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Global Securities Group Client Alert

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SEC GUIDANCE REGARDING DISCLOSURE RELATED TO CLIMATE CHANGE

On Tuesday, February 2, 2010, the Securities and Exchange Commission (the “SEC”) issued an interpretive release (the “Release”) providing guidance to public companies regarding the SEC’s existing disclosure requirements as they apply to climate change matters.¹ This client alert analyzes the new guidance.

Introduction

Climate change has become a topic of extensive public debate in recent years. The Release is an attempt to provide guidance to SEC-reporting companies of the types of disclosure companies should be making regarding climate change matters which affect their businesses in order to comply with existing disclosure requirements under SEC rules and regulations. The Release is not the SEC’s first attempt to venture into the environmental area. The SEC started tackling these issues beginning in the early 1970s, when the SEC issued an interpretive release stating that registrants should consider disclosing in their SEC filings the financial impact of compliance with environmental laws based on the materiality of the information. Information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make an investment decision.

The SEC takes the position that environmental disclosure is not a standalone requirement by itself, but stems from the SEC’s preexisting requirements which ensure that disclosure of material information by registrants is accurate and complete. In the Release, the SEC reviews relevant existing disclosure rule provisions and analyzes the degree to which climate change disclosure could be applicable. The guidance does not purport to create new rules or modify existing ones, but merely clarifies for registrants the types of disclosure that should be included in a registrant’s filings with the SEC when material impacts of climate change may be foreseen.

While the discussion below is of significant applicability to companies in the energy industry, companies in the insurance field, companies with extensive coastal operations, and businesses that supply, are supplied by, or are dependent on the foregoing, the SEC’s intent was for all registrants to examine and assess the principles embodied in the released guidance as the SEC believes that the implications of climate change have far reaching implication from a regulatory, operational, business and financial standpoint.

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¹ Release No. 33-9106 (Feb. 2, 2010).

It should be noted that the SEC's guidance is directed towards both domestic issuers and non-U.S. issuers. While the Release addresses specific requirements relating to domestic issuers, the SEC notes that most of these requirements have parallels under the rules applicable to non-U.S. issuers (although the SEC does note that some of the requirements applicable to non-U.S. issuers are not always as prescriptive as the provisions applicable to domestic issuers).

Overview of Rules Requiring Disclosure of Climate Change Issues

For domestic registrants, disclosure is driven by the requirements of Regulation S-K and Regulation S-X. Additionally, Securities Act Rule 408 and Securities Exchange Act Rule 12b-20 require a registrant to disclose, in addition to the information expressly required by SEC regulation, "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."

1. **Description of Business.** Item 101 of Regulation S-K requires a registrant to describe its business and that of its subsidiaries. With respect to environmental laws, disclosure is required regarding certain costs of compliance with environmental laws, specifically the material effect environmental compliance may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries, as well as disclosure of any material estimated capital expenditures for environmental control facilities for the remainder of its current and succeeding fiscal years and any other further periods deemed material.
2. **Legal Proceedings.** Item 103 of Regulation S-K requires a registrant to disclose material pending legal proceedings to which the registrant or a subsidiary is a party, or to which a property of the company is subject, but typically exempts from such disclosure requirement ordinary routine litigation incidental to a registrant's business or other proceedings below certain thresholds. With respect to environmental litigation or proceedings, the ordinary routine litigation exception does not apply, and disclosure is required if a proceeding is material to the business and financial condition of the registrant or exceeds other specific thresholds.
3. **Risk Factors.** Item 503(c) of Regulation S-K requires a registrant to provide, where appropriate, a discussion of the most significant risk factors facing the registrant. The risks must be clearly stated, and the disclosure should specify how a particular risk affects the particular registrant.
4. **Management's Discussion and Analysis.** Item 303 of Regulation S-K requires a registrant to prepare a "Management's Discussion and Analysis of Financial Condition and Results of Operations" section ("MD&A"). MD&A is intended to satisfy three principal objectives:
 - to provide a narrative explanation of a registrant's financial statements that enables investors to see the registrant through the eyes of management;
 - to enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and
 - to provide information about the quality of, and potential variability of, a registrant's earnings and cash flow.

MD&A disclosure is meant to provide material historical and prospective textual disclosure, with particular emphasis on the registrant's prospects for the future.

MD&A disclosure should be clear and communicate to shareholders management's view of the company's financial condition and prospects. Registrants must evaluate trends, events, demands, commitments and uncertainties through (i) consideration of financial, operational and other information known to the registrant, (ii) identification, based on this information, of known trends and uncertainties, and (iii) assessment of whether these trends and uncertainties will have, or are reasonably likely to have, a material impact on the registrant's liquidity, capital resources or results of operations. Emphasis should be placed on issues reasonably likely to cause reported financial information not to be necessarily indicative of future operating performance or of future financial conditions. Management of the registrant should assess whether a known trend, demand, commitment, event or uncertainty is likely to come to fruition, and disclose it unless it is not reasonably likely to occur.

Climate Change Related Disclosures

Depending on the facts and circumstances of a particular registrant, each of the above referenced disclosure rules may require disclosure regarding the impact of climate change. The SEC highlights the following four areas as examples of climate change issues that may trigger disclosure.

1. Impact of Legislation and Regulation. Significant developments in federal and state legislation and regulation regarding climate change may trigger disclosure obligations under all of the disclosure items discussed above. From a business description standpoint, disclosure of material estimated capital expenditures relating to environmental control facilities (for example) would be required.

Risk factor disclosure may require registrants to consider specific risks they face as a result of climate change legislation or regulation and avoid generic risk factor disclosure that could apply to any company. For example, registrants in the energy sector, who may be particularly sensitive to greenhouse gas legislation or regulation, may face significantly different risks from climate change legislation or regulation compared to registrants that currently are reliant on products that emit greenhouse gases, such as registrants in the transportation sector.

From an MD&A standpoint, registrants are required to assess whether any enacted climate change legislation or regulation is reasonably likely to have a material effect on the registrant's financial condition or results of operation. When there is a known uncertainty (such as in the case of pending legislation/regulation) as to whether disclosure is merited in the MD&A, management must first consider whether the pending legislation/regulation is reasonably likely to be enacted. Unless there is no such reasonable likelihood, the SEC states that the assumption should be that the legislation/regulation will be enacted. Second, management must determine whether such enactment is reasonably likely to have a material effect on the registrant, its financial condition or results of operations. Unless a material effect is determined not to be reasonably likely, MD&A disclosure is required. Additionally, disclosure is required, if material, of the difficulties involved in assessing the timing and effect of the pending legislation or regulation.

Changes in the law or the business practices of some registrants in response to the law may provide new opportunities for registrants, and if so, such positive consequences should also be discussed.

Examples of possible consequences of pending legislation and regulation related to climate change include:

- Costs to purchase, or profits from sales of, allowances or credits under a "cap and trade" system;
- Costs required to improve facilities and equipment to reduce emissions in order to comply with regulatory limits or to mitigate the financial consequences of a "cap and trade" regime; and
- Changes to profit or loss arising from increased or decreased demand for goods and services produced by the registrant arising directly from legislation or regulation, and indirectly from changes in costs of goods sold.

Since climate change regulation is a rapidly developing area, registrants will need to regularly assess their potential disclosure obligations given new developments.

2. International Accords. Registrants should also consider, and disclose when material, the impact on their business of treaties and international accords relating to climate change. The Kyoto Protocol and the European Union Emissions Trading System serve as examples of the many international activities in connection with climate change remediation, and registrants whose businesses are reasonably likely to be affected by such agreements should monitor the progress of any potential agreements and consider the possible impact in satisfying their disclosure obligations based on the MD&A and materiality principles previously outlined.

3. Indirect Consequences of Regulation or Business Trends. Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for registrants, and may create demands for new products or services, or decrease demand for existing products and services. Possible indirect consequences or opportunities may include:

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

These business trends or risks may need to be disclosed as risk factors or in the MD&A, and in some cases such developments could have a significant enough impact on a registrant's business (i.e. through acquisitions or disposition in connection with an opportunity or a risk) to require disclosure under its business description. The materiality of these opportunities and obligations should be considered in the context of the particular facts and circumstances of each registrant.

Another consequence of a potential indirect risk from climate change is the impact on a registrant's reputation, which might need to be considered for risk factor disclosure depending on the nature of a registrant's business and its sensitivity to public opinion. For example, the public's perception of any publicly available data relating to a registrant's greenhouse gas emissions could expose it to potential adverse consequences for its business operations or financial condition resulting from reputational damage.

4. Physical Impacts of Climate Change. Significant effects of climate change, such as effects on severity of weather (for example, floods or hurricanes), sea levels, the arability of farmland, and water availability and quality, have the potential to affect a registrant's operations and results. Possible consequences of severe weather could include:

- For registrants with operations concentrated on coastlines, property damage and disruptions to operations;
- Indirect financial and operational impacts from disruptions to the operations of major customers or suppliers from severe weather;
- Increased insurance claims and liabilities for insurance and reinsurance companies;
- Decreased agricultural production capacity in areas affected by weather-related changes; and
- Increased insurance premiums and deductibles or a decrease in the availability of coverage for registrants with operations in areas subject to severe weather.

Conclusion

This new interpretive guidance does not seek to create new rules or modify existing ones. The intent of the SEC's guidance is to remind registrants of their obligations under existing federal securities laws and regulations to consider climate change and its consequences when preparing and filing disclosure documents. However, the SEC indicated that the SEC staff will be specifically reviewing filings made by registrants to determine their compliance with the guidelines and that the SEC will continue to consider the issues presented by climate change in deciding whether to issue further guidance or engage in rulemaking with respect to this matter.

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