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Climate Change Disclosure: Nothing New Under the Sun

Against the background of an international, highly polarized debate on the implications of global warming and climate change, the SEC recently published an interpretive release intended to provide guidance to public companies on the application of existing disclosure requirements to climate change matters. Although entitled ***Commission Guidance Regarding Disclosure Related to Climate Change (the "2010 Interpretive Release")***,[1] we believe the guidance outlined in this release has much broader significance for companies seeking to adapt to evolving SEC views on risk, materiality and the need to provide "early warning" to investors of contingencies that, if realized, could have a material effect (either positive or negative) on a company's financial condition and results of operations. This guidance is particularly important to preparation of the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") and Risk Factor sections of periodic reports filed with the SEC under the Securities Exchange Act of 1934 ("Exchange Act").

At the time of the SEC vote in late January 2010 on whether to issue the 2010 Interpretive Release (the release itself was not published until February 2, 2010), SEC Chairman Mary Schapiro stressed that it was not intended either to create new disclosure obligations or to modify existing line-items, or otherwise to express a view one way or the other on "whether the world's climate is changing; at what pace it might be changing; or due to what causes."[2] As before, the overarching principle is materiality from the perspective of the investing public, whether dictated by environmental line-item disclosure requirements already in place, which are discussed extensively in the release, or by antifraud considerations compelling the disclosure of "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."[3] Still, the SEC's divided (3-2) vote on the issuance of the release itself mirrors the sharp disagreement on the importance of climate change that lies at the heart of the ongoing debate.

Whatever the relative merits of positions taken by the various participants in the global warming debate, the guidance outlined in the SEC's interpretive release offers a timely summary of existing law as interpreted by the agency, along with suggestions that may facilitate critical disclosure judgments within the existing framework by companies that climate change might affect. Accordingly, the release should be given careful consideration by the wide array of companies the SEC believes either currently, or in the near future may, have some degree of direct or indirect exposure to the effects of climate change that may be material to their business, financial condition or results of operations. Companies that are actually or potentially affected by climate change risk include oil and gas producers,

electrical utilities, manufacturers in any industry that emit greenhouse gases, "green" businesses or producers of alternative forms of "clean" energy poised to capitalize on increased regulation of carbon emissions, users of carbon-based products such as truck, railroad, airline and shipping transportation companies, insurance companies facing mounting claims for property and other damage linked to climate change, and agricultural businesses highly sensitive to severe weather fluctuations.

We begin with a discussion of the four key areas of climate change risk identified by the SEC in the 2010 Interpretive Release. Next, we address how the SEC believes these risks should be analyzed by company management and boards in determining whether disclosure is required in any or all of the following sections of periodic reports on Form 10-K and 10-Q – the MD&A,[4] the Risk Factors,[5] Legal Proceedings[6] and Description of Business.[7] Consistent with the SEC's financial crisis-inspired emphasis on the importance of "early-warning" disclosure of material risks on the horizon, we focus in particular on the MD&A and risk factor disclosure standards.

Guidance on the Identification of Climate Change Risks

Synthesized from a variety of public sources, the interpretive release's background discussion highlights the apparent convergence of several major factors, at least some of which may have prompted the SEC to issue the release at this time: (1) increased attention on the part of federal and state legislators[8] and regulators[9] to the public health and welfare implications of climate change, and the search for comprehensive solutions; (2) international accords such as the Kyoto Protocol of 2006, and continuing multinational efforts to address a perceived problem of global proportions;[10] and (3) enhanced corporate disclosures in response to escalating demands from activist investors[11] and at least one state Attorney General, whose settlements with AES Corporation, Dynegy Inc. and Xcel Energy require more information in annual reports on the material financial risks of climate change regulation and litigation, as well as the possible physical effects of climate change.[12] The SEC expressed concern in the 2010 Interpretive Release that some of these enhanced disclosures, even if voluntary, may be material but have not been included in SEC filings. Accordingly, the SEC urged such companies to assess whether any of the information thus disclosed is called for under the relevant line-items, or is necessary to make the SEC-prescribed disclosure accurate and complete.

In light of these developments, the SEC identified the following four broad categories of possible climate-related risks for evaluation by public companies in connection with the application of their disclosure controls and procedures covering Exchange Act reports and other SEC filings or submissions. Although this evaluation ultimately may result in a conclusion that no disclosure is necessary under any of the potentially applicable line-item requirements, the SEC's strong message here is that the requisite information does have to be collected and analyzed by the appropriate corporate decisionmakers if even remotely relevant to the company's business. The four risk categories outlined in the release are:

- The actual or potential impact of either or both existing and pending legislation and regulation, at either or both the federal and state level;

- The actual or potential impact of treaties and international accords, whether currently effective (*e.g.*, the European Union's "cap-and-trade" system, known as the "EU Emissions Trading System") or in progress (whatever treaties might emerge from the United Nations Climate Conference held in Copenhagen last December);
- Any indirect consequences of regulation or business trends, such as
  - decreased demand for goods that produce significant greenhouse gases,
  - increased demand for goods that produce lower emissions, and increased competition to develop such goods (*e.g.*, the substitution of incandescent light bulbs with compact fluorescent bulbs to comply with 2007 federal legislation),
  - increased demand for generation and transmission of alternative forms of "clean" energy,
  - decreased demand for services that use carbon-based energy sources, and
  - reputational risk, based on negative public perception of publicly reported data on a company's greenhouse gas emissions.[13]
- The actual or potential impact of physical effects attributed by many to climate change, such as more severe weather (*e.g.*, hurricanes, floods), rising sea levels, diminished farmland arability, and reduced water availability and quality, including:
  - increased insurance claims and liabilities for insurers and re-insurers,
  - increased insurance premiums, or even loss of coverage, for companies with plants or operations in areas subject to severe weather,
  - serious risks of property damage and disruptions in product manufacturing and distribution for companies with operations concentrated on or near coastlines, such as offshore oil drilling firms or shipping companies,
  - decreased agricultural production due to drought or other weather-related changes, and
  - adverse, indirect financial and operational effects flowing from weather-disrupted operations of major customers or suppliers.

The SEC's Framework for Analyzing and Disclosing Material Risks, Including But Not Limited to Climate Change

The SEC's 2010 Interpretive Release underscores a theme sounded by the SEC's Division of Corporation Finance over the past few years in the context of speeches, "Dear CFO" letters and the staff's review and comment on periodic reports – the need to use the MD&A, risk factor and other relevant sections of periodic reports to alert investors to the possibility that a company's past performance, as reflected in the historical financial statements, may not be predictive of future results. Given the dramatic levels of volatility and uncertainty generated by the recent financial and economic crises, the staff – and now the SEC itself – has been very clear on the importance of the various mandatory forward-looking disclosure elements of Exchange Act reports, particularly those centered in rules highlighted in the release (as listed above). The SEC's assessment of how well the staff, and at least some of the Commissioners, believe companies are currently doing in this area can perhaps best be

summed up by recent remarks of Commissioner Elisse Walter: "[C]orporate MD&As are still not where they should be. I would like to see companies recognize trends and uncertainties sooner; make reasonable likelihood determinations before they become more likely than not; and disclose this information to investors so that they can make their own, fully informed decisions."[14]

One of the most important aspects of the 2010 Interpretive Release – and one which we believe transcends the topic of climate change – is its clear articulation of the SEC's determination to improve the quality of MD&A disclosure. Periods of great market upheaval seem to elicit further guidance from the SEC addressing perceived disclosure deficiencies, with the last major occasion being the financial reporting scandals that precipitated the enactment of the Sarbanes-Oxley Act of 2002.[15] Almost 15 years earlier, in 1989 (not long after the great market crash of 1987), the SEC published its seminal interpretation of Item 303 of Regulation S-K, stressing (among other things) the significance to investors of information illuminating companies' future prospects.[16]

Since 2007, when the incipient signs of the impending financial crisis began to appear, the SEC staff has been using the bully pulpit and the comment process to urge companies to provide more forward-looking disclosures – in both the MD&A and risk-factor sections of 10-Ks and 10-Qs – of the potential material adverse effects of the use of off-balance sheet arrangements, the application of fair-value accounting concepts to value (and assess impairment of) tangible and intangible assets, such as goodwill, and litigation contingencies. In support of these positions, the staff has invoked the requirement in Item 303 to disclose known trends, events, demands and uncertainties that management deems reasonably likely to have a material effect in future reporting periods on a company's liquidity, capital resources or operational results. Moreover, as part of the comment process, the staff has looked outside a company's SEC filings and submissions to scan the content of its website, listen to replays of management earnings calls, read newspaper and trade journal articles about the company, and even review broker research reports on the company or its industry. Many companies have received a staff comment questioning, for example, why managers depicted the particular company – whether on investor calls or in trade journal interviews – as having a larger number of business segments for market analytical purposes than have been identified for accounting purposes in the financial statements and MD&A sections of periodic reports.[17]

Now the SEC has weighed in again, using the 2010 Interpretive Release to underscore management's obligation 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."[18] As noted, the primary objective of this analysis is to shed light for investors on factors that are "reasonably likely to cause reported financial information not to be necessarily indicative of future operating performance or of future financial condition."[19] These complex, future-oriented disclosure decisions require that management:

- consider financial, operational and other information **known** to the company, which means that management must have in place disclosure controls and procedures that

effectively and efficiently capture this information and bring it to the attention of those within management who are charged with making key disclosure decisions on behalf of the company;

- based on the information thus collected, identify **known trends and uncertainties**; and
- assess whether these identified trends and uncertainties will have, or are reasonably likely to have, a **material** impact on the company's liquidity, capital resources or results of operations.

From the SEC's perspective, the significance of the "materiality" analysis to meaningful MD&A disclosure cannot be overstated. An item of information is "material" if there is a substantial likelihood that a reasonable investor would consider it important to an investment decision, or if that information would alter the total mix of available information.[20] In this connection, the SEC has recognized that the time horizon of a known trend, event or uncertainty is relevant to a materiality judgment, as is the reasonable likelihood of that trend, event or uncertainty's occurrence. Quoting from the Supreme Court's seminal opinion in *Basic v. Levinson*, the SEC observed that, "'materiality' with respect to contingent or speculative information or events … '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.'"[21] Again citing the Supreme Court, the SEC urged companies to resolve all doubts on the question of materiality in favor of disclosure.[22]

In the 2010 Interpretive Release, the SEC reminds companies to rely on the two-pronged test for evaluating the materiality of a known trend, event or uncertainty that the SEC first delineated in its 1989 MD&A Interpretive Release.[23] Specifically, once management knows of a given trend, demand, commitment, event or uncertainty (and as discussed below, management cannot hide its head in the sand to avoid such knowledge, particularly in the Internet era), it must "'make two assessments:

- 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.
- If management **cannot** make that determination, 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 registrant's financial condition or results of operation is not reasonably likely to occur.'"[24]

In the SEC's view, the breadth of the materiality analysis does not give management license to clutter the MD&A with "unnecessary detail or duplicative or uninformative disclosure that obscures the [mandatory] material information."[25] On the other hand, the SEC expects management to cast a wide informational net in arriving at the required forward-looking disclosure decisions: "In identifying, discussing and analyzing known material trends and uncertainties, registrants are expected to consider all relevant information even if that information is not required to be disclosed, and, as with any other disclosure judgments, they should consider whether they have sufficient disclosure controls and procedures to process

this information." In the climate change area, the SEC pointed out that such relevant information may include the type of information a company either voluntarily furnishes to such organizations as the Carbon Disclosure Project, or is compelled to furnish to a federal or state governmental agency.

In sum, as the SEC observed in the 2010 Interpretive Release, there is nothing new about the "known trend and uncertainty" disclosure element of the MD&A. Whatever concerns companies may have about enhanced liability exposure attendant to such forward-looking disclosures – which are mandatory in any case – can be mitigated by the inclusion of robust risk factors. If carefully crafted, "meaningful cautionary statements" will protect against private litigation any future-oriented or "soft" information in the MD&A (whether provided on a mandatory or voluntary basis).

So Where Do We Go From Here?

In the near term, the SEC plans to convene a roundtable this spring to discuss climate change disclosure issues, and will be receiving further advice and recommendations in this area from its Investor Advisory Committee. Further rulemaking is therefore possible, although not likely pending the results of the Division of Corporation Finance's assessment of corporate compliance based on conclusions drawn from the staff's administration of the disclosure review process this year.[26]

Practically speaking, many companies in a variety of sectors should anticipate climate change risk comments on the MD&A, Risk Factor and other pertinent sections of their fiscal 2009 Form 10-K and other SEC filings made throughout 2010. In addition, boards of directors of companies in these sectors should recognize that the staff may be scrutinizing their new proxy statement disclosures about board oversight of risk management for a discussion of how, in particular, the board oversees the management of material risks posed by climate change.[27]

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If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any member of the Firm's Public Company Advisory Group:

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[1] Securities Act Rel. No. 9106 (Feb. 2, 2010)("2010 Interpretive Release"), available at http://www.sec.gov/rules/interp/2010/33-9106.pdf. For a more environmentally-oriented memorandum on

the 2010 Interpretive Release, see Weil, Gotshal & Manges's ***Climate Change Update*** for February 2010 ("WGM Climate Change Update"), available at http://www.weil.com.

[2] Speech by SEC Chairman Mary Schapiro: Statement Before the Open Commission Meeting on Disclosure Related to Business or Legislative Events on Climate Change (Jan. 27, 2010), available at http://www.sec.gov/news/speech/2010/spch012710mls-climate.htm.

[3] Exchange Act Rule 12b-20; *see* Rule 408 under the Securities Act of 1933.

[4] Item 303 of Regulation S-K.

[5] Item 503(c) of Regulation S-K.

[6] Item 103 of Regulation S-K.

[7] Item 101 of Regulation S-K.

[8] In June 2009, the House of Representatives passed the American Clean Energy and Security Act of 2009, H.R. 2454, containing historic "cap-and-trade" provisions. However, action appears to be stalled in the Senate following the introduction of a similar bill last fall, with certain members of Congress working on legislation that would strip the Environmental Protection Agency ("EPA") of its authority to regulate greenhouse gas emissions linked to climate change. *Id.* at 3; *see also* WGM Climate Change Update, *supra* n. 1. At the state level, the SEC offered the example of California's Global Warming Solutions Act of 2006. *See* 2010 Interpretive Release, *supra* n. 1, at 17-18.

[9] At the federal level, notable developments cited by the SEC include the EPA's finding of "endangerment" under the Clean Air Act in late 2009, which will allow more direct regulation of greenhouse gas emissions, and new EPA rules requiring large emitters of greenhouse gases to collect and report emissions data beginning Jan. 1, 2010. State regulatory and other efforts discussed by the SEC include restrictions imposed on greenhouse gas emissions by the California Air Resources Board, and such state and regional programs as the Regional Greenhouse Gas Initiative (to which ten Northeast and Mid-Atlantic states belong), the Western Climate Initiative (comprised of seven Western states and four Canadian provinces), and the Midwestern Greenhouse Gas Reduction Accord (six states and one Canadian province). In addition, a coalition of state insurance regulators, the National Association of Insurance Commissioners, adopted a uniform standard for mandatory reporting to the states by insurance companies of financial risks presented by climate change and mitigating measures taken. *See id.* at 3-5.

[10] Among the initiatives outlined by the SEC (*id.* at 4-5) are the UN Climate Conference in Copenhagen held in December 2009, which could lead to future global treaties on remediation of environmental damage caused by greenhouse gas emissions, and the EU Emissions Trading System, a pan-European "cap-and-trade" system of allowances for the emission of carbon dioxide and other greenhouse gases, based on Kyoto Protocol mechanisms.

[11] *Id.* at 7.

[12] *Id.* at 7-8. In the event a settling company's greenhouse gas emissions have a material effect on its financial condition, that company also must disclose its current position on climate change, its emission levels and strategies to reduce them, and its governance mechanisms to address these risks, including but not limited to board oversight. *See* the New York Attorney General press releases announcing settlements with AES Corporation (at http://www.oag.state.ny.us/media_center/2009/nov/nov19a_09.html), Dynegy Inc. (http://www.oag.state.ny.us/media_center/2008/oct/oct23a_08.html), and Xcel Energy (http://www.oag.state.ny.us/media_center/2008/aug/aug27a_08.html).

[13] While not discussed in any detail in the 2010 Interpretive Release, companies should remain mindful of the material risks posed by environmental litigation in the climate change area. State attorneys general, environmental activists and other private litigants may attempt to use existing law in the courts to limit greenhouse gas emissions. *See, e.g.*, Connecticut v. American Electric Power Co., 582 F. 3d 309 (2d Cir. 2009)(the Second Circuit remanded the dismissal of a case brought by eight states, the City of New York, and several private land trusts against six electric utility companies, seeking to restrict the "public nuisance" of global warming); Comer v. Murphy Oil USA, et al., 585 F. 3d 855 (5th Cir. 2009)(reversal and remand of a lower court's dismissal on political question grounds of a "private nuisance" case brought by 14 private plaintiffs against various chemical companies, utilities and fossil fuel producers, claiming that the defendants' carbon dioxide emissions contributed to global warming effects that warmed the waters in

the Gulf of Mexico and increased the frequency and severity of hurricanes, including Hurricane Katrina). A more extensive discussion of these and other cases can be found in the WGM Climate Change Update, *supra* n. 1.

[14] Speech by SEC Commissioner Elisse B. Walter, "SEC Rulemaking – 'Advancing the Law' to Protect Investors," delivered to the 48th Annual Corporate Counsel Institute, Northwestern University School of Law (Chicago, Ill., Oct. 2, 2009), available at http://www.sec.gov/news/speech/2009/spch100209ebw.htm.

[15] *See* Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Rel. No. 8350 (Dec. 19, 2003)("2003 MD&A Interpretive Release"), available at http://www.sec.gov/rules/interp/33-8350.htm. *See also* Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Rel. No. 8182 (Jan. 28, 2003)(amending Item 303 of Regulation S-K to require new disclosures regarding material off-balance sheet arrangements and contractual obligations), available at http://www.sec.gov/rules/final/33-8182.htm.

[16] *See* Management's Discussion and Analysis of Financial Condition and Results of Operation, Securities Act Rel. No. 6835 (May 18, 1989)("1989 MD&A Interpretive Release"), available at http://www.sec.gov/rules/interp/33-6835.htm.

[17] Because proper identification of operating segments also is critical to the allocation of goodwill and goodwill impairment testing under U.S. Generally Accepted Accounting Principles, an SEC staff comment that segments have been aggregated inappropriately can lead to restatement and other undesirable consequences.

[18] 2010 Interpretive Release, *supra* n. 1, at 17. The SEC explained that, "'[r]easonably likely' is a lower disclosure standard than 'more likely than not.'" *Id.* at 17n. 54 (citation omitted).

[19] *Id.* at 17 (citing the 2003 MD&A Interpretive Release).

[20] Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

[21] 2010 Interpretive Release, *supra* n. 1, at 18, citing Basic v. Levinson, 485 U.S. at 238 (additional citation omitted).

[22] *Id.* at 11, citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976).

[23] See n. 16, *supra*.

[24] *Id.* at 19, quoting from the 1989 MD&A Interpretive Release (emphasis added).

[25] *Id.* at 17.

[26] Senior staff members have indicated informally that this assessment will be part of the regular disclosure review process.

[27] New Item 407(h) of Regulation S-K requires disclosure, in most 2010 proxy statements, of "the extent of the board's role in the risk oversight … such as how the board administers its oversight function and the effect that this has on the board's leadership structure."

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