

Preparing Your 2011 10-K and 20-F – Environmental Disclosure Considerations

Introduction

This memorandum highlights key issues for companies to consider when preparing environmental disclosures for their upcoming 10-K and 20-F filings with the U.S. Securities and Exchange Commission (“SEC”), as well as for their other SEC filings throughout 2012.

These considerations include:

- Environmental Regulatory Updates;
- Climate Change Litigation and Other Developments;
- Continued SEC Focus on MD&A Disclosure;
- Loss Contingencies – FASB and SEC Activity; and
- Hydraulic Fracturing, *Deepwater Horizon* and Other High-Profile Issues.

Environmental Regulatory Updates

In the past several months, the U.S. Environmental Protection Agency (“EPA”) has announced, proposed or finalized numerous stringent, complex and potentially costly rules and regulations governing air and other environmental emissions. These rules and regulations are already affecting, and will soon affect, a broad range of industries, including the power generation, the extractive resource (*i.e.*, oil and gas and mining), the petrochemicals, the biofuels/renewable energy and the automotive industries. Registrants in these industries should carefully review the impacts of these recent updates.

In addition, other companies should consider any significant direct or indirect consequences these updates may have, such as increased operating or supply costs and reduced demand for products or services. The following table identifies a selection of key environmental initiatives and several of the industries most significantly affected by them:

Rule/Regulation	Status	Power Generation	Extractive Industries	Petrochemical	Biofuels / Renewable Energy	Manufacturing	Automotive
Mercury & Air Toxics Standards	Final	X					
Cross-State Air Pollution Rule	Final / Stayed	X					
Greenhouse Gas (“GHG”) Reporting Rule	Final	X	X	X	X	X	
Prevention of Significant Deterioration and Title V GHG Tailoring Rule (a/k/a Tailoring Rule)	Final	X	X	X	X	X	
New Source Performance Standards for GHG Emissions	Expected	X		X			
National Emissions Standards for Hazardous Air Pollutants for Industrial / Commercial / Institutional Boilers and Process Heaters (a/k/a Boiler MACT)	Final / Proposed	X	X	X		X	
National Ambient Air Quality Standards (and related rules) for fine particulate matter and ozone	Expected	X	X			X	
Cooling Water Intake Structure Rule under Section 316(b) of the U.S. Clean Water Act (“CWA”)	Proposed	X					
Coal Combustion By-Product Regulation	Proposed	X	X			X	
Hydraulic Fracturing and Related Regulations	Final / Proposed / Expected		X				
Renewal/Revision of Nationwide Permits under Section 404 of CWA	Proposed		X		X		
Revised GHG and Fuel Economy Standards	Expected						X

* Not all registrants in a given industry are impacted by these regulations, and any particular registrant is likely subject to other important environmental requirements in addition to those listed.

Many of the above listed regulations are being, or will likely be, challenged through litigation or legislative opposition. These challenges, if successful, may result in material changes to, or complete invalidation of, these regulations. Even if the regulations survive such challenges, they may remain subject to further amendment. Affected companies should continue to closely monitor relevant changes to these regulations prior to filing as several key provisions remain in flux.

Climate Change Litigation and Other Developments

Interest in climate change disclosure peaked in January 2010 when the SEC issued its climate change disclosure guidance and when it appeared the U.S. Congress might pass federal cap and trade

legislation.¹ While climate change is no longer in the SEC spotlight, it remains an important consideration for many companies as a result of actual binding or proposed climate change regulations (including those referenced in the table above) and pending climate change litigation.² Affected companies should carefully review their climate change disclosure in light of the SEC's disclosure guidance and recent regulatory and litigation developments, including the following:

- **GHG Reporting Rule Data Now Publicly Available.** Earlier this month, the EPA launched an interactive website that allows public access to emissions data reported under its GHG Reporting Rule.³ The website currently reflects 2010 emissions data for facilities in nine industry groups as well as suppliers of certain fossil fuels and industrial gases. The EPA plans to add data from additional industries as the data is reported for subsequent years. While quantitative emissions data may not need to be disclosed in SEC filings, registrants may be well served to compare their disclosure to their GHG emissions data that is publicly available, including through the EPA's website, their own websites and publications and the Carbon Disclosure Project. Registrants should strive to ensure accurate and consistent emissions data reporting and identify any material trends in emissions levels.
- **Litigation.** Several high-profile common law claims relating to climate change remain pending, including *Native Village of Kivalina v. ExxonMobil Corp.* and *Comer v. Murphy Oil USA, Inc.* These lawsuits have a direct impact only on the several dozen named defendants, but the resolution of these cases could greatly expand the risk of climate change litigation for all significant GHG emitters. As plaintiffs seek future defendants in these and similar lawsuits, we expect they will mine the EPA's GHG emissions data to target the largest emitters nationwide or on a regional or industry basis.
- **Tailoring Rule.** This rule first took effect in January 2011, but is expected to become increasingly stringent as the EPA phases in additional requirements. The EPA may issue by July 2012 more restrictive GHG emission thresholds above which companies could be required to obtain Title V and Prevention of Significant Deterioration air permits. Facility construction or expansion projects that require these federal air permits for GHG emissions could face significant delays, increased costs and rigorous technology mandates to reduce GHG emissions.
- **International/European Union Developments.** While the agreements reached in Durban, South Africa in December 2011 delayed the adoption of any new legal frameworks until closer to 2020, it will be important to monitor developments at the next Conference of the Parties to the United Nations Framework Convention on Climate Change in Doha, Qatar in November 2012. Any agreements reached in Doha will likely determine the direction of future international negotiations and reflect the preferred policies of the various delegations, whose governments may implement national requirements on a faster timeline. Registrants with significant operations in the European Union ("EU") should also pay close attention as the EU develops Phase III of its Emissions Trading System ("ETS") this year. In addition, the airline industry should consider the implications of the EU's recent expansion of its ETS to require certain airlines to hold GHG emissions allowances.

¹ See "Davis Polk Memorandum – Environmental Disclosure in SEC Filings – 2010 Update" for a description of the SEC's guidance, entitled "Commission Guidance Regarding Disclosure Related to Climate Change", and its practical impacts as well as climate change legislation proposed at that time.

² As recently as September 2011, the SEC has issued comment letters addressing the operational and financial risks of climate change.

³ The EPA GHG Reporting Rule data is [available here](#).

Continued SEC Focus on MD&A Disclosure

Our 2009 and 2010 environmental disclosure memoranda discussed the SEC's ongoing focus on improving Management's Discussion and Analysis of Financial Condition and Results of Operation ("MD&A") disclosure. The SEC's focus has not shifted; the SEC continues to criticize underdeveloped MD&A disclosure. For instance, companies tend to include information about material known trends and uncertainties in environmental risk factors, in the business section or in the contingencies footnotes to their financial statements, but fail to discuss these trends and uncertainties in their MD&A section. The MD&A requirements apply to U.S. registrants as well as foreign private issuers filing Form 20-Fs.⁴

Loss Contingencies – FASB and SEC Activity

Since at least 2008, the Financial Accounting Standards Board ("FASB") has attempted to strengthen the standards governing the disclosure of loss contingencies, including environmental loss contingencies. FASB's latest proposed overhaul, entitled proposed Accounting Standards Update, Contingencies (Topic 450), *Disclosure of Certain Loss Contingencies*, however, has been on hold since late 2010.⁵ Instead it appears that FASB is deferring to the SEC to address perceived weaknesses in loss contingency disclosure under existing disclosure standards.⁶

During 2011, the SEC issued dozens of comment letters to a broad array of companies seeking expanded, more timely and consistent disclosure of loss contingencies. In particular, the SEC highlighted the following key principles behind those comment letters at various meetings in June and September 2011:⁷

- Registrants must comply with the existing Accounting Standards Codification 450 ("ASC 450") and should use clear, non-confusing language in loss contingency disclosures that is consistent with ASC 450 (for example, say, "reasonably possible loss" rather than "potential loss").
- If there are reasonably possible losses exceeding amounts already recognized (such as in reserves), the SEC staff has requested disclosure of an estimate of the additional possible loss or range of loss.
- If a company discloses that a contingency is not estimable, the SEC has requested supplemental information about the registrant's process and efforts that led to such conclusion.
- If legal costs are material, the SEC staff has issued comments requesting disclosure of the registrant's policy for accounting for legal costs.
- With respect to uncertainties related to loss contingency recoveries, registrants should disclose:
 - whether ranges of reasonably possible losses are disclosed gross or net of anticipated recoveries from third parties;
 - risks regarding anticipated recoveries; and

⁴ See "Davis Polk Memorandum – Preparing Your 2011 Form 20-F" for more information in the 20-F context.

⁵ See "Davis Polk Memorandum – Environmental Disclosure in SEC Filings – 2011 Update" for more details.

⁶ In 2010, FASB directed its staff to consult with the SEC and the Public Company Accounting Oversight Board regarding those agencies' efforts to address weak loss contingency disclosure under existing standards and to review 2010 calendar year-end filings to evaluate if such efforts were successful.

⁷ See "Highlights of Meeting – Center for Audit Quality SEC Regulations Committee, Joint Meeting with SEC Staff, June 28, 2011", and "Highlights of Meeting – Center for Audit Quality SEC Regulations Committee, Joint Meeting with SEC Staff, September 27, 2011".

- the registrant's accounting policy for uncertain recoveries.
- Loss contingency note disclosure must also comply with Regulation S-K Item 103 on Legal Proceedings (even though that item has different disclosure objectives than ASC 450).
- Companies may aggregate contingencies for disclosure purposes to help mitigate confidentiality concerns.

Importantly, the SEC is also focused on the issue of when a company determines it has sufficient information to make an accrual. Even if SEC comments are closed for a specific filing, the SEC staff has stated that they may review future filings and ask questions based on new developments.⁸ For example, if there is a subsequent settlement or other resolution of a loss contingency, the SEC may question whether an estimate of such loss or range of loss should have been disclosed earlier.

SEC Chairman Schapiro highlighted the SEC's focus on loss contingency disclosure in a July 2011 speech before the Women in Finance Symposium. She described how the SEC examiners in the Division of Corporation Finance are now asking companies to "clarify their exposure to potential losses due to litigation and other contingencies."⁹ Specifically, disclosure examiners are now asking companies, per the existing accounting standards, to begin providing estimated exposure costs for litigation and other contingencies if they have not been doing so already, as well as to "refine their calculations over time as events and circumstances change and new information is obtained."¹⁰

Hydraulic Fracturing, *Deepwater Horizon* and Other High-Profile Issues

The SEC continues to use comment letters to question disclosure relating to high-profile environmental issues. Over the past several months, the media and lawmakers have seized upon alleged environmental concerns and the *Deepwater Horizon* disaster associated with hydraulic fracturing to call for more rigorous regulation of onshore and offshore oil and gas development. During 2011, the SEC has issued comments to numerous companies in the upstream oil and gas industry with a focus on precisely these types of high-profile risks.

- **Hydraulic Fracturing.** Between June and November 2011, the SEC sent comment letters to at least nine oil and natural gas exploration, and/or related service, companies regarding their hydraulic fracturing disclosure. These comments included requests for, among other things, detailed information about the substances used in the well fracturing process, which information has long been sought by opponents of hydraulic fracturing. The SEC came under fire during late summer 2011 for a perceived attempt to force the disclosure of information that was not otherwise legally required. In a September 2011 statement before the House Financial Services Committee on SEC Oversight, SEC Chairman Schapiro responded and assured lawmakers that the SEC is "not regulating fracking in any way," it is not "in the business of regulating fracking" and that its "goal is not to vindicate any kind of environmental interest here."¹¹ From all accounts, the SEC appears to have retreated from what was viewed as an attempted expansion of disclosure regarding the environmental impacts of hydraulic fracturing.

⁸ See "Highlights of Meeting – Center for Audit Quality SEC Regulations Committee, Joint Meeting with SEC Staff, June 28, 2011," and "Highlights of Meeting – Center for Audit Quality SEC Regulations Committee, Joint Meeting with SEC Staff, September 27, 2011".

⁹ Text of this speech is [available here](#).

¹⁰ Text of this speech is [available here](#). While her statements were focused on financial institutions, Chairman Schapiro suggested that they extend to companies in other industries as well.

¹¹ A video of such testimony is [available here](#) at 1:07:23.

Nonetheless, hydraulic fracturing presents several business and regulatory risks that should be reviewed by affected companies. The practice is under review by other federal, state and local regulators and may become subject to additional requirements, including requirements to disclose information about the chemicals used in fracturing fluid. As registrants make available information about their fracturing fluid, whether through the online FracFocus Chemical Disclosure Registry¹² or other publicly available sources, they should consider updating their SEC disclosure to ensure an accurate and consistent presentation of any material information.

In addition, it appears interest by certain shareholders for greater hydraulic fracturing disclosure is increasing. In the 2011 shareholder proxy season, shareholder proposals requesting companies to report on the implications of their use of hydraulic fracturing went to vote at five oil and gas companies. The proposals averaged 40.7% support.¹³

- **Offshore Oil Spill Response.** Following the *Deepwater Horizon* disaster in April 2010, the SEC issued numerous comments in 2010 to oil and gas companies regarding their disclosure relating to offshore oil spill risk. The SEC continued to issue these comments in 2011 to at least eleven companies. The comments generally focused on:
 - the adequacy of insurance for a significant offshore oil spill, including for personal injury and environmental damage claims;
 - contractual arrangements by which customers allegedly indemnify pollution costs; and
 - contingency plans in the event of a significant petroleum spill or leak.

Companies in this industry should review their existing disclosure to determine if it should be modified in light of the matters discussed above. Companies in other industries with high-profile environmental risks should also be prepared for environmental comments from the SEC staff.

Conclusion

Over the past year, the SEC issued numerous comments regarding the environmental, climate change and loss contingency disclosures of over 135 companies spanning a wide range of industries. We expect the SEC will continue to emphasize environmental matters in its review of 10-Ks and 20-Fs filed this year. As registrants prepare their annual filings, they should carefully review their environmental disclosures in light of the regulatory updates and other considerations described herein.

¹² The online hydraulic fracturing chemical registry, FracFocus, is [available here](#).

¹³ In addition, Institutional Shareholder Services, Inc. issued a voting guidance for the 2012 proxy season to vote "FOR" proposals requesting greater hydraulic fracturing disclosure. The guidance is [available here](#).

If you have any questions regarding the matters covered in this publication, please contact Betty Moy Huber, any of the lawyers listed below or your regular Davis Polk contact.

Betty Moy Huber	212 450 4764	betty.huber@davispolk.com
Hayden S. Baker	212 450 4727	hayden.baker@davispolk.com
Kevin J. Klesh	212 450 3092	kevin.klesh@davispolk.com
Loyti Cheng	212 450 4022	loyti.cheng@davispolk.com
Amy E. Turner	212 450 4716	amy.turner@davispolk.com

© 2012 Davis Polk & Wardwell LLP

Notice: This publication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal or accounting advice. If you would rather not receive these memoranda, please respond to this email and indicate that you would like to be removed from our distribution list. If you have received this email in error, please notify the sender immediately and destroy the original message, any attachments thereto and all copies. Refer to the firm's [privacy policy](#) located at davispolk.com for important information on this policy. Please add Davis Polk to your Safe Senders list or add dpwmail@davispolk.com to your address book.

Attorney advertising. Prior results do not guarantee a similar outcome.