

SEC Guidance on Climate Change Disclosure

On February 2, 2010, the Securities and Exchange Commission (“SEC”) released interpretive guidance regarding the application of SEC’s disclosure requirements to climate change issues. The interpretive release does not expressly change the existing disclosure rules, but rather “is intended to remind companies of their obligations under existing federal securities laws and regulations to consider climate change and its consequences as they prepare disclosure documents.” The reality, however, is that the detailed discussion in the interpretive release suggests that, depending upon the industry, more climate change related disclosure is likely required in disclosure documents filed with SEC.

SEC Requirements Pertinent to Climate Change Disclosure

Under Securities Act Rule 408 and Securities Exchange Act Rule 12b-20, a public company must disclose, in addition to the information expressly required by SEC regulation, “such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.” Below is a brief summary of the non-financial statement disclosure rules the SEC identified in the interpretive release as most pertinent to climate change related disclosure and that may be the source of climate change disclosure obligations under the federal securities laws.

Description of Business: Item 101 of Regulation S-K. Item 101 requires a description of a company’s business (including reportable segments) and requires disclosure as to the “material effects that compliance with federal, state and local provisions . . . relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position” of the company.

Legal Proceedings: Item 103 of Regulation S-K. Item 103 requires disclosure as to “any material pending legal proceedings, other than ordinary routine litigation incidental to the business.” Environmental proceedings are not “ordinary routine litigation” and specific requirements apply that call for disclosure of “administrative or judicial proceeding[s] . . .” arising under environmental laws and regulations that meet certain parameters.

Risk Factors: Item 503(c) of Regulation S-K. Item 503(c) provides for the disclosure of the most significant risk factors that make an investment in the company speculative or risky to the extent that they are not generally applicable to any issuer. The disclosure must clearly state the risk and specify effects on the company.

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MD&A: Item 303 of Regulation S-K. Item 303 governs the Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”). Among other required disclosures are “known trends . . . demands, commitments, events or uncertainties” that are reasonably likely to result in material changes to the company’s financial condition or operating performance. As SEC has emphasized in the past with respect to MD&A disclosures, unless the issuer can determine that a trend, demand, commitment, event or uncertainty is *not* reasonably likely to occur, the issuer must assume that it will occur. And, in such an instance, disclosure is required unless the issuer then makes a determination as to whether the trend, demand, commitment, event or uncertainty is *not* reasonably likely to have a material effect on the issuer’s financial condition or results of operations. Importantly, SEC notes in the interpretive guidance that “reasonably likely” is a lower disclosure standard than “more likely than not.” In addition, the interpretive guidance states, consistent with case law, that materiality “with respect to contingent or speculative information or events [*e.g.*, climate change related laws, proposals, initiatives and their consequences], 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 the company activity.”

Foreign Private Issuers. SEC’s interpretive guidance extends to the disclosure obligations of foreign private issuers as well as U.S. issuers. The disclosure obligations of foreign private issuers are governed principally by Form 20-F, the provisions of which also may require a foreign private issuer to provide disclosure covering climate change matters that are material to its business, that relate to legal proceedings or that affect the foreign private issuer’s financial condition and results of operations (including factors and trends that “are anticipated to have a material effect on the foreign private issuer’s financial condition and results of operations”). Line items in Securities Act Forms F-1 and F-3 also may require disclosure of climate change matters, including in particular risk factor disclosure, as required under Regulation S-K Item 503.

Summary of Climate Change Related Issues

The SEC identified four categories of climate change related issues companies should consider when preparing their disclosure documents: (1) the impact of legislation and regulation, (2) the impact of international accords, (3) the indirect consequences of regulation and business trends, and (4) the physical impacts of climate change. These issues should be considered as follows:

Impact of Climate Change Related Legislation and Regulation

Business Description Capital Expenditures. Item 101 requires disclosure of any material estimated capital expenditures for environmental control facilities required under existing federal, state and local provisions which relate to greenhouse gas emissions.

Risk Factors. Item 503(c) may require a risk factor disclosure regarding existing or pending legislation or regulation relating to climate change if the company faces specific risks under such legislation or regulation. The interpretive guidance discourages issuers from providing only a generic risk factor disclosure that could apply to any company.

MD&A. Item 303 requires companies to assess whether any enacted climate change legislation or regulation is reasonably likely to have a material effect on the company’s financial condition or results of operation. In addition, when there is a known uncertainty, such as pending climate change legislation or regulation, the company must determine whether disclosure is required in the MD&A. That determination consists of two steps. First, management must evaluate whether the pending legislation or regulation is reasonably likely to be enacted. If management can determine that it is not reasonably likely to be enacted, then disclosure is not required. If management cannot determine the likelihood, it must proceed on the assumption that the legislation or regulation will be enacted. Second, management must then determine whether the legislation or regulation, if enacted, is reasonably likely to have a material effect on the company, its financial condition or results of operations. If management determines that a material effect is reasonably likely, MD&A disclosure is required. Disclosure need not be limited to the negative consequences. If a proposed law provides opportunities to profit that disclosure should be included, to the extent material.

Impact of International Accords. Companies also should consider, and disclose when material, the impact on their business of treaties or international accords relating to climate change. For example, the Kyoto Protocol, the European Union Emission Trading Scheme and other international activities could have a material effect on certain companies, particularly those with operations outside the United States. The sources of the disclosure obligations would be the same as above.

Indirect Consequences of Regulation or Business Trends

The interpretive release also briefly identifies examples of potential indirect consequences arising from the legal, technological, political and scientific developments related to climate change that might be required to be disclosed in Risk Factors or MD&A. Such examples include a decreased demand for goods that produce significant greenhouse gas emissions, an increased demand for goods that result in lower emissions than competing products, increased competition to develop innovative new products, increased demand for generation and transmission of energy from alternative energy sources, and decreased demand for services related to carbon based energy sources, such as drilling services or equipment maintenance services.

Such developments could be significant enough that Item 101 may require disclosure in the business description. A company that plans to reposition itself to take advantage of potential opportunities may be required by Item 101(a)(1) to disclose this shift in plan of operation. Each company would have to evaluate the materiality of these opportunities and obligations.

The SEC also identifies reputational risks as a potential indirect risk from climate change that would need to be considered for risk factor disclosure under Item 503(c). Depending on the nature of a business and its sensitivity to public opinion, a company may have to consider whether the public's perception of any publicly available data relating to its greenhouse gas emissions could expose it to potential adverse consequences to its business operations or financial condition resulting from reputational damage.

Physical Impacts of Climate Change

The interpretive release identifies several significant physical effects of climate change that have the potential to affect a company's operations and results, such as the severity of weather events such as floods or hurricanes, a change in sea levels, the arability of farmland, and water availability and quality and suggests companies vulnerable to such catastrophic events consider disclosing the risks or consequences of such events. Examples of possible consequences of severe weather pointed to by the SEC include: for companies with operations concentrated on coastlines, property damage and disruptions to operations, including manufacturing operations or the transport of manufactured products; indirect financial and operational impacts from disruptions to the operations of major customers or suppliers from severe weather, such as hurricanes or floods; increased insurance claims and liabilities for insurance and reinsurance companies; decreased agricultural production capacity in areas affected by drought or other weather-related changes; and increased insurance premiums and deductibles, or a decrease in the availability of coverage, for companies with plants or operations in areas subject to weather.

While many of these effects may have been considered or disclosed in the past, the SEC's emphasis upon the specific requirements and the linkage SEC has established between climate change and specific disclosure requirements may require a fresh look at the issue for companies subject to SEC disclosure requirements and those that use such requirements as a guideline for disclosure.

Certain Considerations

It is important for public companies to bear in mind that the interpretive guidance does not change existing legal standards applicable to issuers' disclosure obligations. However, it is equally important to appreciate the heightened sensitivity that SEC has with respect to climate change matters and, accordingly, to take steps to carefully consider SEC's views and the degree to which the nature of climate change matters have impacted, or might impact, a company's business, results of

operations and financial condition and to the extent to which these impacts, or potential impacts, should be disclosed in SEC filings.

Much like its actions in the wake of SEC's prior releases on other than important subjects, such as its release concerning the defense industry issued in the late 1980s and its Y2K views issued close to the end of the last century, public companies can expect SEC to followup on its climate change interpretive guidance by examining climate change disclosures in future SEC filings and taking action where SEC view's such disclosure as deficient.

Lastly, even though calendar year accelerated filers will need to file their Form 10-Ks within just three weeks, these issuers and their disclosure committees and advisors should take the time to consider SEC's interpretive guidance and endeavor to address, to the extent required and feasible, climate change matters in these upcoming Form 10-K filings.