change by Commissioner Paredes, *available at* http://sec.gov/news/speech/shtml.

information which, at best, would be of no real assistance to investors. They also noted that several other areas of disclosure discussed in the Release, such as reputational harm, might foster speculation rather than provide useful information to investors.[21]

ISSUES NOT TREATED DIRECTLY BY THE RELEASE

In addition to assessing the effects of climate change on a company's operations, the Ceres petitioners asked the SEC to require a company to estimate its own effect on climate change. This assessment would have required issuers to determine, among other things, their current and projected emissions levels, tabulating both direct emissions from operations as well as indirect emissions from purchased electricity and purchased products and services.[22] The petitioners also asked that companies be required to estimate their past GHG emissions, as well as significant trends in these levels.

The stated rationale for this position was that such an assessment would help an issuer estimate the possible costs of potential future GHG emission regulation. Petitioners contended that Item 101 is broad enough to require this type of numerical disclosure, both prospectively and retroactively. The current significance of such disclosure to investors is difficult to determine, however, particularly since there is no overarching legislative framework that serves as a context for any numerical emissions disclosure across all industry sectors. If, on the other hand, however, the unit cost of CO_2 emissions becomes commoditized and subject to ordinary forces in an established and stable market, the importance of such disclosure seems likely to decline significantly in the future, because the direct financial impact of CO_2 emissions to any registrants except the largest CO_2 emitters will be small. Although the Release did not adopt the notion that a registrant must disclose its carbon footprint as an independent matter, several aspects of the discussion of disclosure in other areas, such as business trends under Item 303 or strategic planning under Item 101, strongly suggest that emissions calculations may provide some of the numerical underpinning for that disclosure.

THE PRACTICAL IMPLICATIONS OF THE RELEASE

The most immediate and lasting consequences of the Release may be to bring climate change disclosures directly under the main umbrella of the SEC's integrated disclosure requirements found in Regulation S-K. Most notably, the Release reaffirmed that disclosure control procedures – including, where appropriate, correct accounting for GHG emissions – will be necessary in order to substantiate disclosure of matters such as the potential effects of GHG emission regulations. The petitioners had asked the SEC to increase the scope and detail of the disclosure made by issuers on these matters; those same groups had also been demanding more information from issuers in various other ways. Issuers should now consider whether to include in their SEC filings at least some elements of the disclosures they have already been making for some time in other formats and through other vehicles. In doing so, they may have to subject the basis for this disclosure to more rigorous analysis than has been the case to date, consistent with sound disclosure control procedures. Other issuers, after examining the new landscape for climate change disclosure, may be well advised to leave their SEC disclosure practices mostly unchanged and simply say less in other forums, or make that disclosure in a manner, and after an internal review process, that can pass SEC muster.

RELATED ACCOUNTING STANDARDS

The Financial Accounting Standards Board's (FASB) accounting standard pertaining to contingencies, Accounting Standards Codification ("ASC") Topic 450,[23] is the most frequently invoked in the environmental arena, even though it addresses risks far broader than environmental ones. This occurs because most environmental issues pass through a stage in which the financial outcome is contingent on a number of technical and legal factors. ASC Topic 450 mandates that a loss contingency be accrued by a charge to income, and that the nature of the contingency be described in a footnote to the financial statement, if it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated.[24] If a loss contingency is only reasonably possible, or if the loss is probable but the amount cannot be reasonably estimated, then the company is not required to accrue for it, but its nature must be disclosed in a footnote.[25]

---

[21] *Id.* Statements by Commissioners Paredes and Casey.

[22] Petition, p. 53 and Appendix G-3.

[23] ASC Topic 450 codified Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" (the well-known "FAS 5").

[24] *Id.* at § 8.

[25] *Id.* at § 10. *See also* Jonathan S. Klavens, *Environmental Disclosure Under SEC and Accounting Requirements: Basic Requirements, Pitfalls, and Practical Tips, available at* www.abanet.org/environ/committees/counsel/newsletter/aug00/kla.html (August 2000).

In the past, the SEC has used a variety of techniques and guidance to clarify specific expectations within the broad construct of existing financial disclosure principles. This was particularly true as the SEC wrestled with the interlocking, technically complex and financially non-specific disclosure about involvement in multiparty Superfund sites. Staff Accounting Bulletin No. 92 (SAB 92), for example, clarified certain accounting and disclosure issues for contingent environmental liabilities by eliciting "more meaningful information concerning environmental matters in filings" than had been made available to the marketplace.[26] SAB 92 requires that the measurement of a liability be based on "currently available facts, existing technology and presently enacted laws and regulations and should take into consideration the likely effects of inflation and other societal and economic factors."[27] SAB 92 also makes it clear that "management may not delay recognition of a contingent liability until only a single amount can be reasonably estimated."[28] When that amount falls within a range of reasonable, likely outcomes, the registrant is required to recognize the minimum amount of the range.[29]

Many complexities arise in the climate change arena for an issuer attempting to determine whether an event is probable and the liability is estimable. For example, under the E.U. emission trading scheme, for many industries, there is no question of the probability of emission regulation, and the price of a ton of GHG emissions has been established by the market. As a result, financial disclosure quantifies GHG emission risk in these markets where appropriate.[30] In the U.S., however, with limited exceptions (such as CO_2 emissions from power generators operating in member states of the Regional Greenhouse Gas Initiative), neither the regulatory regime nor the cost of emission or compliance has been established, so there is currently no financial statement disclosure driven by climate change.

Furthermore, whether a contingent loss, such as a need to install pollution control equipment in response to pending regulatory requirements, is probable and estimable will vary by industry, company, plant, and jurisdiction. How the SEC's requirements are to be applied in each case is a question to which the answers will continue to change rapidly, particularly in industrial sectors with significant GHG emission profiles. The inherent limitations of determining probability and estimability, coupled with the complexity of the questions surrounding climate change, have already resulted in a wide variety of disclosure decisions. In most instances, this variety is justified, and should continue.

NEXT STEPS

The SEC stated in the Release that it will monitor the impact of the Release on company filings as part of its ongoing disclosure review program. This will likely receive serious attention from the staff in the Division of Corporation Finance. Issuers should expect to receive a greater number of comments in this area.

Although the Release only gives interpretive guidance and does not make new law or impose new disclosure requirements, comments made at the Open Meeting by two of the commissioners in the majority strongly suggest that some issuers may need to examine their existing climate disclosure practices. One commissioner noted the use of numerous vehicles other than SEC filings for disclosure of climate change information. The use of disclosure templates such as the Climate Registry, the Carbon Disclosure Project, and the Global Reporting Initiative was also described at some length in the Release.[31] It has long been good practice to reconcile voluntary and mandatory environmental disclosure.[32] The Commission's new interpretive

---

[26] Commissioner Richard Y. Roberts, *SAB 92 and the SEC's Environmental Liability Disclosure Regulatory Approach*, address delivered at the University of Maryland School of Law, at 5 (April 8, 1994); SAB 92, 58 Fed. Reg. 32,843 (June 14, 1993).

[27] *Id*. at 32,844.

[28] *Id.*

[29] *Id*. at 32845.

[30] *See, e.g.,* Sappi LTD Annual Report, Form 20-F, for the Fiscal Year Ended December 31, 2005, at 38:

> The countries within which we operate in Europe are all signatories of the Kyoto Protocol and we have developed a GHG strategy in line with this protocol. Our European mills have been set CO_2 emission limits of the allocation period 2005 to 2007. Based upon in-depth analysis of our mill production by a Sappi Fine Paper Europe task force it is unlikely that Sappi will exceed their CO_2 emission limits. Consequently in July 2005 Sappi Fine Paper Europe sold

footnote continued from previous column…

> 90,000 surplus CO_2 credits to the value of $2.5 million (euro 2.0 million) on the European Climate Exchange.

[31] Release at pp. 7-10.

[32] For an example where that was not done, s*ee United Paperworkers International Union v International Paper Co.*, 801 F. Supp. 1134, 1137 (S.D.N.Y. 1992), *aff'd as modified*, 985 F.2d 1190 (2nd Cir. 1993) (contrasting the "corporate

guidance adds additional weight and wisdom to such a side-by-side review of all disclosure vehicles.

Another commissioner stated that the SEC will play a "more active role" in climate disclosure, and suggested that issuers who disclose the possible material effects of pending climate legislation should consider whether they have an effective system in place to count and evaluate their GHG emissions. This comment, too, was embodied in the Release, both in the discussion of MD&A disclosure obligations and in the concluding statement that the SEC would "monitor the impact" of the Release as part of its ongoing disclosure review program.[33] While pending EPA regulations may soon require GHG emission inventory and reporting from major facilities,[34] all issuers have had an obligation for several years to have controls and procedures in place to ensure that their senior management is receiving the information it needs to make good disclosure decisions. The language of the Release concerning management's obligations to assemble and evaluate data and information, even if the data are not disclosed,[35] strongly suggests that many issuers should once again review their disclosure controls and procedures, now with an eye on the disclosures related to climate change matters.

In addition to confirming the appropriateness and robustness of their disclosure controls and procedures, issuers should consider their own particular facts and circumstances, as well as conditions in their industries and the capital markets more broadly, in light of the guidance in the Release in order to craft the climate change disclosure that is appropriate for them and their investors. ■

footnote continued from previous page…

happy talk" in the company's annual environmental report with the company's actual annual environmental record, based on violations, fines, and pending proceedings).

[33] Release at p. 27.

[34] *See*, www.epa.gov/SR/documents/GHGTailoringProposal.pdf and Release at pp. 3, 4.

[35] Release at pp. 18, 19.