

**21<sup>st</sup> Annual  
Texas Environmental Superconference**

August 6-7, 2009  
Austin, Texas

Climate Change – Hot Issues

“Climate Change Disclosure”

by

C. Gregory Rogers  
Guida, Slavich & Flores, P.C.  
Dallas, Texas

## TABLE OF CONTENTS

I.	Climate Risk .....	1
A.	Regulatory Risk .....	1
B.	Physical Risk.....	2
C.	Liability Risk .....	2
II.	Disclosure .....	3
A.	GAAP.....	3
1.	Contingent Liabilities.....	3
2.	Emission Allowances .....	3
B.	Securities Laws .....	4
1.	Item 101 Description of Business .....	5
2.	Item 103 Legal Proceedings.....	5
3.	Item 303 Management Discussion and Analysis .....	6
4.	Item 503(C) Risk Factors .....	9
5.	Implied Disclosure Requirements .....	9
6.	Issue-Specific SEC Guidance.....	10
7.	State Blue Sky Laws .....	12
III.	Conclusion .....	13

This paper describes the accounting and legal framework for financial disclosure of liabilities and risks related to greenhouse gas emissions and climate change (herein referred to as “climate risk”). When evaluating climate risk disclosure policy, in addition to the accounting and legal framework described in this paper, corporations and their legal advisors should consider the key legal variables underlying an entity’s climate risk disclosure policy, the extent to which these variables lend themselves to management discretion, and the impact of recent developments on these variables, as well as potential bases for liability arising from mismanagement of climate risk, including securities fraud and breach of fiduciary duty, and the steps the Board and senior management can take to mitigate these risks.

## **I. Climate Risk**

According to the Intergovernmental Panel on Climate Change (IPCC), climate change refers to a change in the state of the climate that persists for an extended period, typically decades or longer. Climate change may be due to natural internal processes or external forcings, or to persistent anthropogenic changes in the composition of the atmosphere or in land use. Climate change may affect the frequency and severity of climate-related hazards, including avalanches, coastal flooding, erosion, sea level rise, drought, extreme heat, freezes, and severe weather and storms.

Greenhouse gases (GHG) are gases in an atmosphere that absorb and emit radiation. This process is the fundamental cause of the greenhouse effect. Common greenhouse gases in the Earth's atmosphere include water vapor, carbon dioxide, methane, nitrous oxide, and ozone.

The primary risks facing U.S. corporations relating to GHG emissions and climate change are widely cited as—(1) risks associated with present or future regulation of GHG emissions (herein called “regulatory risk”); (2) risks associated with climate change and climate-related hazards (herein called “physical risk”); and (3) legal liability arising out of, based upon or attributable to past or continuing emissions of GHG, climate change, or climate-related hazards (herein called “liability risk”). Each of these risks is further described below.

### ***A. Regulatory Risk***

*Regulatory risk* encompasses all financial risks associated with present or future regulation of GHG emissions. The imposition of government-mandated costs for GHG emissions, in the form of a carbon tax or emission allowances, is the most obvious direct financial impact of GHG regulation. Regulation of GHG emissions, however, can impose a far wider range of indirect impacts on both regulated and non-regulated entities. For example, higher carbon costs may increase the costs or decrease the supply of products or services on which the entity depends, decrease demand for the entity’s products or services, decrease the value of the assets used to produce products or services that are no longer in demand, and increase the entity’s cost of capital as investors move their money to different sectors of the economy.

## ***B. Physical Risk***

*Physical risk* encompasses risks all financial associated with climate change and climate-related hazards. Climate change and climate-related hazards have the potential to impact nearly every imaginable aspect of business. Widely cited risks include impacts to water availability and quality, assets located in coastal areas, oceans, or atop permafrost, the operating efficiency of temperature-sensitive equipment, and the health of the workforce. Direct impacts associated with global or regional climate change may vary widely depending upon an entity's location and the nature of its facilities and operations. Similar to regulatory risk, the indirect impacts of climate change—physical impacts to vendors, suppliers, and customers—have the potential to affect a wider range of entities located throughout the world. For example, climate-related hazards to coastal property may pose a material credit risk for banks whose borrowers are located in at-risk areas.

## ***C. Liability Risk***

*Liability risk* encompasses all financial risks associated with legal liability arising out of, based upon or attributable to past or continuing emissions of GHG, climate change, or climate-related hazards. Private suits to hold corporations liable for the alleged effects of global warming may become a fertile ground for civil litigation. A handful of such suits against private parties have already been filed.<sup>1</sup> Plaintiffs have brought climate change suits against GHG-emitting entities seeking relief for injuries they have allegedly incurred or expect to incur as a result of climate change. Some of these suits have primarily sought injunctive relief, while others have sought money damages. Thus far, these suits have been largely unsuccessful. Some legal experts predict climate change litigation will become the next “big thing”. Other experts contend that these suits face a number of procedural and substantive barriers that likely will hinder their success on a large scale.

Insurance companies have special exposure to liability risk through contracts insuring the climate-related losses of others. Pennsylvania Insurance Commissioner Joel Ario, who chairs the National Association of Insurance Commissioners (NAIC) Climate Change and Global Warming Task Force has speculated that climate change will have a huge impact on the insurance industry.<sup>2</sup>

---

<sup>1</sup> *Comer v. Murphy Oil USA, Inc.*, No. 1:05-CV-436 (S.D. Miss. 2006) (dismissed August 2007) (appeal pending; oral argument scheduled for Nov. 2008); *California v. GM Corp.*, No. 3:06-CV-05755 (N.D. Cal. 2006) (dismissed Sept. 2007) (appeal pending); *Native Village of Kivalina v. ExxonMobil Corp.*, 08-CV-1138 (N.D. Cal. Feb. 2008); and *Steadfast Ins. Co. v. The AES Corp.*, No. 2008/858 (Arlington Co. Cir. Ct., filed July 2008).

<sup>2</sup> [http://www.naic.org/Releases/2009\\_docs/climate\\_change\\_risk\\_disclosure\\_adopied.htm](http://www.naic.org/Releases/2009_docs/climate_change_risk_disclosure_adopied.htm).

## **II. Disclosure**

Climate risks may be subject to disclosure under U.S. generally accepted accounting principles (GAAP), federal and state securities laws, or both. In addition, there are several voluntary programs for disclosure of climate risk.

### **A. GAAP**

Climate-related loss contingencies and emission allowances are within the scope of accounting and disclosure standards under GAAP.

#### **1. Contingent Liabilities**

Assuming certain criteria are met, contingent liabilities arising from pending or threatened climate change litigation and actual or possible claims and assessments relating to past GHG emissions will be subject to quantification and disclosure under GAAP.<sup>3</sup> Conversely, physical risks associated with possible future uninsured damage to property from fire, flood, wind or other climate-related hazards generally will not be subject to quantification and disclosure under GAAP.<sup>4</sup> Such events are random in their occurrence and prior to the occurrence of the event there is no diminution in the value of the property. Also, unlike an insurance company, which has a contractual obligation under policies in force to reimburse insureds for losses, an entity can have no such obligation to itself and, hence, no liability. Prospective losses associated with future GHG regulation likewise generally will not meet the definition of an accounting impairment or liability because prior to the change in law, no legal obligation exists.

#### **2. Emission Allowances**

As discussed under Recent Developments below, the U.S. Congress is currently considering enactment of GHG cap-and-trade program. Cap-and-trade programs operate over defined (often annual) compliance periods. Credits are allocated (or auctioned) to the participants at the beginning of the compliance period. During the period, participants may buy or sell allowances directly with other participants or through a broker or on an exchange. At the end of a compliance period, the participant must deliver emissions credits equal to its actual emissions. If a participant fails to deliver the required credits, it may be required to pay fines (or receive a smaller financial incentive) and it may receive a smaller allocation of emissions allowances in the future. In some cases, unused (or excess) credits may be carried forward to future compliance periods.

For a compliance period, a participant has three options:

1. It may emit designated pollutants to the level of its allocated credits.

---

<sup>3</sup> FASB Statement 5, ¶¶ 2-4.

<sup>4</sup> FASB Statement 5, ¶¶ 27-28.

2. It may emit pollutants to a lower level than is represented by the allocated credits and it may sell or bank the excess credits.
3. It may emit pollutants to a higher level than is represented by the allocated credits and either buy additional credits or pay a penalty.

In the extreme, a participant may sell all of its credits at the beginning of the compliance period with the expectation of either buying credits to cover emissions at a later date, or ceasing emissions, or paying regulatory penalties. Typically, brokers and other nonparticipants are also allowed to buy and sell emissions credits, which may increase market liquidity.

Currently, there is no consensus under GAAP on how to account for participation in emission control schemes that use marketable credits. The FASB and the IASB are presently engaged in a joint project to provide comprehensive guidance on accounting issues related to emissions trading schemes, including asset recognition, measurement and impairment, liability recognition and measurement, timing of profit and loss recognition, accounting for vintage year swaps, presentation, and disclosure.<sup>5</sup>

### ***B. Securities Laws***

The SEC imposes certain specific and implied disclosure obligations, with registration statement and prospectus disclosure requirements for companies registering securities for sale or for issuance in business combination transactions under the Securities Act of 1933 (Securities Act), and with periodic and other reporting requirements for companies under the Securities Exchange Act of 1934 (Exchange Act). Reporting requirements must be addressed in quarterly reports on Form 10-Q and annual reports on Form 10-K under the Exchange Act. The filing and reporting requirements arise sooner in the event of a specifically required current report on Form 8-K and in connection with the registration of securities for sale or for issuance in business combination transactions (such as mergers and exchange offers), tender offers or proxy solicitations.

Although timing may vary, sooner or later a public company must assess its disclosure obligations and consider both those disclosure requirements in which the SEC calls for specific information and the disclosure requirements that are driven by a registrant's duty not to mislead, generally relating to the need to disclose all "material" information and to provide "complete" disclosure.

SEC Regulation S-K describes the narrative and quantitative information to be included in the nonfinancial statement portions of SEC reports. Item 101 (Description of Business), Item 103 (Legal Proceedings), Item 303 (Management's Discussion and Analysis of Financial Condition and Results of Operations, a/ka MD&A), and Item 503(C) (Risk Factors) bear the greatest relevance to climate risk disclosure. In addition, the antifraud provisions of the federal securities

---

<sup>5</sup> See [http://www.fasb.org/project/emissions\\_trading\\_schemes.shtml](http://www.fasb.org/project/emissions_trading_schemes.shtml).

laws may impose implied disclosure obligations (beyond that specifically required by Regulation S-K) to ensure that reported information is not otherwise misleading.

### **1. Item 101 Description of Business**

Under Item 101, issuers must disclose, among other things, the material effects of compliance with federal, state, and local environmental provisions on their capital expenditures, earnings, and competitive position. Section (c)(1)(xi) of Item 101 requires registrants to disclose:

the material effects that compliance with Federal, state and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries. The registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material.

There are several important observations to be made about the relevance of Item 101 to climate risk. First, public companies that are presently subject to regulations governing emissions of greenhouse gases must disclose the material effects of compliance with such regulations under Item 101. Second, Item 101 does not explicitly call for disclosure of indirect effects other than legal compliance. Reduction in demand for an entity's products and services due to GHG regulations, for example, does not fall within the plain language of Item 101. Finally, Item 101 does not call for disclosure of anticipated impacts relating to laws that have yet to be enacted. Thus, Item 101 does not require entities to speculate about the impacts of future federal legislation to regulate GHG emissions.

### **2. Item 103 Legal Proceedings**

Under Item 103, registrants must describe certain administrative or judicial legal proceedings arising from federal, state, or local environmental provisions. Item 103 directs registrants to briefly describe:

any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought.

Registrants must also disclose similar information as to any such proceedings known to be contemplated by governmental authorities.

Instruction 5 to Item 103 specifically addresses environmental legal proceedings, providing that “an administrative or judicial proceeding arising under any Federal, State or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment shall not be deemed ‘ordinary routine litigation incidental to the business.’” Environmental legal proceedings must be described if the proceeding:

- (A) Is material to the business or financial condition of the registrant;
- (B) Involves primarily a claim for damages, or involves potential monetary sanctions, capital expenditures, deferred charges, or charges to income and the amount involved, exclusive of interest and costs, exceeds 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis; or
- (C) Involves potential monetary sanctions by a governmental authority, unless the registrant reasonably believes that such proceeding will result in no monetary sanctions, or in monetary sanctions, exclusive of interest and costs, of less than \$100,000, regardless of materiality.

There are several important observations to be made about the relevance of Item 103 to climate-related legal proceedings. First, Item 103 explicitly applies only to pending legal proceedings. The SEC indicated in a 1979 release that a *proceeding* includes any administrative or judicial proceeding pending or contemplated by a governmental authority with respect to environmental matters.<sup>6</sup> Item 103 presumably does not call for disclosure of foreseeable, but as yet unasserted non-governmental claims. Trends relevant to liability risk may be subject to disclosure under Item 303 or 503(C). Second, due to the novelty of climate-related claims, for the foreseeable future such claims are unlikely to be considered ordinary and routine. Third, climate-related litigation will often arise under common law rather than environmental statutes. It is not clear whether common law claims would fall within the scope of Instruction 5 to Item 303. Finally, it is not apparent that climate-related legal proceedings present novel disclosure issues that are substantially different from considerations applicable to other types of litigation.

### **3. Item 303 Management Discussion and Analysis**

The purpose of the Management Discussion and Analysis (MD&A) is to provide investors information relevant to an assessment of the financial condition and results of operations of the registrant as determined by evaluating the amounts and certainty of cash flow from operations and from outside sources. At its best, the MD&A provides investors with an inside view of the state of the business through the eyes of management. Although Item 303 contains no specific

---

<sup>6</sup> SEC Release No. 33-6130, 1979 WL 169925 (Sept. 27, 1979).

environmental requirements, climate risk disclosure may be necessary to understand the registrant's financial condition and results of operations.

Of relevance to climate risk, Item 303 requires disclosure of known trends, events, or uncertainties that have affected, will affect, or are reasonably likely to affect the registrant's liquidity, capital resources, or results of operations. Disclosures should focus specifically on material events and uncertainties known to management that would cause reported financial information not to be indicative of future operating results or of future financial condition. The registrant should describe both matters that are expected to have an impact on future operations, but that have not had an impact in the past, and matters that have had an impact on reported operations and are expected to have a continuing impact on future operations.

Mandatory disclosure of climate risks arising from the future impact of presently known trends, events, or uncertainties and voluntary disclosure of forward-looking information about climate risks (or opportunities) both may involve some prediction or projection. In a 1989 Release,<sup>7</sup> the SEC clarified that the distinction rests with the nature of the prediction required. Required disclosure is based on currently known trends, events, and uncertainties that are reasonably expected to have material effects. In contrast, optional forward-looking disclosure involves anticipating a future trend or event or anticipating a less predictable impact of a known event, trend, or uncertainty.

Entities are required to disclose material risks when a trend, demand, commitment, event, or uncertainty is both presently known to management and reasonably likely to have material effects on the issuer's financial condition or results of operation. SEC Release No. 33-6130 provides the following step-by-step instructions:

When a trend, demand, commitment, event, or uncertainty [having the potential to materially affect the entity]<sup>8</sup> is known, management must make two assessments:

1. Is the known trend, demand, commitment, event, or uncertainty reasonably likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.
2. If the known trend, demand, commitment, event, or uncertainty is reasonably likely to come to fruition, management *must evaluate objectively the consequences of the known trend, demand, commitment, event, or uncertainty, on the assumption that it will come to fruition*. Disclosure is then required unless management determines that a material effect on the registrant's

---

<sup>7</sup> SEC Release No. 33-6835, 54 Fed. Reg. 22427 (May 24, 1989) (emphasis added).

<sup>8</sup> This bracketed text is implied as it is self-evident that an entity does not need to analyze every known trend and uncertainty.

financial condition or results of operations is not reasonably likely to occur.

*Each final determination resulting from the assessments made by management must be objectively reasonable, viewed as of the time the determination is made.*<sup>9</sup>

In a January 2002 Release, the SEC indicated its view that "reasonably likely" is a lower disclosure threshold than "more likely than not."<sup>10</sup>

There are several important observations to be made about the relevance of Item 303 to climate risk. First, the criteria for disclosure under Item 303 require judgment and thus allow for some degree of management discretion. Management must determine that a future outcome is *reasonably likely* to occur and that such outcome is *reasonably likely* to have a *material* effect on the entity's financial condition or results of operations. Second, informed disclosure of climate risk under Item 303 requires an objective evaluation of the potential future effects on the entity's financial condition and results of operations. If management determines that GHG regulation, changes in the climate, or successful climate-related litigation are reasonably likely to occur, it must evaluate objectively the consequences. Third, Item 303 does not require management to explicitly state its determination that new GHG regulations or changes in the climate are not reasonably likely to occur. Thus, in that instance, management is free to say nothing at all about climate risk.<sup>11</sup>

Finally, disclosure of information sometimes can adversely affect a company's business and financial condition because of the competitive harm that could result from the disclosure. SEC regulations seek to balance investors' needs for transparency with the possibility that disclosure will result in competitive harm to the registrant.<sup>12</sup> As climate risk becomes more relevant to business performance, companies will conduct increasingly sophisticated and detailed climate risk assessments and develop increasingly sophisticated and detailed business strategies.

---

<sup>9</sup> SEC Release No. 33-6835, 54 Fed. Reg. 22427 (May 24, 1989).

<sup>10</sup> See SEC Release No. 33-8056 (Jan. 22, 2002).

<sup>11</sup> *But see* the SEC's guidance regarding Y2K issues where registrants are instructed to disclose the status of any ongoing risk assessment.

<sup>12</sup> See e.g., SEC Release No. 33-8182, *Final Rule: Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations* ("The likelihood that competitors could infer proprietary information must be weighed against investors' needs for transparency of financial arrangements and resultant risk exposures."); SEC Release No. 33-8098, *Proposed Rule: Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies* ("If the proposed disclosure would involve competitive or other sensitive information, are there any mechanisms that would ensure full and accurate disclosure while reducing a company's risk of competitive harm?"); SEC Release No. 33-8995, *Final Rule: Modernization of Oil and Gas Reporting* ("A company would not be required to disclose proprietary technologies, or a proprietary mix of technologies, at a level of specificity that would cause competitive harm. Rather, the disclosure may be more general.").

Management is likely to regard such information as sensitive and proprietary and question the materiality of such information to investors. SEC Staff Legal Bulletin No. 1 (February 28, 1997)<sup>13</sup> describes views of the SEC Division of Corporation Finance regarding the requirements a registrant must satisfy when requesting confidential treatment of information that otherwise must be disclosed in documents filed with the SEC. The guidance, which generally tracks the criteria for shielding information from release under FOIA, states that required and/or material information generally must be disclosed, even if confidential.

In some instances the Commission's specific disclosure requirements cover information that could be withheld under FOIA. Except in unusual circumstances, disclosure required by Regulation S-K or any other applicable disclosure requirement is not an appropriate subject for confidential treatment, regardless of the availability of an exemption under FOIA.

#### **4. Item 503(C) Risk Factors**

As set forth in Item 503(C) of Regulation S-K, the SEC has long required issuers to consider, where appropriate, including in prospectuses filed pursuant to the Securities Act, disclosure of factors that make the offering to which the prospectuses relate “risky or speculative.” In 2005 the SEC adopted a requirement that certain issuers include risk factor disclosures in their annual and quarterly reports.<sup>14</sup> Affected issuers must use the standard for risk factor disclosure found in Item 503(C). Disclosures must be updated quarterly to reflect material changes from previously disclosed risk factors.

There are several important observations to be made about the relevance of Item 503(C) to climate risk. First, unlike Item 303, Item 503(C) does not require management to assess the likelihood of future outcomes. This avoids the need for management to determine that a future outcome is *reasonably likely* to occur and that such outcome is *reasonably likely* to have a *material* effect on the entity’s financial condition or results of operations. Rather, management can simply state, for example, that *if* the U.S. adopts a federal GHG regulatory program, the entity *could be* materially affected. Second, by removing the probability criterion, Item 503(C) effectively avoids the need for an objective assessment of the probability and severity of the risk factor in question.

#### **5. Implied Disclosure Requirements**

In addition to the specific disclosure requirements in Regulation S-K, there are additional “implied” disclosure requirements arising under the antifraud provisions of the federal securities laws. The primary implied disclosure obligation is Rule 10b-5.<sup>15</sup> Rule 10b-5 prohibits deceptive

---

<sup>13</sup> [www.sec.gov/interps/legal/slbcf1.txt](http://www.sec.gov/interps/legal/slbcf1.txt).

<sup>14</sup> SEC Release No. 33-8591.

<sup>15</sup> 17 C.F.R. § 240.10b-5.

or manipulative practices in connection with the purchase or sale of securities. In particular, issuers are prohibited from disseminating public information that is false or that fails to include material facts necessary to make the statements, in light of the circumstances in which they are made, not misleading.

In the administrative proceeding *In re United States Steel Corp.*, Exchange Act Release No. 16223, the SEC noted that “compliance with the [SEC’s] specific environmental disclosure rules does not necessarily constitute full compliance with the disclosure requirements of the federal securities laws.” It cites its general disclosure rules (*i.e.*, Securities Act Rule 408 and Exchange Act Rules 12b-20 and 14a-9), which require disclosure of any material information beyond that for which disclosure is specifically required necessary to make required statements not misleading. The SEC goes on to note that:

In the context of its environmental releases, the Commission has interpreted these rules as requiring that all material information relating to environmental matters must be disclosed. *See*, Release 5171, *supra*, at 1; Securities Exchange Act Release No. 5627 (Oct. 14, 1975, at 2). This approach reflects the [SEC’s] belief that omissions of material environmental information would render misleading the required disclosures concerning financial matters and the nature of a registrant’s business.

#### **6. Issue-Specific SEC Guidance**

In the lead up to the new millennium, the SEC provided specific disclosure guidance on Y2K issues. This guidance is illustrative of how the SEC might interpret issues involving climate risk disclosure. In Release No. 33-7558, the SEC offered guidance on determining whether Y2K issues are known material events, trends, or uncertainties that should be disclosed under Item 303. The SEC described the problem this way:

As the end of this century nears, there is worldwide concern that Year 2000 technology problems may wreak havoc on global economies. No country, government, business, or person is immune from the potential far-reaching effects of Year 2000 problems. President Clinton recently stated that "all told, the worldwide cost will run into the tens, perhaps the hundreds of billions of dollars, and that’s the cost of fixing the problem, not the cost if something actually goes wrong.

In the SEC’s view, the uncertainties presented by the Y2K technology issue generally were material and certain to occur, but predicting specific impacts for the overall economy and individual registrants was more problematic:

Only one thing is certain about the impact of the Year 2000 -- it is difficult to predict with certainty what truly will happen after December 31, 1999. To reduce

the impact of this potentially serious, widespread problem, many public officials and private commentators have spoken out about the need to plan properly now.

The SEC found that public companies had ample incentive to provide meaningful disclosure, but that many were failing to do so.

We believe that companies have sufficient incentive to provide meaningful disclosure to investors and meet their Year 2000 disclosure obligations. These incentives include business reasons, investor relations concerns, and possible referrals to our Division of Enforcement.

...

The task force discovered that companies were providing a wide variety of Year 2000 disclosures. While the number of companies disclosing Year 2000 issues has increased dramatically, the task force survey shows that many companies are not providing the quality of detailed disclosure that we believe that investors would expect.

The SEC's guidance on Y2K issues set forth a four-step process as follows. Note the SEC implicitly assumed that the first step of the process had already been decided in the affirmative for all public companies.

1. Determine whether the Y2K problem (a known trend, demand, commitment, event or uncertainty that could materially affect the entity) is reasonably likely to come to fruition.
2. Conduct an assessment of the Y2K compliance status of the entity and any third parties, including vendors, suppliers, and customers, with whom the entity has material relationships.
3. Determine whether the consequences of Y2K issues, including potential liability to third parties, will have a material effect on the entity's business, results of operations, or financial condition, without taking into account the entity's efforts to avoid those consequences.
4. Provide Y2K disclosure under Item 303 if Y2K issues are reasonably likely to have a material effect or if the assessment is not complete.

If disclosure was required, the SEC advised registrants to address four categories of information in their MD&A—(1) the company's state of readiness; (2) the costs to address the company's Y2K issues; (3) the risks of the company's Y2K issues; and (4) the company's contingency plans. The SEC's detailed guidance on each of these areas is discussed below.

State of Readiness. A company should describe its Y2K issues in sufficient detail to allow investors to fully understand the challenges that it faces. The description should be similar to that provided to a company's board of directors, which typically is non-technical plain English and answers the important questions such as "will we be ready?" and "how far along are we?" The description should address, at minimum, both information technology—the obvious problem—and non-information technology systems—the non-obvious problem many companies appeared to be overlooking, the status of the company's Y2K risk assessment, identified by phase, including the estimated timetable for completion of each remaining phase, and a description of the company's Y2K issues relating to third parties with which it has a material relationship.

Actual and Estimated Costs. A company should disclose material historical and estimated future costs of remediation. This includes costs directly related to fixing Y2K issues, even if the company had planned to undertake the action without regard to Y2K and merely accelerated the expenditure.

Reasonable Worst Case Scenarios. A company should describe its most reasonably likely worst case Y2K scenarios. If a company does not know the probability and severity of its Y2K risks, it should disclose this uncertainty, as well as its efforts to analyze the uncertainty and how it intends to handle this uncertainty.

Contingency Plans. A company should describe how it is preparing to handle the most reasonably likely worst case scenarios. This information will help investors evaluate the company's Y2K exposure by answering the important question -- "what will the company do if it is not ready?" The company should describe its contingency plan. If it has not yet established a contingency plan, the company should disclose that it does not have a contingency plan, whether it intends to create one, and the timetable for doing so.

The SEC cautioned that these disclosures should be specific to each company (avoiding generalities and boilerplate) and quantified to the extent practicable.

## **7. State Blue Sky Laws**

Although most regulation of securities in the United States is carried out by the federal government, the Securities and Exchange Act of 1933 permits states to enact their own securities regulations. Most states have adopted their own laws to regulate securities and these laws are commonly referred to as Blue Sky Laws. As discussed under Recent Developments below, the New York Attorney General recently used his authority under the Martin Act,<sup>16</sup> New York's 1921 Blue Sky Law, to subpoena information from five electric utility companies about the increased financial, regulatory and litigation risks associated with GHG emissions from new coal-fired power plants.

---

<sup>16</sup> N.Y. Gen Bus. Law, Art 23-A, § 325.

### **III. Conclusion**

For many investors and shareholder activists, the accounting and legal framework described in this paper affords too much management discretion and produces too little meaningful disclosure. A report released last month by CERES and two environmental groups found that 76 percent of S&P 500 companies failed to mention climate change in their annual SEC reports last year. These groups say the low rate of disclosure demonstrates a "fundamental failure" by the SEC.

In 2007 CERES submitted a 90-page petition to the SEC asking it to issue specific guidance on climate risk disclosure that would force companies to comply. That request collected dust while George W. Bush remained in office, but now appears to have found new life under the Obama Administration. A July 13, 2009 article appearing in the New York Times reported that "Federal regulators are preparing to launch 'a very serious look' at requiring corporations to assess and reveal the effects of climate change on their financial health, according to a commissioner on the Securities and Exchange Commission." If the SEC issues guidance on climate risk disclosure, temperatures soon will be rising in corporate boardrooms.