

ADVISORY

SULLIVAN & WORCESTER LLP CLIMATE-RELATED BUSINESS & TECHNOLOGY ADVISORY

Imperatives for Climate Change-Related Disclosures in SEC Filings Continue to Mount

Companies' exposure to the impact of climate change and related legislation and rulemaking continues to rapidly evolve. As a result, and given persistent outcry from investor groups, coalitions of non-governmental organizations and climate change activists, and political leaders, the SEC may soon explicitly require companies to make specific climate change-related disclosures in their filings. In anticipation of SEC action, this advisory discusses (1) the sources of pressure most likely to cause the SEC to adopt rules specifically requiring disclosures relating to exposures associated with climate change; (2) the current SEC rules requiring disclosures of material information concerning the nature of certain environmental impacts; (3) disclosures that a company may be required to make in the future regarding climate change-related exposures; and (4) the steps that companies may consider taking to prepare for these anticipated new rules.

It is important to understand that the specific disclosures that the SEC may soon impose regarding climate change-related exposures and liabilities are expected to apply to most companies, not just those in industry sectors that may be required to limit their greenhouse gas, or GHG, emissions. Anticipated changes to the physical environment, rising consumer demand for "sustainable" products, potential supply chain disruptions, and other climate change-related impacts also are considered relevant to companies' financial and competitive forecasts. Indeed, if climate change brings the rising sea levels and weather severity predicted in the models adopted by the U.S. Environmental Protection Agency, virtually every business will be vulnerable to climate change in some way. Companies with assets susceptible to climate change-related impacts include those in shipping, agriculture, infrastructure, and construction. Companies involved with real estate and facilities located at sea level also may be vulnerable to rising waters, and thus may be affected by projected changes in the weather. Energy utilities and other emitters of climate-affecting GHGs, heavy energy users, and companies dependent on the supply chains served by such entities potentially face significant increased costs and disruptions.

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Companies' risk management costs also may escalate, as insurers increasingly probe climate change-related risks in the underwriting process. Moreover, litigation against GHG emitters is likely to arise from the EPA's recently issued proposed finding that GHGs threaten the public health and welfare. While many companies that are not in climate-related businesses may have appropriately concluded that climate change presently has no material impact on their current or near-term financial results, nonetheless, these companies will need to continue to evaluate their potential disclosure obligations as new scientific data and legislation emerge.

SEC Pressured to Require Specific Climate Change-Related Disclosures

The SEC faces growing pressure, both directly and indirectly, to adopt rules specifically requiring climate change-related disclosures. Most notably, this pressure stems from political leaders, investor coalitions, and environmental interest groups.

In September of 2007, under New York's sweeping securities law known as the Martin Act, New York Attorney General Andrew Cuomo issued subpoenas to five energy companies and subpoenaed the executives of several of these companies seeking information concerning whether investor disclosures in their filings adequately described the companies' financial risks related to their GHG emissions. During 2008, Attorney General Cuomo announced that settlements had been reached with two of these companies, Xcel Energy Inc. and Dynegy Inc., whereby each company agreed to make disclosures in its annual report on Form 10-K regarding financial risks associated with, and strategic analysis relating to, present and probable future climate change regulation and legislation; climate change-related litigation; and physical impacts of climate change. The precedent set by New York's Attorney General, together with the likely enactment of federal GHG legislation and regulations in the near future, places pressure on the SEC to adopt disclosure rules that recognize the growing concerns about climate change and its potential impact on companies' financial and competitive positioning.

The SEC also has come under pressure from investor coalitions requesting both interpretative guidance regarding the nature of required disclosures concerning climate change, and that

the SEC require specific disclosures. For example, in October of 2006, a coalition of institutional investors, environmental groups and others released the Global Framework for Climate Risk Disclosure whereby companies are urged to disclose specific information regarding climate change and its impact on the company. Similarly, in September of 2007, another coalition, which included New York's Attorney General, petitioned the SEC requesting the issuance of interpretive guidance clarifying companies' climate change-related disclosure obligations. Furthermore, in October of 2008, in response to the SEC's request for comments on ways to modernize its disclosure system, a coalition of institutional investors requested, among other things, that the SEC create a subcommittee to consider how material environmental data can be included in companies' filings.

Climate change lobbying before Congress also serves as a pressure point for the SEC's adoption of rules regarding the disclosure of climate change-related concerns. While no proposed climate change bills have been signed into law, their terms are indicative of what may be enacted if and when federal legislation requiring climate change disclosures comes to pass. For example, in the last Congress, the proposed Global Warming Pollution Act and the Global Warming Reduction Act each would have required the disclosure of financial risk in connection with GHG emissions and the potential impact of climate change on the company. The proposed legislation also would have required the SEC to issue interpretive guidance clarifying companies' disclosure obligations regarding climate change-related risk. Moreover, the proposed Lieberman-Warner Climate Security Act would have required the SEC to adopt regulations requiring disclosure of material risks relating to climate change. While none of the currently pending legislation specifically directs the SEC to require disclosures related to climate change, pending legislation such as the Greenhouse Gas Registry Act would require the annual reporting of GHG emissions by certain "covered entities," as defined therein, to the EPA. Given the existing obligations of public companies to submit periodic filings to the SEC and the likely need to facilitate compliance with periodic GHG disclosures such as those contained in the Greenhouse Gas Registry Act, proposed legislation

specifically aimed at requiring SEC climate change-related disclosures is a logical next step.

Current SEC Environmental Disclosure Rules

Presently, the SEC rules do not explicitly require that companies make disclosures about climate change or its impact on the company's financial condition or competitive position. Nonetheless, the SEC's Regulation S-K, which applies to various filings such as quarterly and annual reports and registration statements, as well as other securities laws, requires "material" disclosure of certain environmental impacts.

Item 101 of Regulation S-K, which provides for a general description of the company's business, requires disclosure as to "the material effects that compliance with federal, state and local provisions ...regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the company." The requirements of Item 101 are not limited to disclosure of the current environmental regulatory impact on a company's financial position, but may also require forecasting as to the anticipated impact of future environmental regulation. Item 101 states that the company "shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and for such further periods as the registrant may deem material." Although no federal climate change laws currently exist as to which a company would be required to disclose the material effect of compliance, Congress is expected to enact such laws in the foreseeable future. The contours of such legislation have begun to take shape over the past two Congresses; thus, companies may begin to predict the manner in which they are likely to be affected. Furthermore, companies operating in certain states that have enacted climate change legislation, or in countries that are signatories to international agreements requiring climate change regulation, should consider whether the effects of compliance with such statutory or regulatory requirements will be material and thus trigger disclosure under Item 101.

Item 103 of Regulation S-K, relating to the disclosure of certain legal proceedings, requires disclosure as to "any material pending legal

proceedings, other than ordinary routine litigation incidental to the business." Examples of legal proceedings involving climate change have emerged with respect to nuisance claims against companies emitting significant amounts of GHGs. Such litigation, should it be deemed "material" and not "ordinary routine litigation," would trigger disclosure under Item 103. The Instructions to Item 103 help to clarify the SEC's position regarding whether certain environmental proceedings are considered "ordinary routine litigation." The Instructions state that disclosure is required regarding "an administrative or judicial proceeding . . . arising under any federal, state or local provisions . . . regulating the discharge of materials into the environment or primary [sic] for the purpose of protecting the environment."

Item 303 of Regulation S-K, which provides for management's discussion and analysis of the company's financial condition, or MD&A, requires disclosure of "known trends or uncertainties" that a company believes will result, or are reasonably likely to result, in material changes in the company's liquidity, net sales, revenues or income from continuing operations. While climate change arguably is becoming a known trend and/or uncertainty that may impact a company's financial condition, nonetheless, many companies have concluded that the impact of climate change or impending climate change-related regulations is not yet material to their businesses.

Item 503(c) of Regulation S-K, which provides for disclosure of risk factors that make investment in the company "speculative or risky," requires a company to disclose such risk factors, but only to the extent they are not generally applicable to "any issuer." Examples of climate change-related risk factors that at some future point may require discussion pursuant to Item 503 include (1) risks to the business of the company such as increased transportation or energy costs, or supply chain disruption; (2) increased costs associated with environmental compliance; (3) market risks associated with any public perception of being environmentally unfriendly; and/or (4) risks associated with increased litigation spawned by climate change activists.

Additional SEC rules may compel disclosure of climate change-related matters in a company's SEC filings. First, Rule 10b-5 of the Securities

Exchange Act of 1934 prohibits making any untrue statement of a material fact or omitting to state a material fact necessary for a statement not to be misleading. The U.S. Supreme Court has stated that omitted facts are material if they significantly alter the "total mix" of information available to investors. Given the mounting pressure, the SEC could conceivably take the view that a company's failure to make material climate change-related disclosures significantly alters the "total mix" of information available to investors. In such circumstances, a company may run afoul of the anti-fraud provisions of Rule 10b-5.

Second, SEC rules require that the financial statements to be included in SEC filings must be prepared in accordance with generally accepted accounting principles, or GAAP. Under GAAP, a company must recognize a "loss contingency" in its financial statements if a loss is probable, and the expected loss is material and reasonably estimated. Even if such loss is not probable or is probable but not reasonably estimated, the company still must disclose the nature of such loss in its financial statement notes. Therefore, a company should consider disclosure of probable loss contingencies associated with climate change and the existing or impending regulation related thereto, in its financial statements filed with the SEC.

In an effort to eliminate ambiguity regarding whether loss contingencies associated with climate change must be disclosed, the Financial Accounting Standards Board, or the FASB, issued a draft proposal entitled *Disclosure of Certain Loss Contingencies: An Amendment of FASB Statements No. 5 and 141(R)*. Under the FASB proposal, the disclosure of loss contingencies associated with certain climate change-related matters would be required. Although the proposal currently is being redrafted following the receipt of numerous comments from supporters and opponents, significant portions of the required climate change-related disclosures appearing in the initial draft may remain in the proposal's final form, which is expected to take effect for fiscal years ending after December 15, 2009.

Anticipated SEC Climate Change-Related Disclosure Requirements

Given recent political activism, heightened investor demands, and proposed legislation, it now may be

prudent to consider the need for inclusion of climate change-related disclosures in SEC filings, even though such disclosures are not explicitly required to be made under current SEC rules. Examples of the types of climate change-related disclosures that may be required under proposals presently circulating include:

- The current and expected impact of climate change-related legislation, regulation, and litigation on a company's liquidity, capital resources, and financial condition;
- The company's position on climate change (e.g., as it relates to its operations and facilities), with an explanation of the company's policies or strategies for addressing GHG emissions reduction;
- Risk factors associated with climate change, including (1) physical risks to the company's business, operations and supply chain; (2) competitive or market risks associated with any perception of the company being environmentally unfriendly; (3) potential liability associated with GHG emissions; and (4) financial or litigation risks resulting from the need to achieve compliance with existing or proposed climate change regulation;
- The company's management practices concerning GHG emissions, and related corporate governance matters;
- Data on a company's GHG emissions, including historical, current, and projected future emissions;
- A list of GHG regulations currently imposed on or applicable to the company, and the company's expectations regarding the future cost of reducing GHG emissions;
- Pending or threatened litigation stemming from the company's GHG emissions, or its level of compliance with existing or proposed climate change-related regulations; and
- The board of directors' role in determining the company's assessment of and policies regarding climate change-related matters.

In the absence of mandated climate change-related disclosures or required disclosures under the existing SEC rules, some companies, nonetheless, have begun to make voluntary climate change disclosures. Apparently, these actions have been spurred by investors and other influential stakeholders who support

environmentally friendly initiatives. However, companies who are considering voluntary disclosures must ensure that policies and procedures are in place to develop the factual data that is needed to support climate change-related disclosures. As discussed, disclosures that are based on speculation or other guesswork may be deemed misleading by the SEC under the anti-fraud provisions of Rule 10b-5.

Preparing for Mandatory Climate Change-Related Disclosure

In anticipation of federal legislation or SEC rulemaking requiring broad-based climate change-related disclosures, companies should consider implementing the appropriate processes and mechanisms required to collect the data needed to provide accurate disclosures. For example, companies should consider adopting management practices and corporate governance measures aimed at identifying and addressing financial and competitive risks associated with climate change. Similarly, companies should develop policies and strategies for determining their GHG emissions (*e.g.*, carbon footprinting) and for analyzing and reporting such data. Consideration also should be given to the manner in which the company might reduce GHG emissions. Further, companies should be mindful of existing state and federal legislation that may affect climate change-related disclosures, as well as proposed climate-related laws and regulations that may materially impact their businesses in the future. Moreover, companies should consider the need to update and/or expand upon climate change-related disclosures in other venues, such as the company's website or press releases, or other print or electronic materials, to ensure consistency with any climate change-related disclosures made in SEC filings.

If the SEC implements new rules requiring climate change-related disclosures, such rules may be far reaching in scope. Companies undertaking steps now to prepare for meeting climate change-related disclosure requirements will be better situated to respond to such rules in a timely manner and with the depth and detail of information likely to be required.

This summary is intended to describe the current SEC requirements for disclosing material information concerning certain environmental impacts, as well as to apprise companies of the type of specific climate change-related disclosures that are likely to be imposed. To obtain a tailored analysis of the existing SEC rules and the manner in which they may affect your company's disclosure obligations, or to obtain further information about, or assistance in evaluating, your company's potential compliance obligations under the anticipated new disclosure rules, please contact the lawyer at Sullivan & Worcester LLP with whom you regularly consult, or any of the lawyers listed above.