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Alert
International Trade/ SEC Disclosure

President Obama Signs Executive Order on New Iran Sanctions Act

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- Foreign Subsidiaries Controlled by US Persons Required to Comply
- SEC Disclosure Required for Activities with Iran

On October 9, 2012, the President issued an Executive Order implementing certain sanctions set forth in the "Iran Threat Reduction and Syria Human Rights Act of 2012" (the Act) and establishing additional sanctions with respect to Iran and entities that deal with Iran. The Act was signed into law by the President in August. The majority of the provisions of the Act expand or intensify sanctions that the President is authorized or directed to take against non-US individuals and entities that do business with Iran in ways that would expand or assist Iran in the petroleum (including petrochemical) and uranium sectors or related to proliferation of weapons of mass destruction or terrorism-related activities. US companies (and US nationals) have long been forbidden under sanctions administered by the Office of Foreign Assets Control (OFAC) from engaging in virtually all transactions with Iran. The objective of the new sanctions is to pressure non-US companies, to which for the most part OFAC sanctions against Iran do not apply, to nevertheless refrain from or narrow their dealings with Iran, especially in the expanded group of sensitive sectors and activities. This Alert does not attempt to summarize all Iran-related activities subject to sanctions or all the available sanctions that may be imposed. Rather, the focus of this Alert is on two provisions of the Act that received less press attention, but which significantly expand the reach of the US sanctions law against Iran and create a related SEC disclosure requirement for certain companies.

Foreign Subsidiaries of US Parents Now Subject to OFAC Sanctions Against Iran

The Act prohibits any entity *owned or controlled* by a US person and established or maintained outside the US from "knowingly"[1] engaging in any transaction directly or indirectly with Iran that would be prohibited by US law if it were engaged in by the US person or in the United States. Prior to the Act and the Executive Order, the mere fact of being owned or controlled by a US parent or person did not cause a foreign (non-US) subsidiary to be liable to comply with OFAC sanctions programs, except for the Cuba sanctions. Likewise, US parents of foreign subsidiaries were not liable under OFAC sanctions programs for activities of their foreign subsidiaries, unless the US parent directed or was otherwise involved with the activities. Again the exception was the Cuba sanctions program, which already applies to foreign companies owned or controlled by US entities. Therefore, US parents could take a hands-off approach and allow their foreign subsidiaries to engage in business with targets of US sanctions (except Cuba), so long as no US companies (including the parent) and no US nationals (including directors or employees of the foreign subsidiary) were involved in the transaction. Under Section 218 of

the Act, the OFAC Iran sanctions will apply to foreign subsidiaries of US companies in essentially the same way as the OFAC Cuba sanctions, which impose liability both on the foreign entity and on the US entity that owns or controls it. For purposes of Section 218, the Act specifically defines "owns or control" to mean with respect to an entity: (i) holding more than 50% of equity interest by vote or value; (ii) holding a majority of seats on the board of directors of the entity; or (iii) "otherwise" controlling the actions, policies, or personnel decisions of the entity.

While violations of the OFAC Iran sanctions generally may subject companies to both criminal and civil penalties, Section 218 of the Act imposes only civil penalties on the US parent. If the foreign company that the US entity owns or controls violates the OFAC Iran sanctions, the US parent is liable for civil penalties as if it had directly engaged in the conduct. Those penalties are the greater of $250,000 or twice the gross value of the violating transaction. The penalties on the US parent will apply if the foreign entity it owns or controls knew or should have known it was engaging in a transaction with an Iranian entity, whether or not the US parent had any knowledge of the activity, and whether or not the subsidiary was aware that US law prohibited such transactions.

The Act creates an exemption for those US persons who divest or terminate business with a foreign entity that they own or control that does business with Iran by February 6, 2013 (180 days after the date of enactment of the Act). While is it not clear from the Act, logically it would seem that there should also be no liability if, rather than divesting the foreign subsidiary, the US parent causes the foreign subsidiary to cease all business with Iran by the February 6 deadline. The latter alternative would seem to support the objective of sanctioning Iran more effectively than divestment, which would leave the former subsidiary still doing business with Iran. The October 9, 2012 Executive Order does not provide clarity on this subject, but it authorizes the Secretary of the Treasury to issue regulations. Absent regulations clarifying that US investors can comply with Section 218 by requiring their subsidiaries to cease doing business with Iran, the only prudent course of action for US investors is to divest of any subsidiary that has done business with Iran any time after October 9, 2012, even if such subsidiary ceases doing business with Iran by February 6, 2013.

The enactment of Section 218 means that US companies can no longer allow their foreign subsidiaries to have any dealings with Iran (other than certain narrow exceptions permitted for US persons, such as for exchange of information materials). US investors acquiring control of foreign companies that do even minor amounts of business with Iran will have to require those companies to cease such business or divest of such business before the US investor assumes control.

New Disclosure Required by SEC-Reporting Companies

Section 219 of the Act added new Section 13(r) of the Securities Exchange Act of 1934, which will require any company required to file annual or quarterly reports under Section 13(a) of the Exchange Act (including foreign private issuers) to disclose in such reports whether it or its *affiliates* have *knowingly* engaged in certain sanctionable activities involving Iran or Iranian entities or nationals during the applicable period. The required disclosure must be included in annual or quarterly reports required to be filed with the SEC after February 6, 2013. In effect, Section 219 of the Act requires companies to disclose precisely the activities that could subject them to sanctions. While SEC rulemaking is not required, the SEC could issue guidance in the future.

New Section 13(r) requires disclosure of any activities of the reporting company or any of its *affiliates* that could subject them to sanctions by the US government. This requirement effectively imposes a due diligence burden on reporting companies that will need to inquire into dealings with Iran by their affiliates. The Act does not define "affiliate." We assume that the SEC definition of "affiliate" under Rule 12b-2 of the Exchange Act applies, which defines "affiliate" with reference to another defined term – "control."[2] The term "affiliate" clearly includes subsidiaries of the reporting company. However, disclosure appears to also be required for the activities of parents or controlling shareholders of the reporting company, as well as sister entities under common control, or joint ventures which the reporting company controls. Whether control exists often depends on the

facts and circumstances involved and may exist in circumstances where a reporting company owns less than a majority of another company.

The Act requires disclosure if the reporting company knowingly or any of its affiliates knowingly engaged in sanctionable activities relating to:

- The Iranian petroleum industry or the development of weapons of mass destruction or other military capabilities, as described in the Iran Sanctions Act of 1996;
- Financial institutions that facilitate weapons of mass destruction, terrorism, money laundering, and other violations, as described in Section 104 of the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (the CISADA);
- The transfer of weapons and technology used in human rights abuses, as described in CISADA Section 105A(b)(2);
- Transactions or dealings with blocked persons who are designated as such pursuant to certain Executive Orders for their involvement with terrorism or weapons of mass destruction; or
- Transactions or dealings with the Government of Iran, or any entity owned or controlled by Government of Iran or acting on its behalf, without the specific authorization of a US Federal department or agency.

The periodic report must include a detailed description of (1) the nature and extent of the activity, (2) the gross revenues and net profits attributable to the activity, if any, and (3) whether the company or its affiliate intends to continue such activity. Concurrently with the filing of the periodic report, the reporting company must file a notice of such filing with the SEC, and the SEC must make the disclosure and notice publicly available on its website. The SEC is required to transmit the report to the President and certain government committees. The President must initiate an investigation, and within 180 days must determine whether to impose sanctions on the company.

The Act's reporting requirements will expand disclosure with respect to activities with or in Iran. Disclosure of Iran activities is now primarily elicited by the SEC Staff in the Division of Corporation Finance's Office of Global Securities Risk through the comment letter process. Currently, SEC Staff issues comments to reporting companies that either have disclosed, or that the SEC Staff otherwise have reason to believe may be engaged in, activities with any country designated by the State Department as "State Sponsors of Terrorism" (Cuba, Iran, Sudan and Syria). The SEC Staff may require additional disclosure, explanation or supplemental information about material contacts with or activities involving these countries. This process has traditionally allowed reporting companies to engage and negotiate with the SEC Staff prior to making any additional public disclosure. New Section 13(r) now mandates disclosure of sanctionable activities related to Iran conducted by reporting companies and their affiliates. This new disclosure requirement significantly increases the risk that sanctions will be imposed on account of disclosed transactions with Iran.

What To Do Now?

- Companies should determine whether their activities or the activities of any "owned or controlled" foreign entity involve sanctionable activities with Iran.
- Companies should prepare to divest prior to February 6, 2013 any "owned or controlled" foreign entity that may be engaging in sanctionable activities with Iran in order to avoid potential liability.
- SEC reporting companies should determine whether their activities or the activities of any of their "affiliates" involving Iran will require disclosure under Section 219 of the Act.
- SEC reporting companies should review and update disclosure controls and procedures for quarterly and annual reports to ensure that any sanctionable conduct is identified and disclosed under Section 219 of the Act.
- Companies should review and update their compliance processes and procedures for the Act.
- Companies should expand compliance and training programs to cover foreign subsidiaries and other affiliates to ensure that such foreign

entities understand the scope of the Act's prohibitions that now apply to them.

- US entities or persons investing in foreign entities should be aware that they could be held liable under Section 218 of the Act for the foreign entity's Iran-related business activities if the US entity or person "owns or controls" the foreign entity.

1 As defined the in Act, the term "knowingly" means that a person had actual knowledge, or should have known, of the conduct, circumstance or result.

2 Exchange Act Rule 12b-2 defines an "affiliate" of a company as a person or entity who directly (or indirectly through one or more intermediaries) controls, is controlled by, or is under common control with such company. "Control" is defined to mean the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person or entity, whether through the ownership of voting securities, by contract, or otherwise.

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