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Disclosing Risks of Climate Change in SEC Filings

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For several years public interest groups have been pressing for greater disclosure of the financial impacts of climate change, and the impact on business operations of regulations to limit greenhouse gas emissions, in the reports of public companies filed with the Securities and Exchange Commission (SEC). Recent developments related to climate change now make it prudent for companies in certain sectors to re-evaluate whether and how to disclose climate risks in their SEC filings.

The challenge for businesses considering climate risk disclosures is that there are no specific rules or SEC guidance as to the length, scope, or substance of such disclosures. As a result, not since companies struggled with disclosure of their Superfund contingent liabilities in the early 1990s has there been so much interest in securities disclosure of environmental issues.

REGULATORY DEVELOPMENTS

Recent regulatory developments may have tipped the scales toward more robust climate change disclosure in certain companies' 10-K filings.

Lawmakers in the 110th Congress appear to be coalescing around legislation to establish an economy-wide cap-and-trade or cap-and-auction program, which would reduce global warming pollution by increasing the cost of emitting greenhouse gases. This movement gained momentum after the U.S. Supreme Court issued a landmark decision in April 2007 that may lead to the first national rules to limit emissions of greenhouse gases from vehicles. *Massachusetts v. EPA*, 549 U.S. __, 127 S.Ct. 1438 (2007).

At the regional level, three initiatives—the northeast Regional Greenhouse Gas Initiative (RGGI), the Western Climate Initiative (WCI), and the Midwestern Greenhouse Gas Accord (MGGA)—will require greenhouse gas reductions within their respective jurisdictions. RGGI is the most developed of these regional initiatives and utilizes a cap-and-trade regulatory approach.

Finally, a number of states have developed individual programs to address greenhouse gas emissions within their borders. California has created its own regulatory initiative, and at least 16 other states have joined California in seeking to establish that state's "clean car" rules, which would require a 30 percent reduction in tailpipe greenhouse gas emissions. EPA recently denied California's request for permission to implement its "clean car" rules, and the State has challenged EPA's decision through a lawsuit filed on January 2, 2008. *California v. EPA*, 9th Cir. No. 08-07011.

INVESTOR EFFORTS TO PROMOTE DISCLOSURE

A number of activists as well as institutional investors have joined the call for companies to disclose the risks associated with present or probable greenhouse gas regulation and legal proceedings related to global warming. These investors generally seek four types of disclosure to analyze a company's business risks from climate change: emissions disclosure, strategic analysis of climate risk and emissions management, assessment of physical risks of climate change, and analysis of regulatory risks.

Investors also are seeking information about the opportunities created by climate change and regulation of greenhouse gases. A company's greenhouse gas emissions potentially represent an opportunity to reduce risks, improve operations, and cut costs, as well as to be seen as a leader by investors and customers. This may be

why increasing numbers of large U.S. companies—146 in 2007— voluntarily disclosed information about their emissions and about climate risks and opportunities to a survey conducted by the Carbon Disclosure Project, a nonprofit that operates the largest repository of corporate climate change emissions data in the world. Indeed, among those S&P 500 companies that responded to the 2007 survey, 69 percent considered climate change to offer commercial opportunities.

In 2005, the Investor Network on Climate Risk, a network of leading institutional investors with collective assets of more than $5 trillion, created a voluntary disclosure initiative called the Global Framework for Climate Risk Disclosure. The Global Framework seeks to standardize climate risk disclosure by providing a method for investors to accurately analyze a company's business risks and opportunities resulting from climate change.

In September 2007, CERES, a national coalition of investors and public interest groups, joined with the financial officers of ten states in submitting a petition to the SEC asking the agency to clarify that publicly traded companies must, under existing law, assess and disclose financial risks and opportunities related to climate change. In addition, at least two bills before the Congress would require SEC-mandated disclosures of climate risk and charge the agency with establishing a uniform format for such disclosures.

SEC DISCLOSURE REQUIREMENTS

SEC Regulation S-K, which provides a framework for the disclosure requirements contained in the Securities Act of 1933 and the Securities Exchange Act of 1934, requires annual and quarterly filing of disclosure reports via Forms 10-K and 10-Q. Three parts of Regulation S-K are especially relevant to the disclosure of impacts of climate change regulation: Items 101, 103, and 303.

Item 101 (Disclosure of Capital Expenditures) requires a company to disclose any material effect that environmental compliance costs associated with enacted or adopted laws may have on its earnings, capital expenditure, and competitive position. "Materiality" concerns whether environmental liability may affect the company's financial position, and a "material" effect is one that may "substantially alter the total mix of information" available to investors. A company must project the costs of environmental compliance for two years, or longer if believed by the company to be material. Disclosure under Item 101 is most important for companies with operations in regions or states with existing climate change laws, and will become increasingly important as more domestic and international laws are adopted.

Item 103 (Disclosure of Legal Proceedings) requires disclosure of any material pending administrative or judicial proceedings to which the company is, or may become, a party. "Material" under Item 103 has the same definition as under Item 101. Although Item 103 expressly relates to parties, companies who are not parties to a legal proceeding should consider disclosure under Item 303 if resolution of the proceeding could materially affect their capital expenditures, earnings, or competitive position. Disclosure under Item 103 is most important for companies that are party to legal proceedings involving greenhouse gas emissions.

Item 303 (Management Discussion & Analysis, or "MD&A") requires a description of any "known trends … events or uncertainties" that are reasonably likely to affect the company's liquidity or capital expenditures. The intent of Item 303 is to allow investors to see the company "through the eyes of management." SEC guidance on Item 303 establishes a two-part disclosure test. First, a company must assume that a trend or uncertainty is reasonably likely to occur, unless it can determine otherwise. Second, if the trend or uncertainty is reasonably likely to occur, the company must disclose if the trend or uncertainty will have a material effect on its financial condition or operations. ("Material" has the same definition as under Items 101 and 103). Disclosure under Item 303 will become increasingly important as climate change regulation becomes more certain.

KEY IMPLICATIONS

We believe it is unlikely that, in the near term, the SEC will release meaningful, specific guidance on climate risk disclosure, just as it did not resolve the uncertainty over Superfund contingent liabilities. In light of recent regulatory developments and investor efforts to promote disclosure, however, we recommend that public companies, especially those in the energy and financial services sectors, consider the following in connection with their SEC filings:

- Disclosure under Item 101 of material costs that have been or are likely to be incurred or expected to be incurred to comply with regulations or regional initiatives to limit greenhouse gas emissions that have been enacted in the jurisdictions where the company operates.

- Disclosure under Item 103 of pending legal proceedings involving greenhouse gas emissions to which the company is a party.

- Disclosure under Item 303 if the company's business could be directly affected by the physical impacts of climate change. For example, the insurance industry will be impacted by more extreme weather events such as hurricanes. Similarly, industries involved in agriculture, particularly in commodity crops, may be adversely affected by shifting weather patterns.

- Disclosure under Item 303 if material effects of climate change on operations are deemed "reasonably likely," with particular focus on whether the company has adopted an internal process to monitor climate change developments and undertake some long-range planning. It also is advisable to acknowledge the emerging consensus on federal legislation to limit greenhouse gas emissions and its inevitable effect of making such emissions more costly.

The determination of whether and how to disclose climate risks in SEC filings in the absence of SEC clarification will, of course, depend on a company's specific operations. We also recommend that public companies ensure consistency between the climate risk and opportunity disclosures in financial reports and statements in their corporate sustainability and climate change reports.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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