

SEC UPDATE

HOGAN &
HARTSON

SEC Guidance on Climate Change Disclosures Emphasizes Need for Early Warnings

The SEC recently issued an interpretive release providing guidance on the application of its disclosure requirements to climate change matters. Although it couched the release as a general reminder to public companies of their disclosure obligations under current requirements, the SEC emphasized the need for public companies to provide early alerts to investors of any potential material effects that may result from climate change developments. The SEC's action comes at a time when various regulatory bodies and Congress are actively considering climate change initiatives. The interpretive release (No. 33-9106) can be found at

<http://www.sec.gov/rules/interp/2010/33-9106.pdf>.

SEC's Focus on Materiality

The interpretive release does not add to or change any of the SEC's current disclosure requirements. Instead, it discusses various 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), management's discussion and analysis (Item 303), and risk factors (Item 503(c)).

In the release, the SEC emphasized that disclosure under these items would be required only if the climate change matters are material to the company. The materiality considerations discussed in the release apply to foreign private issuers as well as to domestic companies, because several provisions of the annual report filed by foreign private issuers on Form 20-F parallel the disclosure requirements of the Regulation S-K items referred to above.

Standard for Materiality. To the extent not specifically mandated by one or more of the four Regulation S-K items, disclosure of climate change developments depends on whether the developments might have a material impact on a company's business. The Supreme Court has held that information about a company is "material" if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote a company's securities or to make an investment decision with respect to the securities. According to the Supreme Court, doubts as to materiality are to be resolved in favor of investors, who are the parties which the securities laws are designed to protect. Where a speculative event that may or may not occur is involved, the Supreme Court has said that the determination of materiality at a particular time requires a balancing of the probability that the anticipated event will occur and the magnitude of the event's likely effect on the company, with probability being of lesser importance where the expected magnitude of the event is large.



General Application of Materiality Standard. A company faced with the need to make materiality judgments involving climate change developments should take into account not only the actual effects of these developments on its business to date, but also the potential future effects of any known trends, events or uncertainties that are reasonably likely to occur. The SEC has made it clear that it expects registrants to be sensitive to the need to warn investors at any early stage, through forward-looking statements, of the potential effects of climate change developments that may cause its prior results not to be predictive of future performance.

Relevant Developments

The SEC's action follows the submission of a number of public petitions for rulemaking from environmental and other groups seeking more disclosure by companies regarding climate change matters. In addition, legislative, regulatory, and other initiatives have contributed to the SEC's heightened attention to the need for public companies to disclose material climate change developments. These include:

- Legislation and regulations by state and local governments that have increased the regulation of greenhouse gas emissions;
- Proposed legislation pending in Congress to limit these emissions;
- Actions by the Environmental Protection Agency to control these emissions under the Clean Air Act and to take other steps to limit the emissions;
- Efforts by members of the international community to address climate change issues on a global basis; and
- The adoption of a uniform standard by the National Association of Insurance Commissioners for mandatory disclosure by insurance companies to state regulators of financial risks arising from climate change developments and actions taken by the companies to mitigate the risks.

The interpretive release acknowledges the significance of these developments, and indicates how the developments should be analyzed for purposes of possible disclosure under one or more of the Regulation S-K items.

Climate Change Disclosure under Regulation S-K

The SEC notes in the release that the need for climate change disclosure may arise by reason of the effects of legislation or regulation to which the company is or may be subject, the indirect effects of climate change, such as changes that may affect suppliers, customers or others whose relationships with the company may affect the company's business or operations, and the direct physical effects of climate change.

Item 101 - Description of Business. Item 101 of Regulation S-K requires a narrative description of the business of a company and its subsidiaries that must include disclosure of certain costs of complying with environmental laws. Among other things, the disclosure must address any material

effects on the capital expenditures, earnings, and competitive position of a company resulting from its compliance with federal, state, and local environmental laws. The item requires disclosure not only of past effects on the company's business, but also any future material effects that could result from the need to comply with environmental laws.

The SEC cites a company's plan to reposition itself to take advantage of potential opportunities presented by a climate change development, such as through material acquisitions of plants or equipment, as one example of a situation in which disclosure of future effects on the business may be required.

Item 103 - Legal Proceedings. Item 103 of Regulation S-K generally requires disclosure of any material pending legal proceedings to which a company is a party or to which its property is subject, as well as any similar actions known to be contemplated by governmental authorities. Among the actions required to be disclosed are any administrative or judicial proceedings arising under any federal, state or local environmental laws that either (1) are material to the company's business or financial condition, (2) involve damage claims, potential monetary sanctions, or charges to income exceeding 10 percent of the consolidated current assets of the company and its subsidiaries, or (3) involve a governmental authority and potential monetary sanctions of \$100,000 or more. The SEC points out in the interpretive release that the exception provided by Item 103 for "ordinary routine litigation incidental to the business" of the company is not available for administrative or judicial proceedings involving issues arising under environmental laws.

Item 303 - MD&A. Item 303 requires a company's disclosure documents to contain a management's discussion and analysis of financial condition and results of operations (MD&A). Consistent with its emphasis on the need for disclosure of potential future effects of climate change developments, the interpretive release pays particular attention to the MD&A requirement to disclose any known trends or uncertainties reasonably likely to have a material impact on the company's liquidity, capital resources, and results of operations. The release states that disclosure decisions concerning trends, demands, commitments, events, and uncertainties generally should involve the:

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

The release adds that:

- The time frame to be considered in assessing the impact of a known trend, event, or uncertainty that is reasonably likely to occur will vary, depending on a registrant's particular circumstances;

- Materiality determinations at any particular time will depend on a balancing of the probability that a speculative event will occur and the anticipated magnitude of the event;
- When making materiality judgments, management should consider (1) all financial and non-financial information (including information not required to be disclosed) relevant to the development under consideration, and (2) whether the company's disclosure controls and procedures are sufficient to process the information; and
- When material, management should (1) address the difficulties involved in assessing the effects of the amount and timing of uncertain events, (2) provide an indication of the time periods in which the uncertainties are expected to be resolved, and (3) disclose any other information believed necessary to an understanding of the company's financial condition and any changes in that condition and the company's results of operations.

Among the matters that a company must assess when preparing the MD&A are the effects of pending legislative or regulatory changes that might have a material impact on the company. As with other developments that may or may not reach fruition, the company should make a two-step assessment when deciding whether disclosure of the proposed changes is required:

- Is the event (*i.e.*, the enactment of the legislation or adoption of the regulation) reasonably likely to occur? and
- If so, is the event reasonably likely to have a material effect on the company, its financial condition, or its results of operations?

Where both questions are answered affirmatively, disclosure in the MD&A is required. The disclosure should include, if material, the difficulties involved in assessing the timing and effect of the pending legislation or regulation.

Item 503(c) - Risk Factors. Item 503(c) requires a company to discuss the most significant factors that make an investment in its securities speculative or risky. In the risk factors section of its disclosure documents, the company must disclose all significant environmental risks affecting it, such as those relating to climate change, contingencies or compliance, litigation and hazardous material exposure. For example, the risks a company may face as a result of climate change legislation may require disclosure in the risk factors section, although, as with all risk factors, the disclosure should detail the specific risks to the company rather than the generic risks that could apply to any company.

Triggers for Climate Change Disclosures

The release provides four examples of relatively common situations involving climate change developments, each of which is described below, that may create a disclosure obligation for companies affected by the developments.

Impact of Legislation and Regulation. Federal or state legislation or regulation involving climate change concerns may trigger risk factor disclosure as well as disclosure in the MD&A. For

example, energy companies that have greenhouse gas emissions may be exposed to material risks from legislation or regulation seeking to limit the emissions. Actions such as the EPA's issuance on April 1, 2010 of the first-ever Clean Air Act standards controlling the greenhouse gas emissions from new motor vehicles and engines could trigger an obligation for many companies to provide new or updated risk factors.

The interpretive release includes 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" system;
- Costs to improve facilities and equipment to comply with greenhouse gas emission legislation; 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.

When deciding whether a pending legislative or regulatory initiative is "reasonably likely to be enacted" and therefore would give rise to a disclosure obligation if its effects would be material, registrants are hampered by the uncertainties inherent in the legislative and regulatory processes. For example, despite the assurance given by members of Congress and the President that climate change legislation would be passed in 2009, no such legislation was enacted. The difficulty facing public companies regarding this aspect of the disclosure process is how reasonably to assess the likelihood that pending legislation will be enacted when a large amount of legislation is introduced each year in Congress and even the "top priority" bills often are not enacted. The answer may be that, because the courts often resolve close questions of materiality in favor of investors, it is prudent to assume that legislative or regulatory initiatives that appear to be receiving serious consideration have a reasonable likelihood of becoming law.

Effect of International Accords. The SEC indicated in the release that registrants should disclose, when material, the impact on their business of treaties or international accords relating to climate change. These would include the Kyoto Protocol, the European Union's Emissions Trading System, and other international activities relating to climate change remediation that either are completed or in progress. The release points out that although the United States may not ratify international agreements relating to climate change, such as the Kyoto Protocol, foreign operations of a domestic company may be subject to the standards established by those agreements, thereby opening up the issue of possible disclosure.

Indirect Consequences of Regulation or Business Trends. The interpretive release indicates that companies should consider the actual and potential indirect risks which legal, technological, political, and scientific developments regarding climate change may have on their businesses and operations. The company may have to disclose those risks in its MD&A or in the risk factor and

business sections of its disclosure documents. The SEC cites the following as examples of developments that may have indirect consequences for companies and require disclosure:

- Decreased demand for goods producing significant greenhouse gas emissions;
- Increased demand for goods with lower emissions than competing products;
- Increased competition to develop innovative new products;
- Increased demand for energy generated from alternative energy sources;
- Decreased demand for services that use carbon-based energy sources; and
- Possible reputational damage resulting from adverse public reaction to publicly available data relating to the company's greenhouse gas emissions.

Disclosure would be required if any of these consequences are considered reasonably likely to have a material effect on the company's business.

Physical Impacts of Climate Change. The SEC indicated in the release that material risks to a company's financial condition and results of operations can arise from the actual or potential physical effects of climate change on the company's business. For example, severe weather (such as hurricanes and floods), non-arable farmland, sea levels, and water availability and quality have the potential to affect a company's operations and results. Some of the consequences of severe weather could include:

- Property damage or business disruptions for companies with coastline operations;
- Disruptions to the operations of major customers or suppliers from severe weather;
- Increased insurance claims and insurance liabilities for insurance companies;
- Decreased capacity for agricultural production and capacity due to drought; and
- Increased insurance premiums and deductibles or a decrease in availability of coverage for companies with operations in areas subject to severe weather.

The SEC cautioned companies whose business may be vulnerable to severe weather or climate-related events that they should consider disclosing any material risks or consequences that could result from these types of events.

Accounting Standards

In the interpretive release, the SEC reminded companies of the accounting standards and guidelines that govern the treatment of environmental liabilities, including those requiring material loss contingencies for events that are more than remote. In addition to the accounting standards discussed in the release, registrants should become familiar with standard E2718-10, released on

April 1, 2010 by ASTM International. The standard provides guidance on the processes for identifying, quantifying, and disclosing potential material impacts related to climate change in disclosure that accompanies audited and unaudited financial statements.

What's Next

The interpretive release may not be the last word by the SEC on the disclosure of climate change developments. The release reflects the SEC's belief that existing disclosure requirements are sufficient, if properly applied by reporting companies, to meet the need of the investing public for accurate and complete information regarding material climate change effects. The possibility exists, however, that the SEC may determine, after monitoring the operation of the current requirements, that the existing framework is not producing adequate disclosures. The SEC has warned that, if it makes such a determination, it will take further action (which may include rulemaking) to address any deficiencies. In deciding whether corrective measures are necessary, the SEC is likely to consider the results of its own internal monitoring of the current disclosure regime, the advice received from its Investor Advisory Committee, and the views expressed at a roundtable planned for this spring to discuss climate change disclosure issues. Regardless of what additional action (if any) may be in store for the future, registrants should be prepared for increasing SEC staff scrutiny of their climate change disclosures.

For more information about the topics discussed in this publication, please contact the Hogan & Hartson attorney with whom you work or any of the attorneys listed below.

PETER J. ROMEO
piromeo@hhlaw.com
202.637.5805
Washington, D.C.

RICHARD J. PARRINO
rjparrino@hhlaw.com
202.637.5530
Washington, D.C.

AMY BOWERMAN FREED
abfreed@hhlaw.com
212.918.8270
New York

MICHAEL J. SILVER
mjsilver@hhlaw.com
410.659.2741
Baltimore

PATRICK D. TRAYLOR
pdtraylor@hhlaw.com
202.637.6866
Washington, D.C.

JENNIE E. INGRAM
jeingram@hhlaw.com
212.918.3540
New York

This Update is for informational purposes only and is not intended as basis for decisions in specific situations. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship.

Copyright © 2010 Hogan & Hartson LLP. All rights reserved. Hogan & Hartson LLP is a District of Columbia limited liability partnership with offices across the United States and around the world. Some of the offices outside of the United States are operated through affiliated partnerships, all of which are referred to herein collectively as Hogan & Hartson or the firm.

www.hhlaw.com