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SEC Interpretive Release on Climate Change Disclosure

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On January 27, 2010, the U.S. Securities and Exchange Commission (the “SEC”) voted three-to-two to issue an Interpretive Release on disclosure requirements relating to climate change. The Release¹ highlights four possible sources of the effects of climate change impacts on registrants that may result in disclosure under existing rules:

- 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 or resulting business trends, such as decreased consumer demand for carbon-intensive goods or the impact on a registrant’s reputation; and
- the physical consequences of climate change, such as direct impacts to a registrant’s facilities (e.g., on coastal sites as a result of rising sea levels) and indirect operational and financial impacts to its operations (e.g., as a result of drought and shifts in weather patterns).

The two commissioners who voted against issuing the Release sharply questioned the need for the action and its appropriateness. They 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 several areas of disclosure discussed in the Release, such as reputational harm, might foster speculation rather than provide useful information to investors and that disclosure on matters such as the physical effects of climate change might either lead to investor uncertainty or risk flooding the market with trivial, non-material information which, at best, would be of no real assistance to investors.

BACKGROUND

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, filed a petition² asking that the SEC issue formal guidance on the circumstances when public companies should disclose risks related to climate change under existing law. 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.

¹ The Release was published on February 2, 2010, and is available at www.sec.gov/rules/interp/2010/33-9106.pdf. It will be effective upon publication in the Federal Register, which is expected to occur sometime within the next week.

² Petition for Interpretive Guidance on Climate Risk Disclosure, Sept. 18, 2007, available at <http://www.sec.gov/rules/petitions/2007/petrn4-547.pdf>. In November 2009, the group filed a Supplemental Petition for Interpretive Guidance on Climate Risk Disclosure 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/petrn4-547-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 <http://www.sec.gov/rules/petitions/2008/petrn4-547-supp.pdf>.

THE PRACTICAL IMPLICATIONS OF THE RELEASE

The greatest significance of the Release may prove to be in the consequences of explicitly bringing climate change disclosures under the main umbrella of the SEC's integrated disclosure requirements found in Regulation S-K. 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. In light of the SEC's actions, issuers may now be well-advised to consider whether they should 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 underpinnings of 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.

The growing use of disclosure templates such as the Climate Registry, the Carbon Disclosure Project and the Global Reporting Initiative was described at some length in the Release.³ It has long been good practice to reconcile voluntary and mandatory environmental disclosure.⁴ The Commission's new interpretive decision adds urgency to such a side-by-side review of all disclosure vehicles.

THE LEGAL FRAMEWORK

The fact that the Ceres petition sought guidance rather than rule-making is significant from both a procedural and 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 established well-recognized standards for materiality while confirming the potential applicability of elements of Regulation S-K to the climate change arena.

The SEC highlighted four items of Regulation S-K that set forth most of the potential scope of climate change disclosure.⁵

- 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.⁶

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.⁷ The element of the Release dealing with international treaties and compacts draws on this well-established approach. The logic of the Release also 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.

³ Release at pp. 7-10.

⁴ See *United Paperworkers International Union v. International Paper Co.*, 801 F. Supp. 1134, 1137 (S.D.N.Y. 1992), 985 F.2d 1190 (2nd Cir. 1993) (contrasting the "corporate happy talk" in the company's annual environmental report with the company's actual environmental record, based on violations, fines and pending proceedings).

⁵ 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). Foreign private issuers should review the Release and consider what, if any, implications the interpretive guidance may have for their disclosures. Release at p. 20.

⁶ See 17 C.F.R. §229.101 (2005).

⁷ 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." 1973 WL 11973 (S.E.C. No-Action Letter) (interpreting precursor to Item 101(c)(xii)).

- 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.⁸

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.⁹ 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.

- 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 views MD&A disclosure as an opportunity to give investors "a look at the company through the eyes of management."¹⁰ 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 obligations regularly. 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.

Item 303 has been interpreted to require two distinct inquiries. First, management must determine whether an uncertainty is reasonably likely to occur.¹¹ Unless management can conclude that the event is not reasonably likely to occur, management must assume that it will occur.¹² 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.¹³ 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."¹⁴ To attempt to capture this balance, Item 303 requires the disclosure of "known uncertainties"¹⁵ - 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."¹⁶ The predictability of the event at issue has as much significance for disclosure purposes as the size of its potential consequences.¹⁷

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

⁸ 17 C.F.R. § 229.103

⁹ Smith, *Climate Change in the U.S. Courts*, 6 Env. Liability 211 (2006).

¹⁰ Richard Y. Roberts, *Update on Environmental Disclosure*, Address at the Colorado Bar Ass'n (Sept. 28, 1991).

¹¹ Sec. Act Release No. 6835, 54 Fed. Reg. 22, 427, 22,430 (May 4, 1989).

¹² *Id.*

¹³ See Management Discussion and Analysis of Financial Condition and Results of Operations: Certain Investment Company Disclosures, Securities Act Release No. 6835, 54 Fed. Reg. 22,427, at 22,430 (May 24, 1989).

¹⁴ See *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*. See Sec. Act Release 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.

¹⁵ 17 C.F.R. § 229.303(a)(1) (2005).

¹⁶ Sec. Act Release No. 6711, Fed. Sec. L. Rep. (CCH) ¶ 84,118, at 88,624 (Apr. 20, 1987).

¹⁷ 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); see also Sec. Act Release No. 6835, 54 Fed. Reg. 22,427, at 22,430 (stating that MD&A requires quantification of potential liability "to the extent reasonably practicable").

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.¹⁸ Similarly, more 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 self-protective and detailed 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.

ISSUES NOT TREATED DIRECTLY BY THE RELEASE

In addition to assessing the effects of climate change on a company's operations, the petition 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.²⁰ The petition 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 now, however, and it seems likely to decline dramatically in the future. Accordingly, the Release rejected the notion that a registrant must disclose its carbon footprint.

The more significant and related aspect of the Release, however, may prove to be its reaffirmation 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.²¹

RELATED ACCOUNTING STANDARDS

The Financial Account Standards Board's (FASB) accounting standard pertaining to contingencies, Accounting Standards Codification ("ASC") Topic 450²² is the most frequently invoked in the environmental arena, even though it addresses risks far broader than environmental ones, 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.²³ If a loss contingency is only reasonably possible, or if the loss is probable but the amount cannot be

¹⁸ The petition 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 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 the impact of weather patterns, such as storm intensity, sea-level rise, and melting of the permafrost; effects of climate change upon land; damage to facilities or decreased efficiency of equipment; and effects of changes of temperature on the health of the workforce.

¹⁹ Release at 22.

²⁰ Petition, p. 53 and Appendix G-3.

²¹ Release at pp. 19 and 24 (reiterating the need for registrants to assess their potential disclosure regularly).

²² ASC Topic 450 codified Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" (the well-known "FAS 5").

²³ Id. at § 8.

reasonably estimated, then the company is not required to accrue for it, but its nature must be disclosed in a footnote.²⁴

In the past, the SEC has used a variety of techniques and guidance to clarify specific expectations under the broad construct of existing financial disclosure principles. For example, Staff Accounting Bulletin No. 92 (SAB 92) clarified certain accounting and disclosure issues for contingent environmental liabilities.²⁵ Broadly speaking, SAB 92 was intended to “elicit more meaningful information concerning environmental matters in filings” than had been made available to the marketplace.²⁶ The measurement of a liability must 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 Although “significant uncertainties” may exist, SAB 92 made 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 should 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 CO₂ 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. We anticipate that this will 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.

²⁴ *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/envirom/committees/counsel/newsletter/aug00/klav.html (August 2000).

²⁵ SEC Release Staff Accounting Bulletin Release No. 92, 58 Fed. Reg. 32,843, 32,843 (June 14, 1993); Richard Y. Roberts, SEC Commissioner, *SAB 92 and the SEC’s Environmental Liability Disclosure Regulatory Approach*, address delivered at the University of Maryland School of Law, at 3 (April 8, 1994).

²⁶ Richard Y. Roberts, SEC Commissioner, *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).

²⁷ SEC Staff Accounting Bulletin Release No. 92, 58 Fed. Reg. 32,843, 32,843 (June 14, 1993), at 32844.

²⁸ *Id.* at 32844.

²⁹ *Id.* at 32845.

³⁰ See 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 CO₂ 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 CO₂ emission limits. Consequently in July 2005 Sappi Fine Paper Europe sold 90,000 surplus CO₂ credits to the value of \$2.5 million (euro 2.0 million) on the European Climate Exchange.

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 underscore that some issuers should 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 guidance adds urgency 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.

This memorandum relates to general information only and does not constitute legal advice. Facts and circumstances vary. We make no undertaking to advise recipients of any legal changes or developments.

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³¹ Release at pp. 7-10.

³² See *United Paperworkers International Union v. International Paper Co.*, 801 F. Supp. 1134, 1137 (S.D.N.Y. 1992), 985 F.2d 1190 (2nd Cir. 1993) (contrasting the "corporate happy talk" in the company's annual environmental report with the company's actual 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.