The SEC's new guidance on public company disclosure of climate change risks

By Treazure Johnson, Lowell Rothschild, and Eric Smith

On Feb. 2, 2010, the U.S. Securities and Exchange Commission (SEC) published interpretive guidance on the disclosure of climate change risks in regulatory filings. Such guidance had long been sought by pension funds, shareholder advocacy groups, and states, all of whom were unhappy with what they viewed as inconsistencies among public companies' disclosures concerning climate change. The guidance makes clear the SEC's renewed focus on climate change risks and its expectation that public companies will specifically include climate change impacts in their disclosures. The SEC's interpretive guidance affects *existing* disclosure requirements and does not create new obligations. Nonetheless, such agency statements drive practice. While not new law, the guidance is a roadmap for the SEC's expectations of public companies' considerations and disclosures under its existing rules. The interpretive guidance became effective immediately upon its publication in the *Federal Register* on Feb. 8, 2010.

The disclosure obligations mainly derive from four Items in SEC Regulation S-K: (1) *Description of Business* (Item 101)—requires a company to describe its business, including its form of organization, principal products and services, major customers, competitive conditions, and certain costs of complying with the environmental laws; (2) *Legal Proceedings* (Item 103)—requires a company to provide a brief description of any material pending legal proceedings to which it is a party and any material proceedings it knows a governmental authority is contemplating against it; (3) *Management Discussion and Analysis of Financial Condition and Results of Operations (MD&A)* (Item 303)—identifies a broad range of disclosure items addressing business factors, including liquidity, capital resources, and results of operations. The disclosure addresses known trends, events, commitments, and circumstances reasonably likely to have a material adverse effect on a company's financial condition or results of operations; and (4) *Risk Factors* (Item 503(c))—requires disclosure of significant factors that make investment in a company's securities speculative or risky.

In light of these disclosure obligations, the interpretive guidance identifies four potential topics of disclosure: (1) *The impact of legislation and regulation*—e.g., additional emission control equipment, costs/profits of purchases/sales under a "cap and trade" program; (2) *The impact of international accords*—e.g., Kyoto Protocol; (3) *The indirect consequences of regulation and business trends*—e.g., increased costs of raw materials caused by climate change, decreased demand for carbon-intensive products, intangible consequences such as the reputational impact of not being "green"; and (4) *The physical impacts of climate change*—e.g., results of greater weather severity, risks of coastline locations, decreased agricultural production.

To provide a framework for disclosure decisions, the interpretive guidance provides a summary of how companies should analyze the *materiality* of known climate change trends, events, and uncertainties. First, a company should determine whether the trend, event, or uncertainty is likely to come to fruition—not a simple task. Legislation, regulation, and international accords are in flux. The U.S. House of Representatives has passed climate change legislation, but the Senate has not; the Environmental Protection Agency (EPA) has proposed four different climate change regulations but not adopted them all; and international efforts last year to reach a successor agreement to the Kyoto Accord were unsuccessful. Similarly, evaluating the physical impacts of climate change (such as severe weather and rising sea levels) and the indirect consequences of climate change (such as the possible decreased demand for carbon-intensive products) are equally problematic because they are not currently quantifiable. No disclosure is required if a company determines the trend, event, or uncertainty is *not* reasonably likely. If the company cannot determine that the trend, event, or uncertainty is not reasonably likely, it *must* evaluate the consequences as though they would occur. Disclosure is then required unless the company determines that a *material* effect is not reasonably likely. Generally, 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, put another way, if the information would alter the "total mix" of available information. *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976). When in doubt, the SEC expects companies to err on the side of finding *materiality*.

In light of the guidance, companies should consider taking the following actions: establishing a process to bring climate change items to the attention of those preparing the company's SEC filings, reviewing the company's current disclosures as they relate to climate change, monitoring climate change related legislative and regulatory activity that could have a material impact on the company, identifying any disclosure the company has made to other regulatory bodies (e.g., EPA or state environmental regulators), and considering whether that information would be "material" to an investor and, therefore, required to be included in SEC filings.

Treazure Johnson *and* **Lowell Rothschild** *are both partners at Venable LLP who practice in the firm's SEC/White Collar and Environmental practice groups respectively.* **Eric Smith** *is a senior associate at Venable LLP who practices in the firm's Corporate Finance, Securities and Mergers and Acquisitions practice group.*