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SEC Update

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SEC staff issues sample comments regarding climate change disclosure

On September 22 the SEC's Division of Corporation Finance published on its website a "Sample Letter to Companies Regarding Climate Change Disclosures," which it characterizes as an "illustrative letter" presenting "sample comments that the Division may issue to companies regarding their climate-related disclosure or the absence of such disclosure." Public companies have started receiving these comments as part of the Division's filing review process. The Division has issued this reminder of current disclosure obligations as it works to deliver for the Commission's consideration by year-end what SEC Chair Gary Gensler has framed as a "mandatory climate risk disclosure rule" that would overhaul the existing regime for climate-related disclosure.

The Division's letter does not reflect a change in the staff's approach to evaluating application of the SEC's current disclosure rules to climate change matters. The staff indicates that its comments are intended to promote compliance with the topics addressed in the interpretive release regarding climate change disclosure issued by the SEC in 2010. The Division's letter, however, signals that climate change disclosure is now a more significant focus of the Division's disclosure review program than it has been in prior years.

The SEC's 2010 interpretive release (No. 33-9106), which can be accessed here, discusses considerations relevant to determining whether climate change disclosure is required under the Regulation S-K items that relate to the company's business (Item 101), legal proceedings (Item 103), risk factors (Item 105), and management's discussion and analysis (Item 303). The comments in the Division's letter center on the discussion of climate-related matters in the company's risk factor disclosure and in MD&A, although some of the matters also implicate the business description. The disclosure considerations discussed in the comments generally apply to foreign private issuers as well as domestic companies, since provisions of Form 20-F filed by foreign private issuers substantially parallel the relevant Regulation S-K items.

The Division's letter may be accessed here.

Context for disclosure

In the lead-in to the nine sample comments contained in its letter, the Division cautions that it has not included an exhaustive list of all of the issues companies should consider in developing their climate change disclosures. The staff indicates that it will issue in the filing review process comments that are tailored to the particular company and its industry and that take into account information previously included in the company's SEC filings.

The Division's reference to tailored disclosure echoes a major theme of Regulation S-K amendments adopted by the SEC since it issued its interpretive guidance. The most recent amendments represent a shift by the SEC towards a more principles-based approach to disclosure and away from prescriptive requirements that specify the content and manner of disclosure. The amended rules governing disclosure relating to a company's business, legal proceedings, risk factors, and MD&A afford the company greater flexibility to determine which information is material to an understanding of its particular business and how to present the information. The Division's letter reiterates that, for climate change disclosure, the company's materiality determinations should be informed by a consideration of the topics addressed in the SEC's 2010 interpretive guidance.

We described the 2020 Regulation S-K amendments in the *SEC Update* we issued on September 25, 2020 (discussing amendments to the disclosure rules for business, legal proceedings, and risk factors) and the *SEC Update* we issued on December 18, 2020 (discussing amendments to the MD&A disclosure requirements). The amendments to disclosures in business, legal proceedings, and risk factors are currently effective, while companies are initially required to comply with the MD&A amendments for their first fiscal year ending on or after August 9, 2021. Companies may elect to comply early with the amended MD&A rules so long as they comply with amended Item 303 in its entirety.

The Division underscores that materiality determinations for climate change disclosure require not only consideration of specific disclosure requirements in Regulation S-K, but also of the parallel directives under Securities Act Rule 408(a) and Exchange Act Rule 12b-20. Those rules require the company to disclose, in addition to any specifically required information, "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they were made, not misleading."

Summary of staff comments

General comment: filing of material voluntary disclosures

The Division's initial comment is directed at a company that has "provided more expansive disclosure" about climate-related matters in its corporate social responsibility report (CSR report) than in its SEC filings. The staff asks the company to advise it as to what consideration the company gave "to providing the same type of climate-related disclosure" in its SEC filings as it provided in its CSR report.

This comment recalls a similar observation made by the SEC in its 2010 interpretive release. There, the SEC acknowledged that CSR reports and other voluntary disclosures can provide investors with important information about climate-related matters, but reminded companies that they "should be aware that some of the information they may be reporting pursuant to these mechanisms also may be required to be disclosed in filings made with the Commission pursuant to existing requirements."

Companies may have encountered in other contexts comparable expressions of staff concern that they might be disseminating material information outside of their SEC filings that also should be disclosed in those filings. The staff, for example, has issued comments addressing this issue over the years to companies that publish performance or liquidity measures which they do not file or furnish in their current or periodic reports.

Many companies organize their voluntary climate-related disclosures according to frameworks published by U.S. and international standard-setting organizations that monitor performance in environmental, social, and governance (ESG) matters. The staff's comment will require companies to revisit their analysis of the application of SEC requirements to the disclosures elicited under those standards or otherwise presented outside of their SEC filings. Any shift from voluntary to mandatory reporting of particular climate change matters would have important legal consequences. Disclosure of such matters in SEC filings would be subject to the company's disclosure controls and procedures, to periodic review and evaluation by the SEC staff, and to additional liabilities under the federal securities laws.

Comments on risk factor disclosure (Item 105)

The Division's two comments on risk factor disclosure direct the company to address:

- the material effects of "transition risks" related to climate change that may affect the company's business, financial condition, and results of operations, such as policy and regulatory changes that could impose operational and compliance burdens, market trends that may alter business opportunities, credit risks, or technological changes; and
- any material litigation risks related to climate change and the potential impact to the company.

The "transition risks" referred to in the first comment generally mean climate risks related to the process of adjusting to a lower-carbon economy. Societal changes in this process can arise in a number of ways, some of which the staff alludes to, including changes in regulation and public sector policies; innovation and changes in the affordability of existing technologies; and changes in investor and consumer sentiment regarding a greener economy. Adverse financial impacts of these changes could include, among others, higher costs of doing business and shifts in asset values. Although not addressed in the staff's comment, developments related to transition risks may be relevant to disclosure regarding the company's business, particularly as such developments might affect corporate strategy.

The SEC has long believed that the materiality of much risk factor disclosure is undermined by the recitation of generic risk factors that are not tailored to the company's individual business. In its 2010 interpretive guidance, the SEC emphasized that companies should identify "specific risks they face as a result of climate change" and should "avoid generic risk factor disclosure that could apply to any company." In discussing the potential impact of legislative and regulatory changes, for example, the SEC highlighted that companies that are particularly sensitive to changes affecting greenhouse gas emissions, such as energy companies, may face risks significantly different from those faced by companies, such as those in the transportation sector, that rely on products that emit greenhouse gases.

Although the SEC's guidance and the staff's letter address pertinent non-financial statement disclosure rules, companies also must consider climate change matters when complying with financial accounting standards. In its guidance, the SEC said that companies should review the application of FASB's ASC Topic 275, Risks and Uncertainties, and ASC Topic 450, Contingencies, when evaluating matters such as those raised in the staff's risk factor comments.

Comments on MD&A disclosure (Item 303)

The Division's letter solicits disclosure in MD&A about a variety of past or potential material effects of climate change on the company's business, liquidity, capital resources, and results of operations. Consistent with the SEC's interpretive guidance, the staff requests that the company disclose with respect to specific topics:

- material *indirect* consequences of climate change – such as reputational damage resulting from public perceptions of data relating to the company's greenhouse gas emissions – as well as material *direct* consequences;
- material *positive* effects of climate change – such as new business opportunities resulting from legislative or regulatory change – as well as material *adverse* effects; and
- *quantification* of material effects of climate change on specified financial measures.

Preparing disclosure that is the responsive to the requirements of Item 303 requires the company to identify and discuss known trends, events, demands, commitments, and uncertainties (trends or uncertainties) relating to climate change that are "reasonably likely" to have a material effect on the company's financial condition or operating performance. The disclosure should highlight issues that are reasonably likely to cause the company's reported financial information not to be indicative of its future operating performance or its future financial condition. As summarized by the SEC in the interpretive release, based on its long-standing MD&A guidance, disclosure decisions relating to known trends and uncertainties generally should involve:

- the consideration of financial, operational, and other information known to the company;
- the identification, based on this information, of known trends and uncertainties; and
- the assessment of whether these trends and uncertainties will have, or are reasonably likely to have, a material impact of the company's liquidity, capital resources, or results of operations.

In the adopting release for its 2020 MD&A amendments and related guidance (No. 33-10890), the SEC fine-tuned its framework for applying the "reasonably likely" standard. We discussed that standard in our *SEC Update* issued on December 18, 2020 referred to above.

The Division's letter contain six comments relating to disclosure in MD&A:

Material effects of legislative or regulatory changes. The first MD&A comment directs the company to add to its existing disclosure information about any material effect on the company's business, financial condition, and results of operations of any material pending or existing climate change-related legislation, regulations, and international accords.

The SEC's interpretive release presents the following examples of potential positive and negative consequences of proposed climate change legislation and regulation that might trigger a disclosure obligation:

- costs to purchase, or profits from sales of, allowances or credits under a "cap and trade" regime;
- costs to improve facilities and equipment to comply with regulatory limits on greenhouse gas emissions or to mitigate the financial consequences of a "cap and trade" regime; and
- changes to a company's profit or loss as a result of changed demand for a company's goods or services resulting directly from legislation or regulation, and indirectly from changes in the cost of the company's goods.

Companies face uncertainties inherent in the legislative and regulatory processes when deciding whether a pending legislative or regulatory initiative is likely to be enacted. Under the SEC's "reasonably likely" standard for disclosing known trends and uncertainties, the determination of whether prospective climate change legislation or regulation is "likely to come to fruition" and therefore constitute a matter for potential disclosure is subject to an "objective" determination of the likelihood that the legislation or regulation will become effective. The SEC's standard would not require disclosure regarding the potential impact of such legislation or regulation if the chances of effectiveness are "remote."

The SEC indicated in its interpretive guidance that registrants should disclose, when material, the impact on their business of treaties or international accords relating to climate change. The SEC pointed out that even if the United States does not participate in particular international agreements relating to climate change, foreign operations of a domestic company may be subject to the standards established by those agreements.

Material capital expenditures for climate-related projects. The second MD&A comment directs the company to identify "any material past and/or future capital expenditures for climate-related projects" and to quantify any such material expenditures. The staff's directive may lead companies to focus, in this context, on the requirement under recently amended Item 303(b)(1)(ii) for a company to describe its "material cash requirements," which could include material demands on the company's capital resources for climate-related projects that extend beyond capital expenditures.

Indirect material consequences of climate-related regulation or business trends. In its third comment on MD&A, the staff directs the company to discuss, to the extent material, the "indirect consequences" of climate-related regulation or climate-related business trends, such as the following:

- decreased demand for goods or services that produce significant greenhouse gas emissions or are related to carbon-based energy sources;
- increased demand for goods that result in lower emissions than competing products;
- increased competition to develop innovative new products that result in lower emissions;
- increased demand for generation and transmission of energy from alternative energy sources; and
- any anticipated reputational risks resulting from operations or products that produce material greenhouse gas emissions.

The non-exclusive list of consequences is derived from the interpretive release, in which the SEC indicated that companies should consider the actual and potential indirect consequences that legal, technological, political, and scientific developments regarding climate change may have on their businesses and operations. The SEC emphasized that a company should not limit its disclosure solely to a description of material "negative consequences," since changes "in the law or in the business practices of some registrants in response to the law may provide new opportunities for registrants."

Material physical effects of climate change. The fourth MD&A comment directs the company to discuss any material physical effects of climate change on its operations and financial results, such as the following:

- severity of weather, such as floods, hurricanes, sea levels, arability of farmland, extreme fires, and water availability and quality;
- quantification of material weather-related damages to the company's property or operations;
- potential for indirect weather-related impacts that have affected or may affect the company's major customers or suppliers;
- decreased agricultural production capacity in areas affected by drought or other weather-related changes; and
- any weather-related impacts on the cost or availability of insurance.

The intensification of severe weather events in recent years is likely to result in increased disclosure of physical impacts that include, among others, harm to plants, facilities, and other physical assets and disruption of manufacturing, service, and distribution operations. The staff's comment calls for a company not only to disclose the material impacts of weather-related events on the company's own operations, but also to address potential material impacts of such events on the operations of its major customers or suppliers.

The SEC stated in its interpretive guidance that companies whose business may be vulnerable to severe weather or climate-related events should consider disclosing any material risks that could result from those types of events.

Material increased compliance costs. The fifth MD&A comment directs the company to quantify any material increased compliance costs related to climate change. Any such quantification would encompass both past and reasonably likely future material compliance costs.

Purchase or sale of carbon credits or offsets. Companies that engage in the purchase or sale of carbon credits or offsets are directed in the last MD&A comment to provide disclosure about any material effects of such transactions on their business, financial condition, and results of operations. This disclosure would address positive as well as negative consequences of climate-related changes in law or business practice, which the SEC in its interpretive guidance said companies should disclose in their filings. The SEC noted that some companies may be able to profit from the sale of allowances if their emission levels are below their emissions allotment, while other companies not subject to statutory emissions caps may profit by selling offset credits.

Looking ahead

Companies, investors, and others have responded to former Acting SEC Chair Allison Herren Lee's March 2021 request for public input on climate change disclosure with a wide range of views on the appropriate elements of a future disclosure framework. The rulemaking process for revised disclosure requirements might extend well into next year. Until the SEC adopts any rule amendments, companies will benefit from careful consideration of the Division's reminder of the application of the current disclosure requirements to climate change matters.

This SEC Update is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed in this update.

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