Cooley

March 9, 2010

On February 2, 2010, the Securities and Exchange Commission issued an interpretive release to provide guidance to public companies regarding the SEC's existing disclosure requirements as they apply to global climate change matters. The release does not create new disclosure requirements—it simply outlines the SEC's views with respect to the existing disclosure requirements. The release was approved by the SEC on a 3-2 vote on January 27, 2010.

This *Alert* summarizes the key elements of the guidance and provides commentary and recommendations for actions companies may want to take in response.

Rules requiring disclosure of climate change issues

The new guidance regarding climate change primarily pertains to disclosures required in SEC filings made by the company related to the description of the company's business, legal proceedings, and risk factors, and to the company's Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). See *Table 1* for a description of these requirements. In addition to these disclosure requirements, the SEC reminded companies that they (1) must disclose any information that would be necessary to make the statements made not misleading, and (2) must also consider any financial statement implications of climate change issues in accordance with applicable accounting standards, including Financial Accounting Standards Board ("FASB") Accounting Standards Codification Topic 450, Contingencies, and FASB Accounting Standards Codification Topic 275, Risks and Uncertainties.

Topics that may trigger disclosure

In the release, the SEC discussed four topics that, in the SEC's view, may trigger disclosure required under the federal securities laws and regulations. In its discussion of the four topics, the SEC focused on the disclosure required under the description of the company's business, risk factors, and MD&A.

I. Impact of legislation and regulation

The release notes that recent legislative and regulatory developments could have a significant effect on some companies' operating and financial decisions. At the federal level, the Environmental Protection Agency ("EPA") is taking steps to regulate greenhouse gas ("GHG") emissions,[1] and pending climate change-related legislation, if enacted, would limit and reduce GHG emissions through a "cap and trade" system, among other provisions.[2] In addition, a number of state and local governments have enacted legislation and regulations that result in regulation of GHG emissions[3] (for example, the California Global Warming Solutions Act of 2006 (AB 32))[4] and multiple states have developed regional programs to restrict GHG emissions.[5]

The release provides the following specific disclosure guidance:

Description of Business: With respect to federal, state, and local provisions that relate to GHG emissions, companies should disclose any material estimated capital expenditures for environmental control facilities.

Risk Factors: Companies should consider providing risk factor disclosure regarding existing or pending legislation or regulation that relates to climate change. In doing so, companies should consider the specific risks they face as a result of climate change or regulation and avoid generic risk factor disclosure that could apply to any company.

MD&A: Companies should analyze whether disclosure is required in MD&A regarding pending climate change legislation and regulation. Specifically, company management should:

1. Evaluate whether the pending legislation or regulation is reasonably likely to be enacted. Unless management determines that it is not reasonably likely to be enacted, it must proceed on the assumption

that it will be enacted.
2. 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. Unless management determines that a material effect is not reasonably likely, MD&A disclosure is required.
3. Consider disclosure, if material, of the difficulties involved in assessing the timing and effect of the pending legislation or regulation.

Companies should consider both positive and negative consequences of a proposed law. Changes in the law or in the business practices of some companies may provide new opportunities (e.g., sale of allowances under a "cap and trade" type system, if one is put into place).

The SEC gave examples of possible consequences of pending climate change legislation and regulation, which include:

- Costs to purchase, or profits from sales of, allowances or credits under a "cap and trade" system;
- Costs required to improve facilities and equipment to reduce emissions in order to comply with regulatory limits or to mitigate the financial consequences of a "cap and trade" regime; and
- Changes to profit or loss arising from increased or decreased demand for goods and services produced by the company arising directly from legislation or regulation and indirectly from changes in costs of goods sold. (See Part III below for further discussion of indirect impacts.)

II. International accords

The release notes that actions taken by members of international community to address climate change issues on a global basis could have a material impact on companies that report with the SEC. For example, although the U.S. has never ratified the Kyoto Protocol, many companies have operations outside the U.S. that are subject to its standards. The SEC notes that the European Union Emissions Trading System is another important international regulatory system.

The release provides the following specific disclosure guidance:

MD&A: Companies with businesses that are reasonably likely to be affected by international accords should monitor the progress of any potential agreements and consider the potential impact in satisfying their disclosure obligations based on the MD&A and materiality principles outlined above. The SEC also noted that the U.S. government is participating in ongoing discussions with other nations, including the recent United Nations Climate Conference in Copenhagen, that may lead to future international treaties focused on remedying environmental damage caused by GHGs. In the SEC's view, these accords ultimately could have a material impact on companies that report to the SEC.

III. Indirect consequences of regulation or business trends

In the SEC's view, companies that may not be directly affected by the developments described in Parts I and II above could nonetheless be indirectly affected, for example, by changing prices for goods or services provided by companies that are directly affected, by new opportunities for investment resulting from new trading markets for emissions credits related to "cap and trade" programs, and by revenue raising opportunities generated through selling instruments such as allowances or offset credits. The release notes that some companies might suffer financially under bills pending before Congress while others could benefit by taking advantage of new business opportunities.

The release provides the following specific disclosure guidance:

Description of Business: Legal, technological, political and scientific developments may create new opportunities or risks. These developments may create demand for new products or services, or decrease demand for existing products or services. In some cases, these developments could have a significant enough impact on a company's business that disclosure may be required. For example, a company that plans to reposition itself to take advantage of potential opportunities, such as through material acquisitions of plants or equipment, may be required to disclose this shift in plan of operation.

Risk Factors: These business trends or risks may be required to be disclosed as risk factors. Examples of potential indirect risks from climate change are:

- Impact on a company's reputation from publicly available data relating to its GHG emissions, depending on the nature of the company's business and its sensitivity to public opinion;
- Decreased demand for goods that produce significant GHG emissions;
- 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.

MD&A: These business trends or risks may be required to be disclosed in MD&A.

IV. Physical impacts of climate change

The release notes that there may be significant physical effects of climate change that have the potential to have a material effect on a company's business and operations. These effects can impact a company's personnel, physical assets, supply chain and distribution chain.

Physical impacts of climate change may include:

- Increased storm intensity and severity of weather (e.g., floods or hurricanes);
- Sea level rise;
- Changes in arability of farmland;
- Changes in availability, quantity, and quality of water or other natural resources;
- Melting of permafrost; and
- Extreme temperatures.

The release provides the following specific disclosure guidance:

Risk Factors: Companies with businesses that may be vulnerable to severe weather or climate-related events should consider disclosing material risks of, or consequences from, such events. Examples include:

- For companies with operations concentrated on coastlines, risks of property damage and disruptions to operations, including manufacturing operations or the transport of manufactured products;
- For banks with borrowers that are located in at-risk areas, credit risks resulting from climate change-related physical changes and hazards to coastal property;
- Indirect financial and operational impacts from disruptions to the operations of major customers or suppliers from severe weather, such as hurricanes or floods (e.g., companies that purchase agricultural products from farms adversely affected by droughts 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;
- Increased insurance premiums and deductibles, or a decrease in the availability of coverage, for companies with plants or operations in areas subject to severe weather;
- Changes in the availability or quality of water, or other natural resources on which the company's business depends;
- Damage to facilities or decreased efficiency of equipment; and
- Decreased consumer demand for products or services resulting from physical changes associated with climate change (e.g., warmer temperatures could reduce demand for residential and commercial heating fuels, service, and equipment).

Relationship to other disclosure and reporting mechanisms

Although some information relating to GHG emissions and climate change is currently being disclosed in SEC filings, much more information is publicly available outside of disclosure documents filed with the SEC as a result of voluntary disclosure initiatives (e.g., The Climate Registry, The Carbon Disclosure Project, and The

Global Reporting Initiative), the disclosure that the EPA began requiring at the start of 2010,[6] and various disclosure requirements mandated at the state level.[7] The SEC noted that companies should be aware that some of the information they may be reporting pursuant to these mechanisms may also be required to be disclosed in filings made with the SEC.

Recommendations and commentary

- Companies should assess the impacts on their business of the four topic areas identified by the SEC.
- The development of risk factors and MD&A disclosure may be particularly challenging. Companies that make filings with the EPA, state regulators or voluntary organizations may find it helpful to identify and review those filings to see whether any of the issues reported might be relevant, following the SEC's guidance, in a risk factors or MD&A discussion.
- Companies should also consider, if and as appropriate for the type of company, instituting a regular review of legislative and regulatory developments at the international, federal, regional, state, and local levels that may affect the company's business.

On the horizon

The release identifies the following specific near-term actions to be taken by the SEC and its Investor Advisory Committee with regard to disclosure of climate change matters:

- The SEC plans to monitor the impact of the release on company filings as part of its ongoing disclosure review program;
- The SEC's Investor Advisory Committee is considering climate change disclosure issues as part of its overall mandate to provide advice and recommendations to the SEC; and
- The SEC plans to hold a public roundtable on disclosure regarding climate change matters in the spring of 2010.

The SEC will consider its experience with the disclosure review program together with any advice or recommendations of the Investor Advisory Committee and information gained through the planned roundtable as it determines whether further guidance or rulemaking relating to climate change disclosure is necessary or appropriate in the public interest or for the protection of investors.

If you have any questions about this *Alert,* please contact one of your Cooley team members or one of the attorneys identified above.

View the full release

Table 1: Rules Requiring Disclosure of Climate Change Issues[8]

ITEM	DISCLOSURE REQUIRED BY RULE
Description of Business	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, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the company and its subsidiaries. (For a "smaller reporting company," a similar requirement exists at Item 101(h)(4)(xi).)

Legal Proceedings	Item 103 of Regulation S-K requires a company to briefly describe any material legal proceeding, other than ordinary routine litigation incidental to the business, to which it or any of its subsidiaries is a party, material pending legal actions in which its property is the subject of the litigation, and similar actions contemplated by governmental authorities. Instruction 5 to Item 103 specifically states that proceedings involving environmental matters shall not qualify as "ordinary routine litigation incidental to the business" and therefore must be disclosed if they meet specified materiality thresholds.
Risk Factors	Item 503(c) of Regulation S-K requires a company to provide a discussion of the most significant factors that make an investment in the company speculative or risky. Risk factor disclosure should clearly state the risk and specify how the particular risk affects the particular company. The SEC reminded companies in the release that risk factors should be specific as to the risk, and that companies should avoid generic risk factors that could apply to any company.

MD&A	Item 303 of Regulation S-K, which mandates the disclosure requirements in MD&A, includes a broad range of disclosure items that address the company's liquidity, capital resources and results of operations. While there are no specific disclosures required in connection with environmental or climate change issues, the SEC requires management to apply certain principles in the context of a company's particular circumstances. The release highlights the following MD&A requirements. • *Known trends, etc.*.Companies are required to identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance—this would include matters relating to environmental issues and global climate change. • *Relevant time periods:* The SEC has not quantified a specific future time period that must be considered in assessing the impact of climate change-related matters. As with any other judgment required by Item 303, the necessary time period will depend on a company's particular circumstances and the particular trend, event or uncertainty under consideration. • *Materiality determinations:* To analyze the materiality of known trends, events or uncertainties, the SEC asserts that management must make two assessments: (i) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required; (ii) If management cannot make the determination described in (i), it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the company's financial condition or results of operations is not reasonably likely to occur. Companies should also address, when material, the difficulties involved in assessing the effect of the amount and timing of uncertain events, and provide an indication of the time periods in which resolution of the uncertainties is anticipated.

Notes

1 In addition to the mandatory GHG reporting requirements established by EPA (see n. 6 *infra*), the EPA in December 2009 issued an "endangerment and cause or contribute finding" for GHGs under the Clean Air Act, which will allow the EPA to craft rules that directly regulate GHG emissions. *See* Endangerment and Cause or Contribute Findings for Greenhouse Gases Under Section 202(a) of the Clean Air Act, Docket ID No. EPA-HQ-OAR-2009-0171, 74 FR 66496 (December 15, 2009). The Clean Air Act is found in 42 U.S.C. ch. 85.

2 *See e.g.,* 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, and Clean Energy Jobs and American Power Act of 2009, S. 1733, 111th Cong., 1st Session (2009), introduced in the Senate September 30, 2009.

3 *See* the listing of state and local government laws and regulations in this field. For a more detailed list of state action on climate change, see Pew Center on Global Climate Change, States News.

4 *See Cooley Alert:* AB 32 Scoping Plan Approved.

5 Examples of regional programs include: Regional Greenhouse Gas Initiative; Western Climate Initiative; and Midwestern Greenhouse Gas Reduction Accord. Since climate change is a rapidly developing area, the SEC notes that companies need to regularly assess their potential disclosure obligations given new developments.

6 On January 1, 2010, the EPA began, for the first time, to require large emitters of GHGs to collect and report data with respect to their GHG emissions. *See* Mandatory Reporting of Greenhouse Gases, Docket No. EPA–HQ–OAR–2008–0508, 74 FR 56260 (October 30, 2009). This reporting requirement is expected to cover 85% of the nation's GHG emissions generated by roughly 10,000 facilities.

7 State requirements include CO2 emissions disclosure requirements for electricity providers, GHG registries for reporting of entity emissions levels and emissions changes, and required reporting of GHG emissions. See a discussion of specific state requirements.

8 Most of the disclosure requirements applicable to domestic issuers under Regulation S-K that are most likely to require disclosure related to climate change have parallels under Form 20-F, which governs disclosure obligations of foreign private issuers.

This content is provided for general informational purposes only, and your access or use of the content does not create an attorney-client relationship between you or your organization and Cooley LLP, Cooley (UK) LLP, or any other affiliated practice or entity (collectively referred to as "Cooley"). By accessing this content, you agree that the information provided does not constitute legal or other professional advice. This content is not a substitute for obtaining legal advice from a qualified attorney licensed in your jurisdiction, and you should not act or refrain from acting based on this content. This content may be changed without notice. It is not guaranteed to be complete, correct or up to date, and it may not reflect the most current legal developments. Prior results do not guarantee a similar outcome. Do not send any confidential information to Cooley, as we do not have any duty to keep any information you provide to us confidential. When advising companies, our attorney-client relationship is with the company, not with any individual. This content may have been generated with the assistance of artificial intelligence (AI) in accordance with our AI Principles, may be considered Attorney Advertising and is subject to our legal notices.

Key Contacts

Kenneth Guernsey San Francisco	kguernsey@cooley.com +1 415 693 2091
Cydney Posner San Francisco	cposner@cooley.com +1 415 693 2132
Sam Livermore San Francisco	slivermore@cooley.com +1 415 693 2113
Tom Reicher San Francisco	treicher@cooley.com +1 415 693 2381
Darren DeStefano Reston	ddestefano@cooley.com +1 703 456 8034
Francis Wheeler Colorado	fwheeler@cooley.com +1 720 566 4231

Miguel J. Vega Boston	mvega@cooley.com +1 617 937 2319

This information is a general description of the law; it is not intended to provide specific legal advice nor is it intended to create an attorney-client relationship with Cooley LLP. Before taking any action on this information you should seek professional counsel.

Copyright © 2023 Cooley LLP, 3175 Hanover Street, Palo Alto, CA 94304; Cooley (UK) LLP, 22 Bishopsgate, London, UK EC2N 4BQ. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley LLP as the author. All other rights reserved.