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Enter the SEC: Iran Sanctions Challenges in 2013—What Companies Need to Know

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February 6, 2013 is a date marked on many corporate calendars. The Securities and Exchange Commission ("SEC") will take on a new role in enforcing U.S. sanctions policy targeting Iran via reporting requirements in annual and quarterly filings due after that date. In addition, Iran sanctions rules for U.S. companies now are generally applicable to foreign subsidiaries with a divestment deadline looming on February 6. These are two major reasons that the ongoing, incremental expansion of U.S. sanctions policy targeting Iran will continue to challenge companies and in-house counsel in 2013.

This article will answer key questions about the new SEC reporting requirements, how the Treasury Department's Office of Foreign Assets Control ("OFAC") is approaching subsidiary liability and what strategic steps companies can take to meet these compliance challenges.

SEC Reporting for Companies and Affiliates

The new SEC reporting requirements were introduced by Section 219 of the Iran Threat Reduction & Syria Human Rights Act of 2012 ("TRA")[2] which added Section 13(r) to the Securities Exchange Act of 1934 ("Exchange Act"). No SEC rulemaking was called for by the statute and none is necessary for the reporting requirement to be effective.[3] Companies registered on national securities exchanges under Section 12 of the Exchange Act will be required to report in their annual and quarterly filings where the company or any "affiliates" knowingly engaged during the reporting period in specified conduct prohibited under U.S. sanctions rules for Iran.[4] This requirement is effective for SEC filings due after February 6, 2013.

Companies suddenly facing the prospect of reporting on their extended corporate family, shareholders and even directors and officers are asking (a) who is an "affiliate"; (b) what specific Iran-related activities must be reported; (c) how does the SEC interpret the initial reporting period; and (d) what is the process for reporting and enforcement?

Who are "Affiliates" under SEC rules?

An affiliate is "a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified." 17 C.F.R. § 240.12b-2.[5] Thus, it is important to understand how the SEC defines "control" and to note that it differs from OFAC's definition.[6] "Control" under Rule 12b-2 is defined as:

> the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

Thus, affiliates could include subsidiaries, joint ventures, and entities which a company otherwise controls. Affiliate relationships can derive from upstream control as well. Where a party has control of a registered U.S. company then other entities with the same parent—e.g., sister companies—might be considered affiliates of the company ("under common control with"). Control can be exercised by both entities and individuals under this definition and in some circumstances, directors, officers or major shareholders of a company could be deemed to have control and thus be affiliates under SEC rules.

U.S. courts have held that there is no bright-line rule for determinations of control and that a finding of control is a fact-specific inquiry requiring the review of the totality of circumstances. Thus, each company approaching these Iran-related reporting requirements would need to make determinations of affiliate status on a case-by-case basis based on SEC rules and case law precedent. Under the right circumstances, minority owners with as little as ten to twenty percent equity ownership might be considered affiliates.[7]

What Iran-related activities by affiliates must be reported?

Section 219 of the TRA describes a set of Iran-related activities which require SEC reporting if conducted, knowingly, by a company's affiliates during a given reporting period. Notably, this does not include all activities proscribed under the Iran sanctions regimes for U.S. persons.

TRA Section 219 requires reporting where issuers or affiliates "knowingly":

- Made investments of a certain size in Iran's energy sector as described in Section 5(a) of the Iran Sanctions Act of 1996 ("ISA") or engaged in the activities described in Section 5(b) of the ISA relating to weapons of mass destruction ("WMD"), conventional weapons, or participation in joint ventures with the government of Iran and certain other persons/entities involving the mining, production or transportation of uranium.
- Engaged in activities described in Section 104(c)(2) or 104(d)(1) of the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 ("CISADA"), including certain activities by foreign financial institutions that:
  - o facilitate efforts by the government of Iran, Iran's Revolutionary Guard Corps or agents/affiliates to acquire or develop WMDs or to support terrorism;
  - o facilitate activities of persons subject to financial sanctions under certain U.N. Security Council Resolutions;
  - o involve money laundering or facilitate efforts by Iranian financial institutions to perform certain sanctionable activity; or
  - o facilitate transactions or provide financial services for Iran's Revolutionary Guard Corps and certain other financial institutions blocked pursuant to the International Emergency Economic Powers Act (IEEPA); and
  - o transactions by persons owned or controlled by a domestic financial institution with or benefitting Iran's Revolutionary Guard Corps or blocked agents/affiliates.
- Transferred certain goods or "sensitive technology" to Iran, or provided services to such items once transferred, to be used to commit serious human rights abuses against the people of Iran as prohibited by Section 105A(b)(2) of CISADA.[8]
- Conducted any transaction or dealing with:
  - o any person blocked under Executive Order No. 13224 (relating to persons who commit, threaten to commit or support terrorism);
  - o any blocked person under Executive Order No. 13382 (relating to weapons of mass destruction proliferators and their supporters); or
  - o the "Government of Iran" without the prior authorization of the U.S. Federal Government.

Note that only the last provision specifically excepts reporting where conducted pursuant to U.S.-Government authorization.[9] Thus, the statute indicates that where a company or its affiliates acted pursuant to OFAC licenses while engaging in the other activities described above, the company needs to report the activity in its periodic SEC filings.[10]

The knowledge requirement noted above can introduce additional, complex legal issues which are not addressed here. The question of whether activity is undertaken "knowingly" is subject to some interpretation under federal securities law.

Approaching the initial reporting period

When approaching the reporting period for annual and quarterly filings due after February 6, 2013, companies should be aware of the following:

First, the requirement applies to reports "due" after February 6, 2013. Thus, filing before February 6 for a report due after that date would not serve to avoid the reporting requirement.

Second, the reporting requirement includes activities within the period of such initial reports, which would look back to include the covered prior year or quarter.[11] This puts companies in a difficult position as U.S. sanctions policy for Iran generally has not applied to non-U.S. affiliates.

Third, a registered company may need to report on relevant activities of any affiliate during the reporting period, even if the individual or entity is not an affiliate at the time of the annual or quarterly filing.[12] Companies will need to look back to assess who were affiliates throughout the reporting period. This may present challenges for companies that went through initial public offerings, mergers, acquisitions or other corporate changes during the initial reporting period.

What is the process for reporting and regulatory response?

Should a company have no activity to report, no action is required.[13] If a company determines that it or its affiliates has engaged in covered activity vis-à-vis Iran during the reporting period, the company must include this information in its annual and quarterly filings. The company is also required to make a separate, concurrent submission to the SEC providing notice of the information contained in the annual/quarterly filing.[14]

The report itself should provide a detailed description of the activity as indicated in Section 13(r)(2) of the Exchange Act, including:

- The nature and extent of the activity;
- The gross revenues and net profits, if any, attributable to the activity; and
- Whether the company or affiliate intends to continue the activity.

The SEC provides any reported information to the President, Congressional oversight committees and the public by posting on the SEC website per Section 13(r)(4).

The President is required under Section 13(r)(5) to undertake an investigation and, within 180 days, report to Congress on whether sanctions should be applied to the company or the affiliate.

Iran Sanctions Applied to Foreign Subsidiaries of U.S. Companies

SEC reporting requirements for affiliates introduce particular risk in light of new subsidiary liability rules under Section 218 of the TRA. This statutory provision was implemented on October 9, 2012 by Executive Order 13628,[15] which prohibits foreign entities owned or controlled by U.S. persons ("foreign subsidiaries") from knowingly engaging in most Iran-related activities that are prohibited for U.S. persons or persons in the United States.[16] U.S. parents were also made subject to penalties for violations of the foreign subsidiary.

"Ownership or control" is defined in the TRA to mean: (a) To hold more than fifty percent of the equity interest by vote or value in the entity; (b) To hold a majority of seats on the board of directors of the entity; or (c) To otherwise control the actions, policies, or personnel decisions of the entity.

The first two standards follow or parallel the common OFAC approach of fifty-percent ownership. The third standard provides a more flexible, case-specific measure of effective control over "actions, policy, or personnel decisions." This may provide OFAC with flexibility in pursuing enforcement for entities in which a U.S. parent has less than fifty-percent control.

However, the TRA provides that penalties will not apply where the U.S. parent divests or terminates business with the subsidiary by February 6, 2013. Thus, companies have been provided a window to avoid potential sanctions, albeit one which is closing shortly.

Addressing the Compliance Challenges

The introduction of new sanctions rules and a new regulator is always challenging. Senior management and counsel can help maximize their company's position through a combination of awareness and following three general rules:

(1) Communicate. Prepare a policy memorandum or other document, signed by an appropriate officer, which describes the SEC reporting requirement and subsidiary liability rules. This will serve to record company policy—a core part of good compliance plans. It will also provide notice to affiliates (and potential affiliates), which is important given that SEC reporting requirements may require companies to report on the activities of other members of the corporate family and, more uncomfortably, potentially on former affiliates, individual directors, major shareholders, or unrelated parties owned by the same parent. Advance communication can help to manage concerns and allow affiliates to share whether they have contacts with Iran that may require further due diligence. It also may highlight additional divestment issues in the short window remaining before February 6, 2013. Finally, company officials and counsel responsible for OFAC compliance will need to communicate with those responsible for SEC matters and vice-versa. After the Sarbanes-Oxley Act, most public companies established disclosure committees to oversee Exchange Act reporting and disclosure procedures. TRA reporting should be integrated with existing SEC disclosure procedures and companies' reporting infrastructure, as well as cross-referenced in compliance materials related to OFAC sanctions.

(2) Conduct and Record Due Diligence. For some companies, it will be easy to determine that no affiliates engaged in covered activities with Iran. For others, there will be difficult first-time questions and some risk that a company may miss affiliates or be unaware of reportable activity. Thus, it is advisable to set up a thorough due diligence process in case further information or inadvertent errors in legal interpretation emerge later, requiring potential disclosures. After implementing that process, in-house or outside counsel can record the due diligence methodology and results in a privileged memo to the compliance file. This will put a company in the best possible position with regulators.

(3) Know the Rules to Report what is Required. After completing due diligence, incorporate any required disclosures in periodic reports to the SEC, or to OFAC for subsidiary liability, if applicable. It may be prudent to err on the side of caution and transparency, but knowing the rules can help avoid over-reporting, which can result in substantial time and legal costs even if not a fine. The risks of misreporting include the (a) cost of internal investigation and dealing with regulators, (b) potential for securities class actions under Exchange Act Section 10(b) or other theories for misleading statements or omissions and (c) potential for derivative actions under state law. Before reporting, apply the SEC rules for "control" and assess who is an affiliate and who is not. Remember that SEC reporting is for "knowing" conduct by affiliates and for a specified set of Iran-related conduct. Finally, pay attention to the different, statutory definition of "ownership or control" that applies to subsidiary liability for OFAC purposes. ❑

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2 Signed into law August 10, 2012. See full text at www.treasury.gov/resource-center/sanctions/Documents/hr_1905_pl_112_158.pdf.

3 Iran-related reporting reflects the second recent instance of Congress employing the SEC reporting system for public companies to advance U.S. sanctions policy. Public companies also are required to make certain reports regarding the use of conflict minerals from the Democratic Republic of Congo and

adjoining countries on or before May 31, 2014 for the calendar year beginning January 1, 2013. Here the SEC was required to issue a final rule. See 77 Fed. Reg. 56274 (Sept. 12, 2012).

4 Section 13 of the Exchange Act provides for annual (Form 10-K) and quarterly (Form 10-Q) filings for companies registered under Section 12.

5 The SEC clarified that "the term 'affiliate' in Section 13(r) is as defined in Exchange Act Rule 12b-2." See Question 147.03 of the SEC's Dec. 4, 2012 Compliance and Disclosure Interpretations at www.sec.gov/divisions/corpfin/guidance/exchangeactsections-interps.htm (hereinafter the "December 4, 2012 SEC Guidance").

6 OFAC guidance indicates that ownership of fifty percent or more of an entity by a specially designated national, whether direct or indirect, generally would be sufficient interest or control for that affiliate to be treated as a blocked person. See Guidance of February 14, 2008 at http://www.treasury.gov/resource-center/sanctions/Documents/licensing_guidance.pdf. Certain OFAC regimes have specified standards for control (see, e.g., the Cuban Assets Control Regulations at 31 C.F.R. § 515.303). As discussed below, Section 218 of the TRA provides another statutory standard for ownership/control.

7 See SEC v. Cavanagh, 445 F.3d 105, 114 n. 19 (2d Cir. 2006) (observing that while "there is no bright-line rule declaring how much stock ownership constitutes 'control' and makes one an 'affiliate' under Section 4(1), some commentators have suggested that ownership of something between ten and twenty percent is enough, especially if other factors suggest actual control.").

8 The State Department provided guidance on what constitutes "sensitive technology" at 77 Fed. Reg. 67726 (Nov. 13, 2012).

9 See Dec 4, 2012 SEC Guidance at Questions 147.05-06.

10 The statutory text is somewhat counter-intuitive and individual companies might consider pursuing guidance from OFAC or the SEC to clarify whether reporting is required for action pursuant to valid authorizations.

11 The SEC confirmed that "an issuer that files an annual report for the fiscal year ending December 31, 2012 is required to disclose any activities . . . that took place between January 1, 2012 and December 31, 2012." Dec 4, 2012 SEC Guidance at Question 147.02.

12 The SEC staff has yet to provide public guidance on this issue. Based on informal conversations with the staff, this is our current interpretation.

13 See Dec 4, 2012 SEC Guidance at Question 147.04.

14 The SEC issued a notice on December 19, 2012 stating that issuers "should prepare a separate document that includes the information required by the statute . . . and submit it using a new EDGAR form type called IRANNOTICE." See http://www.sec.gov/divisions/corpfin/cfannouncements/itr-act2012.htm.

15 OFAC amended the Iranian Transactions and Sanctions Regulations on December 26, 2012 to reflect Section 218 of the TRA, adding 31 C.F.R. § 560.215 and otherwise updating the regulations. See 77 Fed. Reg. 75845.

16 The National Defense Authorization Act for Fiscal Year 2013 ("NDAA 2013"), signed January 2, 2013, requires additional Iran sanctions to be implemented within 180 days. If the orders implementing the new sanctions are made pursuant to IEEPA as well as the NDAA 2013 then Section 218 of the TRA indicates the new sanctions would apply to foreign subsidiaries.

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