

The Securities and Exchange Commission Issues
Interpretive Guidance on Disclosure of Climate Change Impacts
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Introduction

On February 8, 2010, the Securities and Exchange Commission (SEC or Commission) issued its first official interpretive guidance to public companies regarding disclosure of climate change impacts in reports and other documents filed with that agency. *Commission Guidance Regarding Disclosure Related to Climate Change*¹ (Interpretive Release) is of significance to reporting companies for two major reasons:

- It provides useful, substantive interpretive guidance on the *specific disclosures* required of public companies when their financial status is materially affected by *physical, legislative or regulatory* impacts of climate change.
- It is the SEC's first major acknowledgement that climate change issues *may*, under appropriate factual scenarios, be sufficiently financially "material" to merit disclosure.

Although the significance of the first reason is obvious, that of the second one may not be as clear. In any event, neither reason should be taken lightly. That the Commission has stepped forward to promulgate a "final rule" in an area as contentious

¹ SEC Release Nos. 33-9106; 34-61469; FR-82, *Commission Guidance Regarding Disclosure Related to Climate Change*. 17 CFR Parts 211, 231 and 241. See, Fed. Reg. Vol. 75, Feb. 8, 2010, pp. 6290-6297.

and controversial as climate change is a strong signal that should be heeded. The SEC advises that it “will monitor the impact of this interpretive release on company filings as part of our ongoing disclosure review program.”² Therefore, potentially-affected reporting companies should act expeditiously to evaluate their present disclosure policies and practices to be assured that they comport with the guidance provided in the Interpretive Release.

The essential message here is that climate change issues are now “fair game” for SEC regulatory review and enforcement action. As one of the authors predicted in an earlier writing:

Securities law ... will likely have an increasingly greater impact on corporate action, but how much so will depend on the political will of government and the advocacy of plaintiffs. The "take away" message for the corporate community, therefore, is that it should prepare for a new world of demanding climate-change standards.³

The discussion below consists of two Parts. Part I discusses the specific disclosure provisions identified by the Commission as the most likely candidates for climate change disclosure. This Part also discusses certain other provisions that Commission staff may determine are pertinent as they gain greater expertise in this new area. Part II discusses some considerations that may be useful to companies seeking to integrate greenhouse gas (GHG) management and reporting into their overall

² Interpretive Release, 75 Fed. Reg. 6297.

³Perry E. Wallace, *Climate Change, Corporate Strategy, and Corporate Law Duties*, 44 Wake Forest L. Rev. 757, 775 (2009). See also, Perry E. Wallace, *Climate Change, Fiduciary Duty, and Corporate Disclosure: Are Things Heating Up in the Board Room?* 26 Va. Envtl. L.J. 293 (2008); Perry E. Wallace, *Global Climate Change and the Challenge to Modern American Corporate Governance*, 55 SMU L. Rev 493 (2002).

corporate strategic planning and implementation processes. This latter Part has been included because, given the multiple and complex regulatory structures that are now emerging to address the climate change phenomenon, a comprehensive, integrated governance and compliance approach would best serve the interests of companies and their stakeholders.

Finally, we note that both Parts set out very basic discussions of the new corporate governance and regulatory compliance environments that have been driven by climate change developments. As such, they are at most only a starting point for the thorough, in-depth analyses required for proper compliance and effective governance.

I. Specific Disclosure Requirements Implicated by Climate Change Impacts

A. Summary of Disclosure Requirements

The following disclosure requirements include those identified in the Interpretive Release, as well as certain other ones that are potentially applicable.

1. Disclosure Requirements Discussed in the Interpretive Release

- **Description of Business.** Disclosure is required of the development, structure and nature of the business. This includes any “material effects” of environmental compliance and “material estimated capital expenditures for environmental control facilities.”⁴
- **Legal Proceedings.** Disclosure is required of “material pending legal proceedings, other than ordinary routine litigation incidental to the

⁴ Regulation S-K, Item 101(c)(1)(xii), 17 CFR 240.101(c)(1)(xii).

business.” But an environmental legal proceeding is not “ordinary routine litigation” if (1) it is financially “material”; (2) it involves primarily a claim for damages, sanctions or certain charges in an amount exceeding 10 percent of consolidated current assets; or (3) a governmental authority is a party--unless the company reasonably believes that monetary sanctions will either not result or will result in a base amount of less than \$100,000.⁵

- **Risk Factors.** Disclosure is required, in public offerings, “of the most significant factors that make the offering speculative or risky.” The discussion must be concise, logical and specific to the planned offering. “Risk factors” must be detailed and their potential impact must be described.⁶
- **Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).** The MD&A discussion and analysis “shall be of the financial statements and other statistical data that the registrant believes will enhance a reader's understanding of its financial condition, changes in financial condition and results of operations.” In this disclosure, investors get to see the company “through the eyes of management.” Of particular interest to the SEC are any “known trends or any known demands, commitments, events or uncertainties” that are reasonably likely to have a material effect on the company’s financial circumstances. Importantly, the MD&A includes a *prospective aspect*, in that companies must “focus specifically on material events and

⁵ Regulation S-K, Item 103, Instruction 5, 17 CFR 240.103.

⁶ Regulation S-K, Item 503(c), 17 CFR 229.503(c).

uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.”⁷

- **Foreign Private Issuers.** Disclosure requirements for foreign private issuers (non-governmental foreign public companies) are governed principally by Form 20-F⁸ and not by the rules and regulations applicable to domestic public companies. But, essentially, “most of the disclosure requirements applicable to domestic issuers ...that are most likely to require disclosure related to climate change have parallels under Form 20-F.” Forms F-1 and F-3 for public offerings also require disclosures that, particularly in regard to climate change issues, are similar to their domestic counterpart forms.⁹

2. Other Pertinent Disclosure Requirements

- **Accounting Contingent Liabilities.** Under appropriate circumstances, companies that incur certain liabilities or whose assets may become impaired must reflect that increase in liabilities or decrease in assets directly on their balance sheets—*even before the company is completely certain of their occurrence*. Correspondingly, those companies must record an off-setting decrease in equity on the balance sheet and a ‘loss’ expense on the income statement. Such accounting for “contingent” matters is required by SEC accounting standards. In particular, under current applicable standards, such accounting steps are imposed where it

⁷ Regulation S-K, Item 303, 17CFR 229.303.

⁸ Form 20-F, 17 CFR 249.220f.

⁹ Interpretive Release, 75 Fed. Reg. 6295.

is “probable” that an asset had been impaired or a liability had been incurred at the date of the financial statements and where the amount of loss is ‘reasonably estimable.”¹⁰

- **Anti-Fraud liability for Material Misstatements and Omissions.** Anti-fraud provisions in the securities laws prohibit the making of material misstatements and omissions of fact to defraud investors and the securities markets. The most prominent example of an anti-fraud provision is Rule 10b-5, promulgated under Section 10(b) of the Securities Exchange Act of 1934.¹¹

B. Sources, or “Drivers” of Disclosure

The Interpretive Release identifies several categories of sources, or drivers, that could trigger disclosure obligations:

- **Legislation and Regulation.** Significant developments in evolution of law and policy at the federal, regional, state and local levels have created obligations on companies to address climate change. These obligations include requirements for capital and other expenditures for climate change management. Further, management would be obligated to evaluate the impacts of such expenditures. (Business Description and MD&A) Finally, even where such measures are merely *proposed*, some disclosure and evaluation of the legislative and

¹⁰ Financial Accounting Standards Bd., Statement of Financial Accounting Standards: Accounting for Contingencies No. 5, P 8(a)-(b) (1997) (emphasis added). *See also*, Financial Accounting Standards Bd., FASB Interpretation No. 14: Reasonable Estimation of the Amount of a Loss, an Interpretation of FASB Interpretation No. 5 PP 2-3 (1976).

¹¹ 17 C.F.R. § 240.10b-5.

regulatory “risks,” “trends” and “uncertainties” may be necessary.¹²
(Business Description, Risk Factors, MD&A)

- **International Accords.** International accords, such as the Kyoto Protocol and the European Union Emissions Trading System, pose the same potential disclosure duties as do domestic legislation and regulation for companies with transnational operations. Similarly, *proposed* regional and international accords may create disclosure obligations.

Notably, while these two accords are generally well known, other international agreements now in force have also been of major significance in the climate change regulatory arena. For example, the Montreal Protocol on Substances that Deplete the Ozone Layer has been identified as a potent instrument for climate matters, over and above its clear successes on ozone matters. Proper disclosure may well require the identification and assessment of laws whose connection to climate change is less well known—but nonetheless material.

- **Indirect Consequences of Regulation or Business Trends.** The new environment created by increased acceptance of climate change as a legitimate phenomenon and challenge may create material market impacts for some companies. This includes decreased or increased demand for goods and services, depending on whether they have a

¹² Interpretive Release, 75 Fed Reg. 6296.

larger or smaller “carbon footprint,” and competitive impacts as a result of incentives to move toward “green” technologies, goods and services. (Business Description, Risk Factors, MD&A)

- **Physical Impacts of Climate Change.** Physical impacts of climate change may lead to financial impacts on a business. Coastal operations, for example, could suffer property damage and disruptions to operations because of severe weather. Increased insurance claims, of course, would affect insurance companies and insured companies alike. Decreased agricultural production is also a potential outcome. And, of course, damage caused to the property of others could create litigation risks and liabilities. Although climate change litigation, as a technical legal matter, still poses considerable challenges, companies must still consider the substantial relational and economic implications of the increasing volume of such suits. As noted by a recent article in the *New York Times*:

In recent months, two federal appeals courts reversed decisions by federal district courts to dismiss climate-change lawsuits, allowing the cases to go forward ... No one is laughing now. In a report issued last year, Swiss Re, an insurance giant, compared the suits to those that led dozens of companies in asbestos industries to file for bankruptcy, and predicted that “climate change-related liability will develop more quickly than asbestos-related claims.” The pressure from such suits, the report stated,

“could become a significant issue within the next couple of years.”¹³

(Business Description, Legal Proceedings, Accounting Contingencies, Risk Factors, MD&A)

II. Corporate Strategic Planning for Climate Change Management

Many companies are beginning to incorporate GHG management into their overall management structures and even into their larger strategic planning and implementation processes. The case favoring inclusion of climate change management in organizational strategic planning is made forcefully by a document recently issued by the United States Department of Defense. (DoD) “The Quadrennial Defense Review (QDR) is a legislatively-mandated review of Department of Defense strategy and priorities. The QDR will set a long-term course for DoD as it assesses the threats and challenges that the nation faces and re-balances DoD's strategies, capabilities, and forces to address today's conflicts and tomorrow's threats.”¹⁴ With respect to strategic planning for climate change, the QDR states:

In 2008, the National Intelligence Council judged that more than 30 U.S. military installations were already facing elevated levels of risk from rising sea levels. DoD's operational readiness hinges on continued access to land, air, and sea training and test space. Consequently, the Department must complete a comprehensive assessment of all installations to assess

¹³ John Schwartz, *Courts as Battlefields in Climate Fights*, New York Times, January 27, 2010, available at <http://www.nytimes.com/2010/01/27/business/energy-environment/27lawsuits.html>.

¹⁴ The Quadrennial Defense Review (QDR), available at http://www.defense.gov/qdr/images/QDR_as_of_12Feb10_1000.pdf.

the potential impacts of climate change on its missions and adapt as required.¹⁵

One example of such a strategic approach in the corporate context recommends the following “stages”:

- "Stage One" of the method requires that the company develop a "climate strategy." This includes:
 - i. assessing the emissions profile,
 - ii. gauging risks and opportunities of GHG impacts,
 - iii. evaluating action options for addressing these impacts, and
 - iv. setting goals and targets.
- "Stage Two" of the method requires an “inward focus,” by:
 - i. developing financial mechanisms, and
 - ii. engaging the organization.
- "Stage Three" of the method requires an “outward focus,” by:
 - i. formulating policy strategies, and
 - ii. managing external relations.¹⁶

Companies that find themselves heavily engaged in GHG management generally appreciate the benefit of a more efficient, systematic approach. Approaches such as the one just set out can often be quite useful. Note that these approaches require consideration of both more complex, sophisticated techniques and some of the most basic facts about climate. But any analysis in this area must begin with a thorough

¹⁵ *Id.* at 85.

¹⁶ Andrew J. Hoffman, *Carbon Strategies* (2007). *See also*, Rory Sullivan, *Introduction to Corporate Responses to Climate Change 2, 3* (Rory Sullivan ed., 2008); Andrew J. Hoffman & John G. Woody, *Climate Change: What's Your Business Strategy?* 1(2008).

knowledge of the basic facts. For example, climate change is caused by various gases and aerosols such as black carbon soot, and not just CO₂, which represents only 50% of the “radiative forcing” that results in climate change impacts. This is significant because a company must begin its GHG management initiatives by assessing the *full range* of types of its GHG emissions. Otherwise, the entire corporate planning and implementation process that ensued would be fundamentally flawed.

Conclusion

The discussion above identifies and analyzes SEC disclosure requirements related to climate change and discusses the utility of comprehensive corporate strategic planning in GHG management. Because of the SEC’s recent Interpretive Release, potentially affected companies would do well to evaluate their SEC disclosure policies and practices to be sure they are in compliance with this measure. It appears likely that the Commission will approach this area seriously. Certainly, there are countervailing factors: (1) the Commission proceeded carefully in the Interpretive Release (for example, it never affirmed whether climate change is real and imminent); (2) the measure does not purport to make new law, but only expresses the Commission’s “view with respect to ... existing disclosure requirements”; and (3) the measure passed by only a divided 3-2 vote.¹⁷

On the other hand, however, given that a majority of the Commission approved the measure, it says much about the likely direction of specific agency decisionmaking on climate change matters in the future.

¹⁷ See, Joel Kirkland, *SEC Issues Climate-Risk Guidance Despite Tough Political Environment*, New York Times, January 28, 2010, available at <http://www.nytimes.com/cwire/2010/01/28/28climatewire-sec-issues-climate-risk-guidance-despite-tou-27171.html>. Kara Scannell, *SEC Discord Could Stymie Schapiro’s Efforts*, Washington Post, January 6-7, 2010, B1.