

## Environment

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# Alert

## New Climate at the SEC: The SEC Publishes New Guidance on Climate Change Disclosures

Laurie L. Green

Bonni F. Kaufman



After years of pressure from public interest groups, state pension funds and institutional investors, the Securities and Exchange Commission (SEC) recently issued long awaited guidance which clarifies public companies' responsibilities for disclosing the effects of climate change on their business. On February 2, 2010, the SEC published its interpretive release titled "Commission Guidance Regarding Disclosure Related to Climate Change," which will be published in the Federal Register this week.



The interpretive guidance does not create new disclosure requirements, but clarifies existing Regulation S-K reporting obligations, particularly existing requirements with respect to the impact of environmental laws on business operations and profitability.

The relevant rules cover a company's disclosure obligations in the risk factors, business description, legal proceedings, and management's discussion and analysis (MD&A) sections in SEC filings.

In its discussion of the background and purpose of the interpretive guidance, the SEC recognizes that there has been heightened interest in climate change. The guidance specifically points to the Environmental Protection Agency's (EPA) endangerment finding in December 2009 that greenhouse gases present an endangerment to the environment, allowing federal regulation of greenhouse gas emissions under the Clean Air Act. (See <http://epa.gov/climatechange/endangerment.html>.) In addition, the SEC notes in the release that on January 1, 2010, the EPA began to require mandatory reporting for large emitters of greenhouse gases. The EPA's

rule requires over 10,000 facilities to collect and report data with respect to their greenhouse gas emissions, which covers 85 percent of gas emissions in the United States. The SEC also recognized international regulation of greenhouse gas emissions such as the Kyoto Protocol, the European Union Emissions Trading System and the recent United Nations Climate Conference in Copenhagen. All U.S. companies that operate in the EU are subject to these requirements. In addition, many states require disclosure of carbon emissions for electricity providers and other large emitters.

Noting that the impact of these climate change regulatory developments could have a significant affect on operating and financial decisions, including those involving capital expenditures to reduce emissions and purchases of emissions credits, the SEC voted in favor of issuing the guidance.

### Emphasis on Current Sources of Information Regarding Climate Change

The release emphasizes that there have been repeated calls for climate-related disclosures by shareholders of public companies, including several petitions for interpretive advice by large institutional investors and other investor groups. Much information is available outside of the public company disclosure documents filed with the SEC, including the Climate Registry, the Carbon Disclosure Project and the Global Reporting Initiative, which are all sustainability frameworks and data collection systems. Even though materiality determinations may limit what is disclosed, the SEC noted in the release that materiality considerations "should not limit the information that management considers in making its

determinations.” Thus, companies will have to pay greater attention to regulatory and economic developments related to climate change and carbon emissions – even if these developments may not ultimately be material for reporting purposes.

## Overview of Rules Requiring Disclosure of Climate Change Issues

In the release, the SEC described the most pertinent non-financial statement disclosure rules that may require disclosure related to climate change.

### Description of Business

Item 101 of Regulation S-K expressly requires disclosure regarding costs of complying with environmental laws.

- Item 1010(c)(1)(xii) requires disclosure of the material effects that compliance with federal, state and local laws regulating the discharge of materials into the environment or relating to the protection of the environment have upon the capital expenditures, earnings and competitive position of the company and its subsidiaries.
- Smaller reporting companies must disclose the costs and effects of compliance with federal, local and state environmental laws pursuant to Item 101(h)(4)(xi).

Public companies have been subject to these environmental reporting requirements for many years and most companies generally include a broad statement in their SEC reports with respect to the fact that the company has to comply with environmental laws and regulations and could become subject to more regulation in the future. The SEC’s new guidance appears to imply that a more specific disclosure is necessary in terms of climate change impacts and the likelihood of future emissions controls arising out of pending climate change regulations.

### Legal Proceedings

Item 103 of Regulation S-K requires disclosure of material pending litigation involving the company or its subsidiaries, other than ordinary routine litigation incidental to its business. Instruction 5 to Item 103 provides that certain environmental litigation will not be deemed ordinary litigation and must be described if:

- The proceeding is material to the company’s business or financial condition.
- The claim for damages exceeds 10% of the company’s consolidated current assets.

- The government is a party to the proceeding and the proceeding involves monetary sanctions, unless the company reasonably believes there will be no monetary sanctions, or that the sanctions will be less than \$100,000.

At the present time there is little to no litigation pending against companies that is specifically related to climate change concerns (although the New York Attorney General has brought several lawsuits against energy companies for failing to disclose climate change impacts under New York securities laws). However, the EPA is evaluating the issuance of new regulations as a result of its finding that greenhouse gases present an endangerment to the environment. EPA enforcement actions against companies that emit even small amounts of greenhouse gases could become subject to these litigation disclosure requirements in the future.

### Risk Factors

Item 503(c) of Regulation S-K requires a discussion of the most significant factors that make an investment in the company speculative or risky. Such risks should be specific to the particular company, and not generic to any company or any offering. With respect to climate change, companies in the utility, energy, insurance and fuel sectors are particularly subject to unique risks from climate change regulation and should evaluate their disclosures carefully in the light of the guidance.

### Management’s Discussion and Analysis

Item 303 of Regulation S-K requires that companies 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. The SEC reiterated that when a trend, demand, commitment, event or uncertainty is known, management must make two assessments:

- 1) 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.
- 2) 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 operations is not reasonably likely to occur.

## Climate Change-Related Disclosures

Depending on a company's particular facts and circumstances, each of the above items may require disclosure regarding the impact of climate change. The release highlights the following areas as examples of where climate change may trigger disclosure requirements:

- **Impact of Legislation and Regulation:** When assessing potential disclosure obligations, a company should consider whether the impact of certain existing or pending laws and regulations regarding climate change is material. With respect to the potential impact of pending laws and regulations, companies must use the two-step assessment process described above to determine whether disclosure is required in the MD&A. Examples of possible consequences of pending legislation include:
  - costs to purchase, or profits from sales of, allowances or credits under a “cap and trade” system
  - costs required to improve facilities and equipment or reduce emissions in order to comply with regulatory limits or to mitigate the financial consequences of a “cap and trade” regime
  - changes to profit or loss arising from increased or decreased demand for goods and services produced by the company arising directly from legislation or regulation, and indirectly from changes in costs of goods sold
- **Impact of International Accords:** A company should consider, and disclose when material, the risks or effects on its business of international accords and treaties relating to climate change.
- **Indirect Consequences of Regulation or Business Trends:** Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for companies. For instance, a company may face:
  - decreased demand for goods that produce significant greenhouse gas emissions
  - increased demand for goods that result in lower emissions than competing products
  - increased competition to develop innovative new products
  - increased demand for generation and transmission of energy from alternative energy sources
  - decreased demand for services related to carbon-based energy sources, such as drilling services or equipment maintenance services

These business trends or risks may be required to be disclosed as risk factors or in the MD&A. Also, if the development will have a significant impact on a company's business, disclosure may be required in the business section. For example, where a company repositions itself to take advantage of potential opportunities through material acquisitions of plants or equipment, disclosure of this shift in the plan of operation may be required in the business section.

A company should also consider risk factor disclosure of the impact on a company's reputation. For example, a company may have to consider whether the public's perception of any publicly available data relating to its greenhouse gas emissions could expose it to potential adverse consequences to its business operations or financial condition resulting from reputational damage.

- **Physical Impacts of Climate Change:** The guidance also instructs companies to evaluate for disclosure purposes the actual and potential material impacts of environmental matters on their business. Significant physical effects of climate change, such as effects on the severity of weather (*e.g.*, floods or hurricanes), sea levels, the arability of farmland, and water availability and quality have the potential to affect a company's operations and results. The following are the SEC's examples of possible consequences of severe weather:
  - for companies with operations concentrated on coastlines, property damage and disruptions to operations
  - disruptions to the operations of major customers or suppliers
  - increased insurance claims and liabilities for insurance and reinsurance companies
  - decreased agricultural production in areas affected by drought
  - increased insurance premiums and deductibles

## Conclusion

Just as the general public has become more aware of climate change impacts and many households, government agencies, municipalities and public interest groups have made greater efforts to reduce their carbon footprint, the SEC has become aware that climate change can have a real financial impact on public companies and their long-term investments and profitability. As a result, the SEC will be taking a harder look at public company general environmental disclosures, with a particular emphasis on climate change disclosures.

The SEC guidance is effective immediately and should be considered in drafting the annual report and other SEC filings. The release can be found at <http://www.sec.gov/rules/interp/2010/33-9106.pdf>.

Holland & Knight lawyers can provide assistance with SEC reporting, climate change compliance issues and other related legal issues.

**For more information, contact:**

**Laurie L. Green (SEC Reporting Issues)**  
954.468.7808 | [laurie.green@hklaw.com](mailto:laurie.green@hklaw.com)

**Bonni F. Kaufman (Climate Change and Environmental Issues)**  
202.419.2547 | [bonni.kaufman@hklaw.com](mailto:bonni.kaufman@hklaw.com)

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## About the Authors

**Laurie L. Green** is a Partner representing public companies in the areas of securities, mergers and acquisitions and corporate governance. Her practice includes the representation of public companies in public and private offerings of debt and equity securities, mergers and acquisitions, exchange offers, cash tender offers, cross-border tender offers, and distressed debt restructurings and the preparation of proxy statements, annual reports and other reports under the Securities Exchange Act of 1934.

**Bonni F. Kaufman** is a Partner in the firm's Public Policy and Regulation Group where she focuses on environmental law. Ms. Kaufman represents real estate, industrial, transportation and manufacturing clients in a wide variety of matters focusing on regulatory enforcement and compliance, environmental aspects of corporate and real estate transactions, and litigation. She counsels clients on compliance with the Clean Water Act, Clean Air Act, RCRA, CERCLA, TSCA, FIFRA and state law. Ms. Kaufman represents developers, lenders, and bond issuers in connection with military housing privatization projects. She also advises clients on the purchase, sale and development of environmentally impacted properties and brownfields development; and for the resolution of environmental claims in bankruptcy.

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