

ANDREWS & KURTH CLIMATE CHANGE OUTLINE © 2010



TABLE OF CONTENTS

1. Recent SEC Interpretive Guidance	4
A. Background.....	4
(1) The SEC states that disclosure controls and procedures should be “rigorously applied with respect to climate change.”	4
(2) The SEC’s interpretative guidance highlights for public companies four areas on which to focus and to disclose if the impact is material:.....	4
(3) S-K Items Affected by Climate Change Interpretive Guidance	4
(4) Legal Proceedings (Item 103).....	5
(5) Management’s Discussion and Analysis (Item 303).	5
(6) Risk Factors (Item 503(c)).....	6
(7) State of Financial Accounting Standards No. 5 Accounting for Contingencies (FAS 5).	6
B. Climate Change Interpretive Considerations.....	6
(1) Careful review necessary.....	6
(2) Possibility of formal rulemaking.	6
(3) Consistent disclosures.....	7

1. RECENT SEC INTERPRETIVE GUIDANCE

These settlements may not be binding interpretations of federal securities laws but they are certainly a starting point of issues to consider when drafting climate change disclosure.

A. Background

After being prodded by investor groups for several years, the SEC has issued "interpretive guidance" focused on how to evaluate the impacts of climate change for the purpose of making disclosures to investors and shareholders. There is no change to the legal basis of such an evaluation, but the interpretive guidance does signal that the SEC will be focusing on climate change disclosures.

(1) The SEC states that disclosure controls and procedures should be “rigorously applied with respect to climate change.”

Curiously, as was pointed out by Commissioner Casey in her dissent, the SEC has never made a specific finding that climate change disclosures are materially deficient. Also, it is worth noting that the SEC was careful to avoid making a statement on the science of climate change.

(2) The SEC’s interpretative guidance highlights for public companies four areas on which to focus and to disclose if the impact is material:

(a) Climate change legislation and regulation, both existing and pending.

This would include the Greenhouse Gas Reporting Rule, American Clean Energy and Security Act of 2009 as passed by the House as well as state and regional initiatives.

(b) New laws or international treaties on climate change.

These could include impacts resulting from a treaty limiting greenhouse gas emissions and the impact of such limitations on a company's operating costs or business.

(c) Business and legal trends related to climate change.

For example, legislation mandating increased production of renewable electricity or renewable fuels standards could result in business opportunities, increased operating costs or expected losses. In addition, the demand for products or activities that generate significant greenhouse gas emissions could be adversely affected relative to competing products that generate lower emissions. Companies should consider whether there is a potential for lawsuits claiming operations resulted in climate-change that caused personal or property damage.

(d) Potential physical impacts of climate change.

For example, companies that invest in coastal properties might be impacted by hurricanes and rising seas.

(3) S-K Items Affected by Climate Change Interpretive Guidance

According to the SEC release, the following provisions under Regulation S-K require the issuer to disclose material climate change risks and effects. Examples, including those likely to be required under each item from the terms of Xcel Energy's settlement agreement with the State of New York (2007) are included below.

(a) Description of Business (Item 101).

Under Item 101, the issuer must report the material effects of complying with federal, state or local provisions regulating environmental protection on the issuer's capital expenditures, earnings and competitive position. Additionally, the issuer should identify future laws or trends in legislation that could have a material effect on operations. Examples include:

(b) Massachusetts v. Environmental Protection Agency, No. 05-1120 (April 2, 2007);

(c) Bali Action Plan (United Nation Climate Change Conference, December (2007);

(d) Lieberman-Warner climate bill (S. 2191);

(e) Individual states enacting climate change legislation – over 36 states have adopted direct action plans; over 17 have mandatory reduction targets;

(f) California Air Resources Board to cut GHG emissions and establish joint carbon trading program; and

(g) Regional Greenhouse Gas Initiatives.

(4) Legal Proceedings (Item 103).

Item 103 and the instructions thereto require the issuer to disclose material legal proceedings, including those relating to environmental protection having a material financial effect on the issuer. Examples include:

(a) Public nuisance claims filed by eight states against top GHG emitting electric companies in NY. The district court found the plaintiffs "presented non-justifiable political questions." On appeal, the 2nd Circuit determined that the plaintiffs have standing and there is a justiciable interest.¹

(b) In California, an action was filed against automakers that was also dismissed as a political issue. Its on appeal.²

(c) Mississippi dismissed a public nuisance claim against petrochemical companies for aggravating the effects of Katrina. On appeal, the 5th Circuit determined the Plaintiffs had standing.³

(5) Management's Discussion and Analysis (Item 303).

¹ *Connecticut v. AEP*, No. 05-1504 (2nd Cir. Sept. 21, 2009).

² *Village of Kivalina v. ExxonMobil*, 2009 U.S. Dist. Lexis 99563 (N.D. Cal. Sept. 30, 2009).

³ *Comer v. Murphy Oil Co.*, 2009 U.S. App. Lexis 22774 (Oct. 16, 2009).

The management discussion and analysis section requires the issuer to disclose known trends or uncertainties that the issuer believes will result or likely result in material changes to the issuer's liquidity, net sales, revenues or income from operations. Known trends require consideration of (1) **physical impact of climate change**; and 2) the effect of such strategies on future GHG emissions. examples include:

- (a) weather;
 - (b) water use and scarcity; and
 - (c) sustainability strategies.
- (6) Risk Factors (Item 503(c)).

Item 503(c) requires the issuer to disclose factors that make investing in the company speculative or risky. The risks included under 503(c) should not be generally *applicable* to all issuers. Examples include:

(a) The issuer must include financial risks resulting from climate change, including those stemming from physical impacts associated with climate change such as increasing sea level and changes in weather conditions, changes in precipitation, water shortages or changes in temperature;

- (b) Weather; and
- (c) Water use or scarcity.

(7) State of Financial Accounting Standards No. 5 Accounting for Contingencies (FAS 5).

(a) Requires a company to accrue a charge against current income for the entire amount of a material liability that is probable and reasonably estimable.

(b) In its September 2007 petition, the Coalition stated that “examples of companies that have likely crossed the FAS 5 threshold for accruing actual dollar values for climate-related contingent liabilities include companies that emit significant levels of greenhouse gases and are already subject to direct regulation of those emissions here or abroad, companies considering major capital investments that are affected by new and evolving regulatory treatment of greenhouse gas emissions, and companies whose physical operations are at hazard due to developments, such as melting permafrost or storm damage.”

B. Climate Change Interpretive Considerations

- (1) Careful review necessary.

Companies preparing their 10-Ks should carefully consider this new interpretive guidance when reviewing the materiality of the potential impact of climate change. Should there be doubt regarding whether certain information is material, we believe that the clear message is to err on the side of disclosure. **[Add SOX]**

- (2) Possibility of formal rulemaking.

It is possible that the SEC could resort to formal rulemaking in the future that would require specific disclosure of carbon footprints and other quantitative measurements. To avoid this situation, companies should pay close attention to improving the quality and detail of climate change disclosures.

(3) Consistent disclosures.

Companies disclosing information under any voluntary or mandatory greenhouse gas initiative should be sure such disclosures are consistent with all securities filings.