

Climate Alert

Significant Climate Change-Related News and Updates from the LLB&L Climate Change Practice Team

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SEC Guidance Highlights Need for Climate Change-Related Disclosures

Although recently a primary focus of the climate change debate has been whether and how greenhouse gas (“GHG”) emissions should be regulated, the issue of climate change has other legal implications for businesses beyond the possibility of direct GHG emissions regulation. One of these is the extent to which public companies must disclose to shareholders the potential impacts of climate change on their businesses. On February 2, 2010, the Securities and Exchange Commission (“SEC”) released a new interpretive guidance that seeks to clarify how the SEC’s existing disclosure requirements apply to matters affected by climate change (“[Commission Guidance Regarding Disclosure Related to Climate Change](#)” (the “Guidance”). The Guidance became effective on February 8, 2010, the date of its publication in the Federal Register.

Non-SEC Triggers for Climate Change Related Disclosures

In the Guidance, the SEC identified several recent developments that have led to disclosure of various types of climate change impacts and information by public companies, including:

- State disclosure requirements;
- EPA’s mandatory GHG emissions reporting rules, which became effective January 1, 2010;
- A uniform standard promulgated by the National Association of Insurance Commissioners (“NAIC”) that, if adopted by state regulators, would require insurance companies to disclose financial risks due to climate change; and
- A recent settlement between the New York Attorney General and three major energy companies, requiring a minimum level of disclosure in the companies’ SEC filings regarding their GHG emissions and climate change risks.

In addition, the SEC noted that public company shareholders have been increasingly calling for disclosure of the potential implications of climate change on the business of reporting companies. As a result, many companies already are participating in one or more of several voluntary climate change-related reporting initiatives, such as:

- The Climate Registry, which sets standards to calculate, verify and publicly report GHG emissions into a single public registry;
- The Carbon Disclosure Project, established by a consortium of 475 institutional investors to collect information on actual emissions as well as climate change-related risks and opportunities, to which 2,500 public companies (including over 500 U.S.-based companies) voluntarily reported in 2009; and
- The Global Reporting Initiative, a widely used reporting framework focusing on the sustainability efforts of participating companies.

While many public companies are subject to these specific reporting requirements and/or have elected to participate in a voluntary reporting initiative for one reason or another, many others have not, and even those involved in these various initiatives may not have carried over the information to their SEC reports. The SEC issued the Guidance to advise companies that although the SEC has not adopted climate change-specific reporting requirements of its own, many of the same issues that are subject to these targeted mandatory and voluntary reporting regimes can have a significant effect on the operating and financial decisions of a public company, as well as material physical effects on the company’s business and operations, and therefore may need to be included in the company’s SEC filings.

Application of Existing SEC Rules to Climate Change: The Guidance

To be clear, the SEC has not created new legal requirements or modified existing disclosure requirements. Rather, the Guidance aims to assist companies in the application of existing disclosure requirements to climate change.

The Guidance does not modify any SEC disclosure rule or modify the definition of materiality. Under the Guidance, climate change disclosure could be required under any of the following Regulation S-K disclosure items:

- **Item 101 (Description of Business):** Requires a company to disclose the material effects that compliance with environmental laws may have on the company.
- **Item 103 (Legal Proceedings):** Requires a broad description of any material pending legal proceeding involving environmental matters.
- **Item 303 (Management's Discussion and Analysis ("MD&A")):** Requires disclosure of known trends and uncertainties that a company believes will result, or are reasonably likely to result, in material changes to the company's financial condition or results of operations.
- **Item 503(c) (Risk Factors):** Requires disclosure of factors that make an investment in the company speculative or risky.

The Guidance discusses four ways in which these disclosure items may require disclosure of climate change-related issues.

1. Impact of Existing or Pending Legislation and Regulation

Companies must disclose material estimated capital expenditures necessary to comply with environmental laws pur-

suant to Item 101 of Regulation S-K. Item 503(c) may require a company to disclose risk factors regarding existing or pending legislation or regulations that relate to climate change. Also, based on Item 303, companies must assess whether enacted climate change legislation or regulation is reasonably likely to have a material effect on the company's financial condition or results of operation. With respect to pending legislation or regulation, the first step is to evaluate whether the legislation or regulation is reasonably likely to be enacted. Unless the company determines that it is not reasonably likely to be enacted, the company must assume that it will be enacted, and evaluate 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. Examples of disclosures based on the impact of pending legislation or regulation may include the costs to purchase carbon allowances or offsets under a cap and trade system, costs required in order to comply with the legislation or regulation or changes in profit or loss arising from increased or decreased demand for the company's goods and services. Importantly, the SEC also reminds companies to look on the bright side and include discussion of any opportunities that climate change or climate change regulations may provide, such as the ability to sell some of their carbon allowances or generate offsets.

2. International Accords

Companies should also consider the impact on their businesses of treaties or international accords relating to climate change. The potential disclosure obligations are similar to those discussed above for U.S. legislation and regulation.

3. Indirect Consequences of Regulation or Business Trends

Climate change regulation could have

indirect consequences on the business, including decreased demand for goods that are associated with high emissions, increased demand for goods that have lower emissions than competing products, increased competition to develop innovative products, increased demand for energy from alternative energy sources, decreased demand for services related to carbon-based energy sources and adverse consequences to a company's reputation. These trends or risks may need to be disclosed as risk factors or in the MD&A section, or if they are significant enough, disclosed in the business description under Item 101.

4. Physical Impacts of Climate Change

Companies whose businesses may be vulnerable to climate-related events should consider whether the consequences of such events must be disclosed. Companies should consider potential impacts of increased severe weather (e.g., hurricanes, flooding), water availability and quality, sea levels, and changing weather patterns over farmland.

Difficult Timing, but Limited Real Impact

Because the Guidance was released in February 2010, it comes at a time when many companies are finalizing their 2009 Form 10-K annual reports, requiring these companies to quickly reconsider and/or supplement their analysis of the potential impacts of climate change on their businesses. It also arrives in an environment where the prospect of climate change legislation from Congress or regulation by EPA is very uncertain, making accurate predictions nearly impossible. But the Guidance makes clear that the fact that federal climate change legislation or regulation has not been implemented does not mean that public companies can avoid a thoughtful

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SEC Guidance Highlights Need for Climate Change-Related Disclosures (cont'd.)

analysis and discussion of the potential impacts of pending climate change legislation or regulation on their business.

In preparing their SEC disclosure documents, companies need to consider the potential impacts of climate change on their business in light of the direction provided by the Guidance. Companies must engage in a meaningful review and analysis of all relevant financial and non-financial information relating to the impact of climate change on their business. A crucial component of this review and analysis is the consideration of whether the company has sufficient disclosure controls and procedures in place to evaluate and process this information in order to make the necessary disclosure decisions.

The Guidance is a clear signal that all public companies need to take the time to analyze the potential impact, risks and opportunities that climate change may have on their business so they can adequately disclose those issues in their SEC filings. In some cases, a thorough analysis, particularly of the potential regulatory impacts and the new market opportunities presented by climate change regulation, may require the assistance of outside advisers. Locke Lord's Climate Change Practice Team includes experienced environmental and securities lawyers who can help companies identify the issues, risks and opportunities presented by climate change and assist them in preparing their disclosure documents in accordance with the Guidance. Please contact any of the authors of this *Climate Alert* listed or your Locke Lord relationship attorney if your company is in need of assistance with these issues.

About the Authors

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