Client**Alert**

Capital Markets

February 2010

SEC Adopts Interpretive Guidance on Climate Change Disclosure Obligations

On February 2, 2010, the US Securities and Exchange Commission (the **"SEC"**) issued new interpretive guidance (the **"Interpretive Release"**) clarifying the disclosure obligations of publicly-traded companies with respect to material climate change information.[1]

The Interpretive Release does not create new legal requirements nor modify existing ones. Furthermore, it does not alter the standard under which companies assess materiality, which determines what information a public company must disclose under the federal securities laws.[2] Rather, the Interpretive Release reaffirms that existing rules require disclosure of climate change information when material to a public company and highlights the following areas as examples of situations where climate disclosure may be required:

- impact of legislation and regulation;
- international accords;
- indirect consequences of regulation or business trends; and
- physical impact of climate change.

Each of these areas is discussed in more detail below.

The Interpretive Release is effective immediately, making it applicable to annual reports on Form 10-K to be filed for the upcoming proxy season. In addition, the SEC believes that the rules applicable to foreign private issuers filing annual reports on Form 20-F result in substantially the same disclosure requirements as apply to domestic issuers.[3] In both cases, companies that have previously considered their climate change disclosure carefully should find that the Interpretive Release results in minimal changes to such disclosure.

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1. *See* Commission Guidance Regarding Disclosure Related to Climate Change, Release Nos. 33-9106; 34-61469, available at http://www.sec.gov/rules/interp/2010/33-9106.pdf.
2. Information is material when there is "a substantial likelihood" that "the reasonable investor" would have regarded it "as having significantly altered the 'total mix' of information available to the public." *TSC Industries v. Northway, Inc.,* 46 U.S. 438, 449 (1976).
3. With respect to Form 20-F, Item 3.D requires disclosure of risk factors, Item 4.B.8 requires disclosure of the material effects of governmental regulation, Item 4.D requires disclosure of environmental issues that may impact the use of assets, Item 5.D requires disclosure of any known trends or uncertainties that are reasonably likely to have a material effect on a company's net financial position, and Item 8.A.7 requires disclosure of legal or arbitrational proceedings, including governmental proceedings, that may have significant effects on a company's financial position.

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Impact of Legislation and Regulation

The SEC identified several examples of the impact of current or pending climate change regulation or legislation that may trigger disclosure obligations, including (1) the financial effects of a "cap and trade" system, (2) costs required to improve facilities and equipment to meet regulatory requirements or (3) profits or losses resulting from increased or decreased demand for goods and services.

Business Description

Item 101 requires companies to disclose the material effects that compliance with existing federal, state and local environmental regulations may have on capital expenditures, earnings and competitive position. The effects of climate change legislation or regulation will vary depending on the nature of each company's business, ranging from the direct regulation of an energy company to a retail store being forced to raise its prices because of increased energy costs. In addition, companies are required to disclose any material estimated capital expenditures for environmental control facilities for the remainder of the current fiscal year, the following fiscal year and such further periods as the company may deem material.

In drafting their disclosures, companies should monitor regulatory developments, paying particular attention to state and regional restrictions, to determine whether any effects of such regulations on a significant component of their business necessitate disclosure. Further, companies should evaluate how their businesses might have changed relative to the current regulatory regime, addressing any material changes in their public filings.

Management's Discussion and Analysis (MD&A)

Item 303 requires discussion in the MD&A of material known trends, events or uncertainties. In determining whether to include any *enacted* climate change legislation in its MD&A, a company must assess whether such legislation is "reasonably likely to have a material effect on [the company's] financial condition or results of operation." In determining whether to include disclosure regarding potential effects of *pending* legislation, a company must assess whether (1) such pending legislation is reasonably likely to be enacted, and then, if enacted, (2) whether it is reasonably likely to have a material effect on the company. MD&A disclosure of pending legislation is required if a material effect is reasonably likely. In deciding whether to include disclosure regarding any enacted or proposed law, a company should not only consider negative consequences, but also consider opportunities the proposed law might create, such as the ability to sell offset credits or unused allowances under a "cap and trade" system.

The challenge presented by disclosure relating to pending legislation is that it calls on companies to speculate on what legislation will pass and its expected impact. This affords investors an opportunity to reevaluate the company's disclosure with the benefit of hindsight. One approach to this would be to present the effects of various regulatory scenarios on the company and shareholder value, including an analysis based on an appropriate range of carbon costs, and the indirect effects of regulation such as increased energy and transportation costs.

In light of the recent environmental regulatory efforts in the United States and overseas, public companies remain uncertain as to the effects of climate change and related legislation on their businesses. This uncertainty itself, if material, could warrant discussion in a company's MD&A or disclosure as a risk factor. This would be relevant, for example, if a company delayed investments in particular assets because it was unsure what impact environmental regulation could have on them.

Risk Factors

Item 503 requires disclosure of the most significant factors that make an investment in a company speculative or risky. Depending on the nature of the company's business, evolving legal requirements may lead to increased permitting and compliance costs, contamination and remediation liabilities, hazardous material exposure issues, changes in or even discontinuance of certain business operations, as well as any related litigation. As in the past, the SEC has cautioned against relying on boilerplate language to outline risks relating to climate change. Instead, risk factors should be particular to the company, and not applicable to companies at large. For example, an energy company would face significant risks from "cap and trade" legislation and would be required to disclose the financial risks relating to purchasing allowances where reduction targets cannot be met. Risks for other companies could be limited to capital expenditures to reduce emissions in response to regulatory developments.

International Accords

Any company with operations outside the United States should be aware that treaties to which the United States is not a party may be applicable to them. Such companies should implement internal mechanisms to carefully monitor the existing non-US international laws and potential future legal developments that might affect their businesses and analyze whether any of the existing or pending non-US regulations may have a material impact on the company's financial position. Furthermore, international regulation may have an indirect material impact on companies otherwise not subject to any non-US laws and regulations if their non-US business partners, customers or competitors are affected by the new regulations. Any such developments may require disclosure in a company's business section, MD&A or risk factors.

Indirect Consequences of Regulation or Business Trends

The Interpretive Release also addresses disclosure obligations arising from the indirect consequences of climate change. Specifically, the SEC stated that disclosure may be required relating to (1) decreased demand for "non-green" goods, (2) increased demand for "green" goods, (3) increased competition to develop innovative new products, (4) increased demand for the use of alternative energy sources or (5) decreased demand for services related to carbon based energy sources.

Business Description

The changing environmental landscape, including legal, technological, political and scientific developments, may impact companies' business decisions and strategies, creating new opportunities or posing new risks for companies. Any significant shifts in operations resulting from new acquisitions, introduction of new products or changes in supplier relationships may warrant disclosure under Item 101. For example, if a company plans to introduce "greener" products or services or if a supermarket chain plans to develop new supplier relationships in response to public demand for organic foods, if material, these shifts in plans of operations would be disclosable. Companies whose business partners or customers may be directly affected by climate change, may in turn experience indirect effects of climate change through increased costs of goods or services or decreased demand.

MD&A and Risk Factors

Climate change is going to affect different issuers in different ways. While utility companies may be affected more directly than financial institutions or service providers, companies should carefully consider the impact of climate change on their specific circumstances. For example, while the impact on a service provider might be less significant, an increase in energy costs caused by climate change legislation could affect such company's customers, which may in turn have a material effect on the company's business. The Interpretive Release states specifically that harm to a company's reputation may be one of the indirect risks of climate change that necessitates disclosure. A company must consider "whether the public's perception of…its greenhouse gas emissions" could have a negative effect on its financial condition. Of course this turns on the nature of the company's business, and its sensitivity to public opinion. For example, if an energy company which uses fossil fuels competes in a market where a number of energy company choices are available, indirect reputational consequences to such company may be a material risk or a known trend or uncertainty disclosable in the MD&A.

Physical Impact of Climate Change

The SEC identified certain physical consequences of severe weather that may require disclosure, including (1) effects on companies with business operations concentrated on coastlines, (2) disruptions to the operations of major customers or suppliers due to severe weather, (3) increased insurance claims and liabilities, (4) decreased production in areas affected by drought or (5) increased insurance premiums or a decrease in the availability of coverage.

While most companies susceptible to effects of severe weather already disclose risks to plants, facilities, personnel, supply, distribution chains and owned, operated or insured property posed by hurricanes, earthquakes, floods, rising sea levels or increasingly severe storms, the Interpretive Release suggests that the SEC expects all public filers to specifically consider any physical impact of climate change on their businesses and reassess their filings in light of the increased emphasis on environmental disclosure. For example, beyond physical damage to property, certain changes, like warmer temperatures, could affect demand for products or services. In addition, banks whose borrowers are located in at-risk areas may suffer indirect risks that may have to be disclosed. Therefore, all companies should carefully consider whether climate change could have any direct impact, such as damage to facilities, or indirect impact, such as damage suffered by customers or suppliers. Further, companies susceptible to the physical impact of severe weather, for example, as a result of their location, should discuss trends or uncertainties relating to climate change in their MD&A.

Other Considerations

The Interpretive Release does not address in detail disclosure regarding legal proceedings under Item 103 of Regulation S-K[4] and related disclosure in the footnotes to the financial statements with respect to such legal proceedings.[5] However, companies should consider monitoring this area carefully, and disclose litigations when proper. While almost all prior law suits relating to climate change have failed to survive a motion to dismiss, the Second Circuit recently held that public nuisance actions can be brought against private emitters of greenhouse gasses, remanding the case back to the District Court.[6] This ruling could have the dual effect of prompting new lawsuits and influencing other climate change nuisance actions that are pending. This also indicates that the courts, like the SEC, have an increasing sensitivity to and awareness of climate change.

4. Item 103 of Regulation S-K requires disclosure of "any material pending legal proceedings, other than ordinary routine litigation incidental to the business…[and] similar information as to any such proceedings known to be contemplated by the governmental authorities." The instructions to Item 103 specifically state that "an administrative or judicial proceeding...arising under any Federal, State or local provisions...regulating the discharge of materials into the environment...for the purpose of protecting the environment shall not be deemed 'ordinary routine litigation incidental to the business.'"
5. *See* Accounting Standards Codification Topic 450, Contingencies; *see also* Accounting Standards Codification Topic 275, Risks and Uncertainties.
6. *State of Connecticut, et al. v. American Electric Power Company Inc., et al.,* No. 05-5119-cv, (2d Cir. Sept. 21, 2009), available at http://www.globalclimatelaw.com/uploads/file/05-5104-cv_opn(1).pdf.

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