SHEARMAN & STERLING LLP

Client Publication

Litigation | July 2006

SEC Requires Enhanced Disclosures of Dealings with Disfavored Countries

Since 2005, the staff of the Division of Corporation Finance (Staff) of the U.S. Securities and Exchange Commission (SEC) has sharply increased its scrutiny of disclosures made by issuers about their business dealings with certain countries disfavored by the U.S. Government. Both U.S. and non-U.S. issuers are subject to this enhanced scrutiny – and a number of issuers have been required to provide additional disclosures as a result. The expanded disclosures are intended to inform the investing public of dealings in these countries, even when such dealings, under a traditional materiality analysis, are both financially immaterial and legal.

This initiative is led by the Office of Global Security Risk (OGSR) created by the SEC at the urging of Congress. To date, OGSR proceeds mainly through questions and comments to issuers that have already mentioned a disfavored country in filed disclosure documents or, in the case of a foreign private issuer that is not yet reporting with the SEC, draft disclosure documents furnished to the Staff. However, we understand that OGSR is developing its own research capacity to enable it to proactively identify issuers with dealings in disfavored countries.

The Disfavored Countries

It is clear that OGSR is reviewing disclosures about dealings in the five countries designated by the U.S. Department of State as "state sponsors of terrorism": Cuba, Iran, North Korea, Sudan, and Syria.

To varying degrees, the designated state sponsors of terrorism are subject to U.S. economic sanctions. The broadest U.S. economic sanctions programs target, at the moment, Cuba, Iran, and Sudan (as well as Burma, which is not designated as a sponsor of terrorism). However, OGSR has pressed for enhanced disclosure about activities that are clearly not prohibited by these sanctions – including dealings with Libya during the period after President Bush terminated sanctions against that country but before he removed Libya from the list of sponsors of terrorism, and sales of "informational materials," which Congress has expressly exempted from sanctions. The lawfulness of the business dealings therefore does not appear to be a successful argument with OGSR.

For the moment, OGSR appears to be focusing entirely on dealings with the five sponsors of terrorism. But the scope of OGSR's mission likely is not limited to these five countries. Based on a Congressional report about the establishment of OGSR, OGSR's mission also seems to include requiring disclosure about dealings in countries with significant human rights problems. In the future, OGSR may begin to scrutinize dealings in such countries, although it is not clear what criteria OGSR would use to identify countries with significant human rights problems, and OGSR has not provided any public guidance to assist companies in identifying such countries (such as either a list of countries of concern or criteria for identifying such countries).

Qualitative Materiality

Issuers are required to disclose information that is material to the reasonable investor. Staff members have publicly advised that OGSR will not change the traditional materiality analysis. In addition to quantitative factors, issuers should consider "qualitative" aspects of materiality. That is, issuers should consider whether sales that are financially immaterial may nevertheless be material to reasonable investors for other reasons. For example, there may be "asymmetrical risk," where financially immaterial business dealings nevertheless pose material risks to the company. Then-SEC Chairman William H. Donaldson said that such asymmetry may arise when, as a result of dealings with a disfavored country, "a company faces public or government opposition, boycotts, litigation, or similar circumstances that are reasonably likely to have a material adverse impact on a company's financial condition or results of operations."

In practice, this analysis appears to conclude that all sales to countries identified by OGSR, however small in absolute or relative terms, are per se material. Indeed, such a rule seems to have been contemplated by the Congressional report, which declared that "a company's association with sponsors of terrorism and human rights abuses, no matter how large or small, can have a material adverse effect on a public company's operations, financial condition, earnings, and stock prices, all of which can negatively affect the value of an investment."

Future Developments

OGSR is still a relatively new office, so we expect that its focus and practices will continue to evolve. Changes may come as a result of world events, ongoing Congressional interest in OGSR's mission, and new leadership at the SEC. Issuers with international business dealings should remain alert to these changes as they prepare disclosures and other correspondence with the SEC.

For more information on the topics covered in this issue, please contact:

Perry S. Bechky
Washington, D.C.
+1.202.508.8095
pbechky@shearman.com

Danforth Newcomb
New York
+1.212.848.4184
dnewcomb@shearman.com