

Alert 10-032

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SEC Issues Interpretive Guidance About Climate Change Disclosures for Public Companies

On February 2, 2010, the Securities and Exchange Commission (the "SEC") issued its previously announced interpretive guidance addressing public company disclosure standards in connection with climate change.

The interpretive guidance reflects an effort by the SEC to provide companies with greater clarity about existing obligations under the federal securities laws that relate to climate change and its consequences. While the interpretive guidance comes partly in response to several petitions from institutional investors and advocacy organizations, the SEC's intent was not to establish new legal requirements or modify existing rules. The touchstone of climate change disclosure will continue to be governed by the well-established "materiality" standard.

The following is a brief summary of the key disclosure areas addressed in the interpretive guidance:

- **Impact of Legislation and Regulation:** Depending on the facts and circumstances of a particular company, federal and state legislation and regulation regarding climate change may trigger disclosure obligations under SEC rules and regulations, pursuant to Items 101, 103, 503(c), and 303 of Regulation S-K.
 - **Business:** Item 101 of Regulation S-K requires a company to describe its business and that of its subsidiaries, such as its form of organization, principal products and services, major customers, and competitive conditions. It also expressly requires disclosure regarding certain costs of complying with environmental laws, as well as disclosure of material estimated capital expenditures for environmental control facilities. Thus, disclosure may be required if compliance with environmental laws creates a material effect on the company or its subsidiaries. A material effect could be a function of capital expenditures, earnings, products and services, raw materials, or the competitive position of the company and its subsidiaries.
 - **Legal Proceedings:** Item 103 of Regulation S-K requires a company to describe any material pending legal proceeding to which it or any of its subsidiaries is a party, excluding ordinary routine litigation incidental to its business. Item 103 additionally states that environmental litigation shall not be considered an "ordinary routine litigation" if the proceeding: (1) is material to the business or financial condition of the company, (2) involves damages that exceed 10 percent of the current assets of the company and its subsidiaries on a consolidated basis, or (3) involves a governmental authority as a party, and the proceeding involves potential monetary sanctions of \$100,000 or more. Accordingly, it is currently required that certain environmental proceedings be disclosed, and the enactment of climate-change-related laws and regulations may require additional disclosures in this area in the future.
 - **Risk Factors:** Item 503(c) of Regulation S-K requires a company to discuss significant factors that make an investment in the company speculative or risky. Companies should consider specific risks they face as a result of legislative and regulatory developments related to climate change, as well as potential physical effects, and avoid generic risk-factor disclosure that could apply to any company. Thus, companies that are particularly

sensitive to climate change developments, such as companies in the energy sector or energy-intensive manufacturing operations such as cement, aluminum, glass, steel and petroleum refining, will likely need to disclose and discuss the material risks to their business related to climate change issues. For example, water-dependent businesses such as agriculture, as well as energy producers and many other manufacturers that use water in cooling processes, may need to disclose possible curtailments in water supply during drought conditions, or the increased costs of compliance with regulatory initiatives intended to limit water usage.

- **Management's Discussion and Analysis:** Item 303 of Regulation S-K requires a company to assess whether climate change legislation or regulations, as well as the physical effects of climate change, are reasonably likely to have a material effect on the company's financial condition or results of operation. If material to the company, the effects must be disclosed in the Management's Discussion and Analysis section. With respect to climate change legislation that is pending but has not been enacted, its effects on the company may still necessitate disclosure unless: (1) management determines it is not reasonably likely to be enacted, or (2) if enacted, the effects will not be material to the company. In addition to disclosing the potential effect of pending legislation or regulation, the company also has to consider disclosure, if material, of the difficulties involved in assessing the timing and effect of the pending legislation or regulation. For example, if compliance with the new mandatory EPA greenhouse gas ("GHG") regulation has a material effect on operations or financial conditions, that may need to be disclosed. On a state level, about half of the states have broad plans aimed at reducing carbon dioxide emissions. Six states—California, Connecticut, Hawaii, Massachusetts, Maryland and New Jersey—have already adopted binding caps on GHG emissions.
- **Impact of International Accords:** Companies should consider, and disclose when material, the impact on their business of treaties or international accords relating to climate change. Companies whose businesses are reasonably likely to be affected by such agreements should monitor the progress of any potential agreements and consider discussing their effects in the Management's Discussion and Analysis section. For example, U.S. carriers flying into Europe may need to evaluate the impact of the EU directive subjecting them to the EU's scheme for greenhouse gas emission allowance trading.
- **Indirect Consequences of Regulation or Business Trends:** Companies may come across new opportunities or risks arising from legal, technological, and scientific developments in connection with climate change. These developments may create demand for new products or services, or decrease demand for existing products or services. These business trends (positive and negative) and risks may be required to be disclosed as Risk Factors or in the Management's Discussion and Analysis section. Companies should also evaluate their own particular facts and circumstances to assess whether these developments may have a material-enough impact to require disclosure in the Business section. Companies whose opportunities for GHG offset reductions and subsequent sale are particularly lucrative may want to disclose those opportunities.
- **Physical Impacts of Climate Change:** Companies should consider whether they may be vulnerable to severe weather or climate-related events. Significant physical effects of climate change, such as floods, hurricanes, the arability of farmland, and water availability, have the potential to affect a company's operations and results. Possible consequences of severe weather could include:
 - Property damage and disruptions for companies with operations concentrated on coastlines
 - Financial and operational impacts from disruptions to the operations of major customers or suppliers
 - Increased insurance premiums and deductibles, or a decrease in the availability of coverage

If the company determines it is susceptible to such weather or climate-related events, it should consider disclosing material risks of, or consequences from, such events in its publicly filed disclosure documents.

Given the SEC's recent focus on risk management by public companies, this guidance should serve as an important reminder for public companies to assess whether climate change may have a material impact upon their business and financial condition. As public, political, and scientific attention to climate

change continues to mount, companies should expect a greater focus by the SEC and third-party observers in reviewing and evaluating disclosure practices related to climate change.

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For more information on the SEC's interpretive guidance and the legal consequences of climate change, contact one of Reed Smith's securities or environmental attorneys listed below, or your regular Reed Smith attorney.

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