



SECURITIES AND ENVIRONMENTAL LAW UPDATE

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SEC INTERPRETIVE RELEASE ON CLIMATE CHANGE DISCLOSURE

On February 2, 2010, a divided Securities and Exchange Commission (SEC) published a release stating its views regarding disclosure of climate change issues under its existing rules (Release) under the Securities Act of 1933 and the Securities Exchange Act of 1934. According to the SEC, its existing disclosure requirements under Regulation S-K are applicable to climate change matters. The Release was issued after requests were made over several years by a variety of environmental, investor and business groups, as well as some members of Congress, for the SEC to address when and how registrants should address climate change issues in their SEC filings. The Release appears against a backdrop of growing international, federal, state and local debate, legislative activity, and business initiatives about climate change. The Release itself has generated controversy. Representative Spencer Bachus (R-AL), the ranking member of the House Committee on Financial Services, has sent a letter to SEC Chairman Schapiro suggesting that the Release is motivated by a political partisan agenda, not protecting investors. Representatives Greg Walden, (R-OR), ranking member of the Oversight and Investigations Subcommittee, and Joe Barton, (R-TX), ranking member of the House Energy and Commerce Committee, have written the Chairman a letter suggesting that the Release circumvented rulemaking requirements and questioned its appropriateness. The challenges from members of Congress present points also made by the two dissenting Commissioners.

The Release is available at <http://www.sec.gov/rules/interp/2010/33-9106.pdf>

To put the Release into context, and to provide examples of when disclosure about climate change may be required, the SEC summarizes current legal initiatives addressing climate change, especially international accords, legislation and regulation.

The United States has been participating in discussions with other countries, including at the United Nations Climate Conference in Copenhagen, that could lead to treaties. Since 2005, the European Union has operated a "cap-and-trade" system to meet its obligations under the Kyoto Protocol to the United Nations Framework Convention on Climate Change to reduce carbon dioxide emissions.

Although the United States is not a signatory to the Kyoto Protocol, a number of legal developments are being considered, or have occurred, across the country to address climate change. At the federal level, the House of Representatives passed H.R. 2454,

the American Clean Energy and Security Act of 2009 (H.R. 2454), which includes a “cap-and-trade” program. The Senate is considering various legislative proposals to address climate change, but what action (if any) Congress will ultimately take, and when it will do so, is uncertain. In the meantime, the United States Environmental Protection Agency (USEPA) is almost certain to finalize the first mandatory greenhouse gas regulations in March of this year. As a precursor to such regulations, which will impact motor vehicles and a wide range of stationary sources, in December 2009 USEPA issued an “endangerment finding” for greenhouse gas emissions under the Clean Air Act that will allow the agency to promulgate rules to regulate them. USEPA also earlier this year enacted a regulation mandating large emitters of greenhouse gas emissions to collect and report information about them.

Many states are also acting. For example, the Regional Greenhouse Gas Initiative (RGGI) is a cooperative effort by ten Northeastern and Mid-Atlantic states to reduce carbon dioxide emissions through a “cap-and-trade” program for emissions from certain fossil fuel-fired electricity generating units. California has enacted AB 32, the Global Warming Solutions Act of 2006, under which the state is developing a plan to reduce greenhouse gas emissions. Other states and some Canadian provinces participating in either the Western Climate Initiative or the Midwest Greenhouse Gas Accord are considering ways to reduce emissions.

Against this background, the SEC asserts that its existing disclosure requirements cover climate change issues. In its view, the most pertinent non-financial statement disclosure rules that may apply to climate change are Regulation S-K Item 101 (Description of Business), Item 103 (Legal Proceedings), Item 503(c) (Risk Factors) and Item 303 (Management’s Discussion and Analysis of Financial Condition and Results of Operations or MD&A). The Release identifies legislation and regulation, international accords, indirect consequences of regulation or business trends, and physical impacts of climate change as four developments that may elicit disclosure requirements under one

or more of the items. The identified items apply to certain registration statements and to annual reports on Form 10-K and 20-F. This Update summarizes the provisions of Regulation S-K discussed in the Release and discusses climate change developments that the SEC believes may trigger disclosure.

PROVISIONS OF REGULATION S-K

Item 101

Under Item 101 a registrant describes its business and addresses specified issues about it. These include “appropriate disclosure” of the material effects that compliance with environmental laws may have on the company’s capital expenditures, earnings and competitive position. It must disclose material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year, succeeding fiscal year and further periods deemed material by the registrant.

Item 103

Item 103 requires descriptions of material pending legal proceedings to which a registrant or its subsidiary is a party, including proceedings in which its property is the subject of the litigation. Similar actions that, to the company’s knowledge, are contemplated by governmental authorities must be disclosed. Item 103 includes specific disclosure requirements for certain types of environmental proceedings. Administrative or judicial proceedings arising under environmental laws must be disclosed if: (1) the “proceeding is material to the business or financial condition of the registrant”; (2) it involves a claim for “damages, . . . monetary sanctions, capital expenditures, deferred charges or charges to income” exceeding “10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis”; or (3) a government authority is a party and the proceeding involves potential monetary sanctions, unless the registrant reasonably believes the proceeding will result in no sanctions or sanctions of less than \$100,000.

Item 503(c)

Item 503(c) calls for a discussion, “where appropriate,” of the most significant issues that cause an investment in it to be speculative or risky. By the item’s terms, the disclosure should discuss how specific risk affects the registrant and should not be a general discussion that could apply to any registrant, although common disclosure practices and the apparent expectations of the SEC’s review staff suggest otherwise.

Item 303

Item 303 prescribes disclosures of a company’s financial condition, liquidity and capital resources, and results of operations. In the SEC’s view, MD&A disclosure should allow a reader to see a registrant’s financial statements “through the eyes of management.” It should also be a context for analyzing the registrant’s financial information. Item 303 also requires a registrant to disclose any “known trend, event or uncertainty.” As the item is interpreted by the SEC, such disclosure is compulsory unless management can determine that the trend, event or uncertainty is not reasonably likely to occur or, if it is, that a material effect on the registrant’s financial condition or results of operations is not reasonably likely to result. The Release repeats the SEC’s surprising contention that “‘reasonably likely’ is a lower disclosure standard than ‘more likely than not’.” The time period for evaluating a trend, event or uncertainty will depend on a registrant’s circumstances and the particular trend, event or uncertainty.

The Release comments that, because many corporations have voluntarily reported information about their greenhouse gas emissions and other climate change matters to organizations, such as the Carbon Disclosure Project, who make that information publicly available, registrants should consider whether that disclosure is consistent with its disclosure in SEC filings.

CLIMATE CHANGE DEVELOPMENTS THAT MAY TRIGGER DISCLOSURE

Legislation and Regulation

The Release states that legislative and regulatory developments may trigger disclosure under Items 101, 103, 503(c) and 303 of Regulation S-K.

The SEC reminds registrants to consider whether international, state or local climate change requirements impose an obligation on them to disclose the material costs of complying with environmental law under Item 101. An example is the cap-and-trade system the European Union adopted to meet its obligations under the Kyoto Protocol to reduce carbon dioxide emissions. Under that system, certain emitters of carbon dioxide, primarily in the power generation and industrial sectors, must obtain allowances or carbon reduction offsets. The Release states that registrants with operations subject to the European Union’s “cap-and-trade” program should consider whether they have disclosure obligations. Certain fossil fuel-fired electricity generating units in the northeastern United States have been subject to similar “cap-and-trade” requirements under the Regional Greenhouse Gas Initiative.

Depending on a registrant’s circumstances, it may need to make risk factor disclosure concerning existing or pending climate change legislation. The SEC advises companies to consider the specific risks they face and avoid generic disclosure. As an example, the SEC explains that registrants that could be significantly impacted by greenhouse gas legal requirements, such as energy companies, may confront very different risks from such requirements than registrants that rely on greenhouse gas emitting products, such those who provide transportation. Another climate change development that could impact demand for products is that a number of countries have indicated an intention to impose a carbon tax on products originating from countries that do not, in the view of the importing state, take adequate steps to curb greenhouse gas emissions.

The SEC argues that Item 303 requires registrants to evaluate whether climate change statutes or regulations are reasonably likely to have a material effect on their financial condition or results of operations. With regard to a known climate change uncertainty, such as pending legislation or regulation, the SEC advises registrants to engage in a two-step analysis. The first step is to determine whether the pending legislation or regulation is reasonably likely to be enacted. Unless management can make that negative determination, it must assume the legislation or regulation will be enacted. If management must assume enactment, it proceeds with the second step of the analysis. In that step, unless management can determine that enacted legislation or regulation is not reasonably likely to have a material effect on it, its financial condition or results of operations, disclosure is required. The Release does not demand disclosure of the amount of greenhouse gas emissions, but it indicates that a registrant should have enough information about them to assist it in making judgments about disclosure. The Release also states that the registrant needs to consider disclosure, if material, of the difficulties of assessing the timing and effect of the pending legislation or regulation.

Examples of the financial consequences of pending climate change legislation and regulation identified by the SEC include possible costs to upgrade facilities and equipment to reduce emissions to meet regulatory limits or to reduce the costs of acquiring allowances or offset credits in a cap-and-trade program. Changes to profit or loss might also result from a change in demand for goods or services arising from legislation or regulation.

Because climate change legislation and regulation are evolving quickly, the SEC advises registrants to regularly evaluate their potential disclosure obligations in light of new developments. Sidley Austin is tracking closely regulatory developments at USEPA and potential impacts to various energy, manufacturing, and transportation sectors, and can advise on these impacts in further detail.

International Accords

The Release advises registrants to evaluate the impact of proposed and existing treaties and other international accords concerning climate change, and to consider whether those impacts should be disclosed under existing SEC requirements, especially Item 303. For registrants who are reasonably likely to be affected by potential international climate change agreements, the SEC advises them to monitor the progress of the agreements when making disclosure decisions.

Indirect Consequences of Regulation or Business Trends

The Release states that “[l]egal, technological, political and scientific developments regarding climate change may create new opportunities or risks for registrants.” Release at 25. They may create new or increased demand for some products or services, such as for energy-efficient products that result in lower emissions than competing products and for electricity generated from alternative energy sources. Similarly, they may create decreased demand for goods that cause significant greenhouse gas emissions or services related to carbon-based energy, such as drilling or equipment maintenance services. According to the Release, those business trends or risks may need to be disclosed as risk factors or in the MD&A. In some cases, the developments may have a sufficiently significant impact on a registrant’s business that disclosure would be required under Item 101, as might be the case if a registrant decided to change its plan of operation to benefit from potential opportunities.

A novel perspective suggested by the Release is the possible need to disclose reputational risk resulting from climate change developments. “Depending on the nature of a registrant’s business and its sensitivity to public opinion,” the SEC asserts, “a registrant may have to consider whether the public’s perception of any publicly available data relating to its greenhouse gas emissions could expose it to potential adverse consequences to its business operations or financial condition resulting from reputational damage.” Release at 26.

Physical Impacts of Climate Change

The Release contends that “[s]ignificant physical effects of climate change, such as effects on the 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.” Release at 26. The Release relies on a 2007 Government Accountability Office report and the sources it cites for the proposition that elevated levels of greenhouse gases can cause severe weather. The Release identifies examples of the possible consequences of severe weather as including: (1) property damage and disrupted operations for businesses on coastlines; (2) indirect financial and operational impacts if the operations of major customers or suppliers are disrupted by hurricanes or floods; (3) increased claims for insurers and reinsurers; (4) decreased agricultural output in areas impacted by drought; and (5) increased premiums and deductibles, or decreased insurance coverage availability, for facilities and operations in areas prone to severe weather. The Release advises registrants whose businesses may be harmed by severe weather or other climate-related events to consider disclosing “material risks of, or consequences from, such events in their publicly filed documents.” Release at 26.

PRACTICAL ISSUES

The Release is expected to cause registrants to take a harder look at whether climate change issues are reasonably likely to have a material impact on them, whether they should disclose climate change matters in their SEC filings and, if they have been making such disclosure, whether it is adequate. Although the SEC has advised registrants not to dilute the usefulness of their disclosure with immaterial information, registrants in business sectors that could conceivably be sensitive to climate change impact may well be questioned by SEC staff if their filings omit any discussion of matters covered by the Release. Of course, if a registrant decides to disclose its assessment that climate change is not reasonably likely to have a material impact on it, the registrant will want sufficient information to support that conclusion if it is questioned by the SEC.

NEXT STEPS FOR THE SEC

In the Release, the SEC states that it will monitor the impact of the Release on corporate filings through its ongoing disclosure review process. Its Investor Advisory Committee will consider climate change disclosure issues in connection with its general mandate to advise the SEC and make recommendations to it. A public roundtable on climate change disclosure issues will be held in the spring of 2010. Further guidance, or rulemaking concerning climate change disclosure, may follow.

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