

Client Alert

Latham & Watkins Environment, Land & Resources and Corporate Departments

SEC Issues Interpretive Guidance on Disclosure of "Business or Legal Developments Regarding Climate Change"

On February 2, 2010, the Securities and Exchange Commission (SEC) published its interpretive guidance for disclosures relating to climate change.¹

We summarize the guidance in this *Client Alert*. Before turning to the specifics of the guidance, there are several points to note about this development:

- *Commission guidance is not rulemaking.* As Chairman Schapiro emphasized in her statement at the SEC open meeting on January 27, the guidance does not create new legal obligations — it merely clarifies existing ones.
- *Chairman Schapiro explained that the SEC "is **not** making any kind of statement regarding the **facts** as they relate to the topic of 'climate change' or 'global warming.'"*² Moreover, Chairman Schapiro noted that the SEC's guidance is "not opining on whether the world's climate is changing; at what pace it might be changing; or due to what causes." Nevertheless, in a separate speech Commissioner Aguilar asserted that "it is 'unequivocal' that the Earth's climate is warming." It is not certain how companies will reconcile these views when deciding how to implement the new guidance.
- *The ultimate result of the guidance remains unclear.* Each public

company will need to consider how (and whether) to disclose climate change matters, taking the guidance into account among a range of other factors. Determining what (if anything) to disclose and the scope of disclosure may remain difficult for public companies in view of the uncertainties that surround the entire topic of climate change.

Sources of Disclosure Obligations

The guidance points to four specific provisions of Regulation S-K as sources for potential disclosure of climate change:³

- *Item 101 – Business Description.* Item 101 requires disclosure of "material effects" that compliance with environmental laws may have on capital expenditures, earnings and competitive position of a company and its subsidiaries. It also calls for disclosure of "material estimated capital expenditures for environmental control facilities."
- *Item 103 – Legal Proceedings.* Item 103 requires disclosure of "material pending legal proceedings" to which a company or its subsidiaries is a party. Instruction 5 to Item 103 provides specific requirements for disclosure of certain environmental litigation.

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- *Item 503(c) – Risk Factors.* Item 503(c) requires disclosure of the most significant factors that make an investment in the company risky, and states that the disclosure should specify how the particular risks affect the particular company (and not present risks that could apply to any issuer or offering).
- *Item 303 – Management’s Discussion and Analysis (MD&A).* Item 303 requires disclosure of known trends that are reasonably likely — a lower disclosure standard than “more likely than not” — to have a material impact on a company’s financial condition or operating performance.
- *International accords* – Companies should consider and disclose, if material, the impact of international accords and treaties relating to climate change.⁶
- *Indirect consequences of regulation or business trends* – Companies should consider possible indirect consequences or opportunities of climate change, including decreased demand for products that produce significant greenhouse gas (GHG) emissions or increased demand for goods associated with low GHG emissions. In addition, the guidance mentions the potentially negative effect on the reputation of a company involved in high GHG emissions as an indirect risk to consider.
- *Physical effects of climate change* – Companies should consider the actual and potential physical impacts of climate change, such as the effects of rising sea levels or severe weather (pointing to a GAO report citing a number of sources to support the view that severe weather scenarios will increase as a result of climate change).

Potential Climate Change Disclosure

The guidance gives a variety of examples of climate change disclosure that a company may need to consider, based on its specific situation. These include:

- *Risk factor disclosure* – Companies may need to disclose existing or pending legislation relating to climate change, particularly for companies in industries such as the energy sector.⁴
- *MD&A disclosure* – The guidance states that, in the case of a known uncertainty, such as pending legislation or regulation, the analysis of whether disclosure is required in MD&A consists of two steps. First, management must evaluate whether the pending legislation is “reasonably likely” to be enacted. Unless management determines that the legislation is not reasonably likely, it must proceed on the assumption that it will be enacted. Second, management must determine whether the legislation, if enacted, is reasonably likely to have a material effect on the company, and unless management determines that a material effect is not reasonably likely, MD&A disclosure is required.⁵

Conclusion

Climate change is a highly controversial topic. For example, the guidance was adopted on a 3 to 2 vote. One dissenter, Commissioner Casey, asserted that the issuance of the guidance “at a time when the state of the science, law and policy relating to climate change appear to be increasingly in flux, makes little sense.” Commissioner Paredes, the other dissenter, argued against the guidance in part because climate change is “an area far outside this agency’s expertise.”

We will continue to monitor developments in this area and, above all, how public companies implement the guidance.

Endnotes

- ¹ Release No. 33-9106, *Commission Guidance Regarding Disclosure Related to Climate Change* (Feb. 2, 2010). See <http://www.sec.gov/rules/interp/2010/33-9106.pdf>.
- ² Speech by SEC Chairman: Statement Before the Open Commission Meeting on Disclosure Related to Business or Legislative Events on the Issue of Climate Change, <http://www.sec.gov/news/speech/2010/spch012710mls-climate.htm>.
- ³ The guidance notes that foreign private issuers look principally to Form 20-F as the source of specific line-item disclosure obligations, but notes that these four provisions of Regulation S-K have parallels in Form 20-F. In particular, the guidance points to Form 20-F Item 3.D (risk factors), Item 4.B.8 (effects of government regulation on business), Item 4.D (effects of environmental issues), Item 5 (operating and financial review, *i.e.*, MD&A) and Item 8.A.7 (legal proceedings). The guidance also notes that registration statements on Forms F-1 and F-3 must comply with Regulation S-K Item 503 regarding risk factors.
- ⁴ Note also Staff Legal Bulletin 14E, in which the SEC Staff addressed the question of companies' ability to exclude shareholder proposals relating to an evaluation of risk — potentially including environmental risk — from their proxy statements under Rule 14a-8(i)(7)'s exclusion for matters relating to ordinary business operations. Under SLB 14E, rather than focusing on whether a proposal and a supporting statement relate to an evaluation of risk, the Staff will instead focus on the subject matter to which the risk pertains or that gives rise to a risk; the fact that a proposal would require an evaluation of risk will not be dispositive of whether the proposal may be excluded under Rule 14a-8(i)(7). See Staff Legal Bulletin No. 14E, *Shareholder Proposals* (Oct. 27, 2009).
- ⁵ It remains to be seen how companies will evaluate the guidance while making these determinations, particularly since judgments of this sort would appear to involve conclusions about the outcome of fluid and uncertain legislative processes. In addition, different companies may come to quite different views about probability with respect to any given piece of legislation.
- ⁶ Companies may find it particularly challenging to judge the outcome of various international accords. For example, the guidance notes that the United States has not ratified the Kyoto Protocol, and that the Protocol is set to expire by its terms in 2012.

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