

# ADVISORY

**SULLIVAN & WORCESTER LLP SECURITIES AND CLIMATE-RELATED BUSINESS AND TECHNOLOGY GROUPS**

## SEC Emphasizes Obligation of Public Companies to Assess and Disclose Climate Change-Related Business Impacts

Recently published interpretive guidance by the Securities and Exchange Commission directs public companies to consider a suite of climate change-related issues in determining whether disclosures must be included in SEC filings. As the SEC notes, disclosure of certain environmental-related information has long been required, but disclosures about possible climate-related impacts have remained fairly uncommon in SEC filings. The guidance provides a template to guide companies through their analyses of whether certain climate change-related matters may trigger disclosure obligations.

Despite criticisms that the SEC was unduly influenced by investor groups and motivated by a political agenda in issuing the interpretive guidance without sufficient public debate, and even though many public companies are already deep into drafting their annual reports, the guidance is immediately effective. Moreover, while the guidance is not a rule or a regulation, and, as the SEC noted, "interpretive releases do not create new legal requirements nor modify existing ones," published guidance such as this reveals the SEC's views on disclosure topics and must be given considerable weight. Therefore, we recommend that companies subject to the guidance carefully consider and apply it in preparing their annual reports due in March 2010 and other upcoming SEC filings.

### ***Applicable Disclosure Rules***

Our May 2009 [Client Advisory](#) detailed certain existing SEC and accounting rules that may require the evaluation and disclosure of certain environmental-related impacts and identified steps for companies to consider in preparing for a possible expansion of the SEC's climate change-related disclosure rules. In that earlier Advisory, we discussed certain applicable SEC rules, including (1) Item 101 of Regulation S-K relating to the business of a company and the costs of compliance with environmental laws; (2) Item 103 of Regulation S-K relating to legal proceedings; (3) Item 303 of Regulation S-K relating to management's discussion and analysis of financial condition and results of operations (MD&A); and (4) Item 503(c) of Regulation S-K relating to "risk factors" that make

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investing in a company speculative or risky. In concert, these rules apply to various filings, such as quarterly and annual reports and registration statements.

The SEC explains that, depending on facts and circumstances of a particular public company, each of these rules may require disclosure relating to climate change. It then focused on four aspects of climate change as examples of those that could impact businesses in a manner that may trigger disclosure requirements: (1) the effects of existing or pending domestic legislation and regulations that address greenhouse gas (GHG) emissions; (2) the effects of international accords and treaties; (3) physical risk caused by changing weather patterns; and (4) indirect consequences, of both a positive and negative nature, of regulation and business trends. This Advisory discusses the four topics of concern highlighted by the SEC and the manner in which the SEC suggests that companies must evaluate climate change impacts and determine whether disclosures are required.

### ***Impact of Legislation and Regulation***

The SEC's guidance reviews several "significant" developments in federal and state legislation and regulation regarding climate change that may trigger disclosure obligations. These developments include regulations concerning GHG emissions promulgated by the Environmental Protection Agency and uniform standards for mandatory disclosure by insurance companies to state regulators of climate change-related financial risks promulgated by the National Association of Insurance Commissioners. Surprisingly, the SEC also identifies pending Congressional legislative initiatives (the American Clean Energy and Security Act of 2009 in the House of Representatives and the Clean Energy Jobs and American Power Act of 2009 in the Senate) as climate change-related developments that companies should consider in evaluating disclosure requirements under existing SEC rules.

In applying the SEC's disclosure rules to legislative or regulatory initiatives, the guidance states that Item 101 requires disclosure of any material estimated capital expenditures for environmental control facilities, which might increase based on either EPA regulations or the passage of climate-related federal or state legislation. Moreover, Item

503(c) may require disclosure of investment risk factors arising from existing or pending climate change legislation or regulation that could impact a company's financial projections or business operations. The SEC warns that such risk factor disclosures should not be of a generic nature; rather, such disclosures must instead focus on the risks particular to the company and the company's industry.

Further, according to the guidance, Item 303 requires companies to assess whether any climate change legislation or regulation is reasonably likely to have a material effect on their financial condition or results of operations, including liquidity and capital resources. Generally, MD&A should provide disclosures that enable investors to assess a company's future prospects by explaining its financial statements in a way that allows investors to view the company through the eyes of management. MD&A also should provide information about the quality of, and potential variability of, a company's earnings and cash flow so that investors can ascertain the likelihood that past performance is indicative of future performance. The SEC's guidance states that, in the case of a known trend or uncertainty, such as pending legislation or regulation, the analysis of whether disclosure is required consists of a two step process. First, management of a company must determine whether the pending legislation or regulation is reasonably likely to be enacted. Unless management determines that it is not reasonable likely to be enacted, it must proceed on the assumption that it will be enacted. In other words, if management cannot make the determination, it must assume enactment of the legislation or regulation. Second, if enactment is reasonably likely (or assumed to be), management must determine whether the legislation or regulation is reasonably likely to have a material effect on the company. The SEC affirms that, unless management determines that a material effect is not reasonably likely, MD&A disclosure is required.

The SEC provides the following examples of possible consequences, negative and positive, of possible future legislation on current disclosure, including:

- the costs to purchase, or the profits from sales of, allowances under a potential "cap and trade" system;

- the costs required to improve facilities to comply with regulatory limits; and
- the 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.

### ***International Accords***

In addition to assessing domestic legislation and regulations, the SEC advises companies to consider the impact on their business of climate change-related treaties and international accords. The SEC notes that the Kyoto Protocol, an international agreement that places carbon emission limits on various industries in developed countries, and the European Union's Emission Trading System, which establishes a "cap and trade" marketplace for carbon emissions, could trigger disclosure under Item 303. The SEC advises that companies should apply to international accords the same two-step analysis described above.

### ***Indirect Consequences of Regulation or Business Trends***

The SEC guidance urges companies to consider, and disclose where material, any indirect consequences of legal, technological, political and scientific developments relating to climate change, mindful that any potential indirect consequences hinge on existing or proposed legislation. Domestic and international climate change legislation and regulation may change the demand for existing or new products or services, including creating entirely new markets and triggering the proliferation of disruptive technology, which is technology originally designed for one purpose but redeployed in a new market because of unpredicted demands. Essentially, legislation and regulation could:

- decrease demand for goods that produce GHG emissions;
- increase demand for goods that result in lower emissions than competing products;
- increase competition to develop innovative new products;
- increase demand for generation and transmission of energy from alternative energy sources; and
- decrease demand for services related to carbon-based energy sources.

The SEC encourages companies to recognize that climate legislation could reverberate through a variety of markets that now are only tangentially connected to carbon emissions. For example, carbon emission reduction and clean energy technology markets are expected to become some of the largest markets in the world; thus, technology and service providers should reflect on potential opportunities and effects of the projected growth of such markets and consider whether business trends or risks may require disclosure as risk factors or in MD&A.

With respect to disruptive technology in particular, maturing clean and renewable energy technologies and GHG emission markets may cause companies to reposition their businesses to capitalize on potential new opportunities. Companies should monitor the evolution of business plans that may at some point result in strategic changes that trigger a disclosure requirement under Item 101.

### ***Physical Impacts of Climate Change***

In addition to business risks and opportunities presented by legislative and market forces, the SEC observes that the physical impact of climate change potentially could materially affect a company's business operations. These could include changes in weather patterns, storm intensities, sea levels, glacier melt and temperatures. As an example, the SEC discussed possible adverse affects of severe weather, such as property damage, business interruptions, decreased agricultural production capacity and increased costs of insurance. While the guidance discusses these factors in relation to current and future impacts of climate change, it is also helpful as a reminder of disclosure obligations for companies whose business and operating results are reasonably likely to be affected by storms, floods and other weather-related phenomena (considered regardless of climate change).

### ***Compliance***

The recent climate change-related Congressional legislative proposals and federal and state regulations, the attention to carbon markets and emission reduction projects and emerging clean and renewable energy technologies (including investment and project finance and development) potentially could implicate the disclosure requirements for a wide range of public companies. Whether such events, activities, or effects actually

reach the materiality threshold—that is, whether there is a substantial likelihood that a reasonable investor would consider the information to be important in deciding how to vote his or her securities or in making an investment decision, thus triggering a disclosure obligation under SEC rules, must be analyzed carefully on a case-by-case basis.

Accordingly, in performing a “materiality” evaluation, a company must be well-versed in climate-related issues in order to conduct the type of informed and realistic appraisal that is contemplated by the guidance. A particularly difficult aspect of the required assessment is that the SEC places the onus on companies to prognosticate regarding which of the emerging trends or developments in the climate change field are likely to come to fruition.

Companies could be questioned by SEC staffers who review their filings regarding the specific information that was collected and considered in assessing the need for climate change-related disclosure. Moreover, companies may be asked to explain why climate change-related disclosures were *not* included in an SEC filing, especially if a company otherwise discloses climate change-related information in other forums, such as in industry surveys, voluntary data gathering programs, in its website or press releases or to other agencies.

In the context of the new guidance, companies should implement appropriate processes and procedures for collecting and evaluating the necessary information to determine the applicability of existing and pending climate change-related legislative and regulatory initiatives to their business operations. According to the SEC, “management should ensure that it has sufficient information regarding the registrant’s greenhouse gas emissions and other operational matters to evaluate the likelihood of a material effect arising from the subject legislation or regulation.” Moreover, the SEC has stated its expectation that companies will continuously assess their potential disclosure obligations, in recognition that climate change regulation is a rapidly developing area.

And, of course, all of this must be done quite quickly by those companies facing looming filing deadlines.

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If you have any questions regarding the SEC’s interpretive guidance, or require assistance in assessing whether a particular climate change-related disclosure may be required in an SEC filing, please contact any of the attorneys listed in this Advisory.

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