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SUNLIGHT ON IRAN:
HOW REDUCTIVE STANDARDS OF MATERIALITY EXCUSE INCOMPLETE DISCLOSURE UNDER THE SECURITIES LAWS

Amy Deen Westbrook*

I. INTRODUCTION

Barclays Bank Plc paid a $298-million fine for violating U.S. sanctions on Iran and other terrorism-sponsoring countries. A billboard asking "Today's Work, Tomorrow's Nuclear Iran?" featuring pictures of Iranian president Mahmoud Ahmadinejad and Caterpillar Inc. equipment was erected near Caterpillar Inc.'s corporate headquarters in Illinois. The

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* Associate Professor and Director, Business and Transactional Law Center, Washburn University School of Law. This article builds on What's in Your Portfolio? U.S. Investors Are Unknowingly Financing State Sponsors of Terrorism, 59 DePaul L. Rev. 1151 (Summer 2010) in which I presented original empirical research demonstrating that reporting companies are not disclosing their operations in countries subject to comprehensive U.S. sanctions. This article uses the lack of disclosure of operations in Iran, established in What's in Your Portfolio and elsewhere, to argue for more general doctrinal reformulation. I would like to thank Myrl Duncan, Linda Elrod, Bill Merkel, Cheryl Nichols, Bill Rich, and David Rubenstein for their helpful comments, Mike Schwartz, Brad Borden and Marc Miller for their terrific advice, and United Against Nuclear Iran (I serve as a member of their Advisory Board). I would also like to thank Rebecca Sanders for her wonderful research assistance. Finally, I would like to thank my husband, David A. Westbrook, for his encouragement and his very insightful suggestions. All mistakes are my own.

1. Press Release, U.S. Dep't. of Justice, Barclays Bank Plc Agrees to Forfeit $298 Million in Connection with Violations of the International Emergency Economic Powers Act and the Trading with the Enemy Act (Aug. 18, 2010), available at http://www.justice.gov/opa/pr/2010/August/10-crm-933.html (announcing that Barclays had agreed to forfeiture of $298 million, a public admission of its illegal acts, and the implementation of stringent compliance measures to settle charges that it conducted illegal transactions on behalf of customers from Iran, Cuba, Sudan and other countries sanctioned in programs administered by the Office of Foreign Assets Control (OFAC)).

Wall Street Journal reported that technology from Nokia Corp. and Siemens AG was being used by Iran to spy on Iranians and crack down on dissent, and included the YouTube video of the killing of female Iranian music student, Neda Agha Soltan, in the online article. Media campaigns were launched to pressure General Electric Company, Huntsman Corporation, and Ingersoll Rand Plc to cease operations in Iran. Should investors have known that those companies were doing business in Iran before the negative publicity or fines? Certainly. Had these companies disclosed their involvement in Iran? Hardly. How, in a world of publicly traded securities and ostensibly transparent markets, did this happen?

It would be tough to imagine an issue more clearly important to the public and risky for investors than a company’s business operations in Iran. Nuclear threat, sponsor of global terrorism, and human rights violator, Iran is the object of comprehensive U.S. and international sanctions; its government is unstable; there is a high risk of recurring violence; and there are even suggestions that military action may be taken against it. It is illegal for a U.S. person, either a corporation or a business, to do business in Iran. However, most U.S. laws do not apply to foreign companies, including foreign subsidiaries of U.S. companies. If their home countries do not impose restrictions on Iranian activities, such companies may do business in Iran and sell securities in the U.S. markets. As a result, U.S. investors may own stock in a company that either directly or indirectly conducts business in Iran.

Although business activities in Iran are important to the public, it requires an enormous wellspring of investor demands and nongovernmental organization (NGO) action to elicit disclosure. So much investor effort is needed, in part, because the Securities and Exchange Commission (SEC) has refrained from identifying business in Iran as “material,” which is a key factor in determining whether particular information about a public company must be disclosed. It appears the SEC does not consider business in Iran to have a significant direct financial impact on a company.


5. Nokia Corp. and Siemens did make some minimal disclosure of the fact that some sales were made to Iran, with no details and no discussion of the risks. Nokia Corp., Annual Report (Form 20-F), at 47 (Mar. 20, 2008) (the same language is used for several years); Siemens AG, Annual Report (Form 20-F), at 11–12 (Nov. 28, 2007) (also asserting that such operations do not represent a material investment risk). For a more general discussion of non-disclosure of business operations in state sponsors of terrorism, see generally Amy Deen Westbrook, What’s in Your Portfolio? U.S. Investors Are Unknowingly Financing State Sponsors of Terrorism, 59 DEPAUL L. REV. 1151 (2010) (presenting empirical evidence of a low corporate disclosure rate of business activities in Cuba, Iran and Sudan).

Thus, until the financial cost of doing business in Iran becomes undeniable, companies do not disclose. Investors invest on the basis of inadequate information. Business that the United States wants to discourage is, in fact, encouraged by the provision of capital at prices that do not include (price in) recognition of doing business in a state sponsor of terrorism. When the risks become reality, companies, and by extension investors, lose money. When a company’s business in Iran is not disclosed to investors, it constitutes a failure of the regulatory disclosure regime established under the securities laws and enforced by the SEC. How did this happen, and what is to prevent it from happening again?

Answering these questions requires some understanding of the mandatory disclosure regime imposed on publicly traded companies by the federal securities laws. In particular, the regulatory concept of “materiality” is used to help define what a company is required to tell the public about its business, and conversely, what a company is allowed to keep secret. The concept of materiality, however, is not rigidly or even clearly defined. Regulatory understandings of what is material— and therefore, as a practical matter, what must be disclosed— have shifted over the years. In its most basic formulation, materiality means that the information is likely to be significant to a reasonable investor in making an investment decision. In practice, if a business activity does not have a current, quantifiable impact, companies tend to avoid disclosure. As discussed below, when it comes to operations in Iran within a multinational group, disclosure generally has not been required unless and until the issue becomes so important that it has substantial financial repercussions, such as legal proceedings or regulatory compliance costs, that presumably would affect share prices. At that point, the operations are identified as “material,” and disclosure is required.

Companies doing business in Iran often successfully maintain that their Iranian operations have negligible effect on the bottom line, and therefore do not need to be disclosed. Even though it seems implausible that companies are doing business in a state as problematic as Iran without making money, and that it just as unlikely that U.S. investors do not care if companies are engaged in business forbidden to the investors themselves, the lack of a current, quantifiable impact seems to be dispositive in almost
all cases of business in Iran.

The resulting lack of disclosure of company operations in Iran thus illustrates the failure of a reductive understanding of materiality. In particular, understanding materiality in purely quantitative terms is inadequate because reasonable investors want to know some information that is not easily quantifiable. In addition, exclusive reliance on quantification implausibly presumes sound accounting and efficient financial markets, both presumptions that were called into question in the recent financial crisis. Limiting materiality to significant effects on revenues may also undercut other U.S. policies, such as national security concerns in the case of Iran, and is at odds with the plain meaning of securities laws. In addition, such a simplified understanding of materiality may not trigger disclosure of changing circumstances, so investors are not adequately apprised of issues that have not yet, but may later, impose significant costs.

This article argues that the SEC should cease accepting company interpretations that deny materiality of information based almost solely on a lack of currently quantifiable costs. The SEC should make it clear that materiality means what the Supreme Court said decades ago: “a substantial likelihood that the disclosure . . . would have been viewed by the reasonable investor as having significantly altered the ‘total’ mix of information made available . . .”\(^{10}\) The Court’s formulation includes more than simple financial impact.

This Article explores why the SEC’s reductive understanding of materiality is hindering disclosure of investor priorities, as demonstrated by how the securities laws deal with business operations in Iran. Part II provides an overview of the duty to disclose under U.S. securities laws, as delineated by the doctrine of materiality, and reviews past efforts to define materiality, especially in the contexts of management integrity and climate change issues. Part III discusses how business operations in Iran belatedly become material, to the cost of investors and U.S. interests. Part IV argues that the reductive standard requiring a direct quantifiable impact as a *sine qua non* of materiality is bad as a matter of law and policy. The Article concludes with a recommendation that the SEC should reassert a broad understanding of materiality and require disclosure when it is needed by investors. If you are guiding a car backing into a parking space, you should not wait until the car hits the curb before you say “stop.”

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II. THE DOCTRINE OF MATERIALITY

A. THE DUTY TO DISCLOSE AS LIMITED BY THE DOCTRINE OF MATERIALITY

1. Disclosure-Based Securities Regulation

Part of sweeping financial reform in the wake of the 1929 stock market crash, the Securities Act of 193311 and the Securities Exchange Act of 193412 (together, the Securities Acts) were enacted to prevent a recurrence of financial catastrophe by requiring disclosure of information to investors and imposing penalties for false or misleading disclosures.13 Moreover, the Securities Exchange Act created the SEC to interpret the statutes, to promulgate regulations and rules as needed, and to enforce the regime.14

The resulting body of securities law establishes an elaborate system of mandatory disclosure requirements. The emphasis on the disclosure of information in the securities laws15 is often associated with the words of Louis Brandeis: “Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”16 In a well ordered society, or market, making information publicly available is the best way to ensure good behavior. Accordingly, the securities laws require companies to tell their investors, their owners and providers of capital, what the company does.

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15. LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, FUNDAMENTALS OF SECURITIES REGULATION 32–45 (Aspen 5th ed. 2004) (discussing “The Battle of the Philosophies” in which Brandeis’ disclosure philosophy was chosen over Professor William O. Douglas’ arguments for greater control over the securities being offered to the public).
16. LOUIS D. BRANDEIS, OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT 92 (1914). Felix Frankfurter, who was also strongly associated with the disclosure mechanism, commented “[t]he Securities Act is strong insofar as publicity is potent; it is weak insofar as publicity is not enough.” Felix Frankfurter, The Federal Securities Acts: II, FORTUNE, Aug. 1933, at 55.
The U.S. system of federal securities regulation is disclosure-based, not “merit-based”; it requires that the information be provided to investors, but does not regulate soundness of investments. The regime thus assumes that well-informed investors, not the government, should decide where capital should be invested and that a market mechanism should control the allocation of capital, thereby guiding the direction of business. From the corporate perspective, disclosure may be viewed as an obligation that companies undertake in order to avail themselves of the privilege of selling securities to the public. From society’s perspective, the perspective of the law, information helps ensure that capital formation is responsible.

2. The Need for Limits on the Duty to Disclose

A document cannot represent literally everything about a company’s existing business and prospects, both good and bad. The world is too complicated. Even if such a document could be written, who could read it?

17. Many state “blue-sky” laws were merit-based. The federal and state systems continue to coexist, but the federal system increasingly preempts state regulation. The scope of state securities regulation was significantly curtailed in 1996 with the passage of the National Securities Markets Improvement Act of 1996 (NSMIA), which generally preempts state regulation that requires registration or qualification of most publicly traded securities listed on a national exchange. National Securities Markets Improvement Act § 102 (amending Section 18 of the Securities Act of 1933), 15 U.S.C § 77r(b)(1)(A).

18. The disclosure based system has of course not been without critics. See, e.g., George J. Benston, Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934, 63 AM. ECON. REV. 132 (1973); David J. Schulte, The Debatable Case for Securities Disclosure Regulation, 13 J. CORP. L. 535, 536 (1988). This debate is tied to the merits of the Efficient Capital Markets Hypothesis, a full discussion of which is beyond the scope of this article.


20. A model in which the government mandates company disclosure is a form of civil regulation in which society makes the choice of which behavior to support and which to eschew. John Parkinson, Disclosure and Corporate Social and Environmental Performance: Competitiveness and Enterprise in a Broader Social Frame, 3 J. CORP. L. STUD. 3, 4 (2003). This transfer is seen as efficient, both in terms of regulatory resources and decision-making. Karkkainen, supra note 19, at 293.


As such, the general obligation to disclose is limited both by a list of specific requirements and by a general notion of what is relevant to investor decisions: that which is “material.”

The disclosure requirements may reflect a regulatory agenda, that is, the SEC’s evolving ideas about what is important to investors and, more broadly, the public interest in sound markets. For example, the 2002 Sarbanes Oxley Act requires publicly traded companies to disclose whether they have financial experts on their audit committees. The goal of this disclosure requirement is to encourage companies to place such experts on their committees. Similarly, the rules and regulations requiring disclosure of executive compensation arrangements have sought to mobilize shareholder outrage in order to reduce compensation packages.

Thus, over time, as issues arise and are addressed, disclosure regulation tends to accumulate. Petitions to add items to the list of mandatory disclosure are common. Petitions to remove items are rarer. There is always the possibility that the SEC, seduced by the relative ease and efficiency of requiring disclosure, will require companies to disclose more and more information, until the cost is unduly burdensome to companies and/or there is so much information in the marketplace that investors are unable to sift through it to get to what is “important.” In this way, disclosure is like a Victorian house that has accommodated generations of owners with numerous additions and small changes, getting bigger and more awkward each time. When disclosure results in

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32. Such Victorian-era houses are also very hard to sell.
"information overload" it is no longer effective.33

3. How Does Disclosure Work?

The Securities Acts, as further defined by SEC rules and regulations, require companies that sell securities to the public to "file," i.e., disclose or report, information with the SEC at certain times.34 "Reporting companies" or "public companies"35 include companies that have listed securities on a U.S. exchange,36 companies with a nexus to interstate commerce that have at least 500 shareholders and $10 million in assets,37 and companies that have made a registered public offering in the United States.38

Foreign companies39 that avail themselves of the U.S. markets are subject to disclosure requirements, on slightly different forms, that are very similar to those applicable to U.S. issuers.40 Consequently, foreign companies, to which U.S. law generally does not apply (and which therefore need not abide by U.S. sanctions on Iran or other countries) are nonetheless subject to U.S. disclosure laws if they sell securities in the U.S. markets.

A reporting company is required to disclose specified information upon the initial issuance of securities,41 periodically thereafter,42 and


34. Securities Act of 1933 §19(c), 15 U.S.C. §77s(a) (2002) (granting the SEC authority to make "such rules and regulations as may be necessary to carry out the provisions of this title"); Exchange Act §23(a)(1), 15 U.S.C. § 78w(a)(1) (2006) (granting the SEC authority "to make such rules and regulations as may be necessary or appropriate to implement the provisions of this [title]").

35. For purposes of this article, a company that sells securities to the public is the same as a reporting company.


39. A "foreign private issuer" is any foreign issuer (other than a foreign government) unless over half of the issuer's stock is held by U.S. residents, the majority of its officers or directors are U.S. citizens, more than half of its assets are located in the United States or its business is administered principally in the United States. See Exchange Act Rule 3b-4, 17 C.F.R. § 240.3b-4. As of December 31, 2009, there were nearly 1000 foreign private issuers registered with the SEC. See, U.S. SEC. & EXCH. COMM'N, FOREIGN COMPANIES REGISTERED AND REPORTING WITH THE U.S. SECURITIES AND EXCHANGE COMMISSION (Dec. 31, 2009), available at http://www.sec.gov/divisions/corpfin/internatl/foreignalpha2009.pdf.


41. See Securities Act of 1933, §§ 5,7,10, Schedules. A and B, 15 U.S.C. §§ 77e, 77g, 77j, 77aa (1994). The registration process for issuing securities to the public includes the production of a prospectus and a registration statement (using for example Form S-1 or Form S-3, or, in the case of non-U.S. issuers, Form F-1 or Form F-3) in order to provide investors with the information they need to make an informed decision about purchasing the securities.
whenever there is an extraordinary corporate event. Once reported to the SEC, this information is usually made immediately available to the public using the SEC website and its Electronic Data Gathering Analysis and Retrieval (EDGAR) system.

A key source of specific disclosure requirements under the federal securities laws is Regulation S-K (Reg S-K). Reg S-K specifies a number of “line item” categories of information that must be disclosed in the non-financial portions of registration statements and periodic reports: information about the company’s business; the company’s securities; the company’s financial data; the company’s management and certain security holders; and other information from the registration statement and prospectus.

Some of the “line item” areas of disclosure pertain to the disclosure of information that cannot be reliably quantified at the time of reporting. For example, Item 101 (Description of Business) requires disclosure of the “general development of business” and a “narrative description of business” including, “to the extent material to an understanding of the

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42. Exchange Act, §§ 12(b)(1), 12(g)(1), 13, 15(d), 15 U.S.C. §§ 78(b)(1), 78(g)(1), 78m, 78o(d) (1994). This includes filing annual (for example, Form 10-K or in the case of non-U.S. issuers, Form 20-F reports) and quarterly (Form 10-Q) reports. It also includes proxy statements filed in connection with shareholders meetings pursuant to Section 14(a).


44. Some information included in correspondence and petitions may be redacted at the request of the company.


51. 17 C.F.R. § 229.101(a) (describing the general development of the business of the registrant).

52. 17 C.F.R. § 229.101(c) (describing the business done and intended to be done by the registrant). Item 101 also instructs companies to describe “any risks attendant to [their] foreign operations.” 17 C.F.R. § 229(d)(1)(3). The instructions to Item 101 specifically instruct companies to “take into account both quantitative and qualitative factors.” 17 C.F.R. § 229.101 ("situations may arise where information should be disclosed about a segment, although the information in quantitative terms may not appear significant to the registrant’s business taken as a whole.").
registrant’s business taken as a whole," information about where a company does business, the principal markets for the company’s products, and the sources of the raw materials used by the company.

Item 103 of Reg S-K (Legal Proceedings) requires disclosure of “any material pending legal proceedings . . . to which the registrant or any of its subsidiaries is a party,” including any such proceeding “known to be contemplated by governmental authorities” which is not routine or incidental to the company’s business.

Item 303 (Management’s Discussion and Analysis of Financial Condition and Results of Operations) requires a broad discussion of the company’s operations from the management’s perspective. Item 303(a) thus requires the company to disclose “currently known trends, events, and uncertainties that are reasonably expected to have material effects” on results of the company’s operations or to cause a material increase or decrease in the company’s liquidity or capital resources.

In addition, a company that sells securities to the public in the United States is required by Item 503(c) to disclose risk factors that may affect the issuer of the securities being offered. In many cases, investor concerns

54. 17 C.F.R. § 229.101(c)(1). Item 101 does, in several cases, provide specific numerical benchmarks for the disclosure of particular information. For example, Item 101 requires that amount or percentage of revenue contributed by a company’s product or service must be described if it accounted for “10 percent or more of consolidated revenue in any of the law three fiscal years, or 15% or more of consolidate revenue if the total revenue was not greater than $50,000,000 during any such fiscal years.” 17 C.F.R. § 229.101(c)(1)(i).

55. 17 C.F.R. § 229.101(c)(1)(i).

56. 17 C.F.R. § 229.101(c)(1)(ii).

57. 17 C.F.R. § 229.103. The instructions indicate that qualitative factors, even if not reliably quantifiable, should be considered. See Yvonne Ching Ling Lee, The Elusive Concept of 'Materiality' under U.S. Federal Securities Laws, 40 WILLAMETTE L. REV. 661, 671–72 (2004).

58. Concept Release on Management’s Discussion and Analysis of Financial Condition and Operations, Exchange Act Rel. No. 6211, 52 Fed. Reg. 13715, 13717 (Apr. 26, 1987). Regulation S-K, Item 303(a)(1) (Liquidity), for example, instructs companies to “[i]dentify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonable likely to result in the registrant’s liquidity increasing or decreasing in any material way.” For example, if substantial numbers of investors ceased purchasing or divested themselves of the securities of a company because of operations of which investors disapproved, such investor actions could have a “foreseeable material impact on the company’s ability to raise cash through the sale of its securities,” and the company would be required to disclose those material effects. Memorandum from David B.H. Martin, Dir., Div. of Corp. Fin., U.S. Sec. & Exch. Comm’n, in response to letter dated April 2, 2001 from Congressman Wolf (May 8, 2001) (hereinafter “Martin Memorandum”) reprinted in 33rd Annual Institute on Securities Regulation, November 8-10, 2001 at 1127 (Pl.I Corp. Law & Practice, Course Handbook Ser. No. 1125, 2001). The Martin Memorandum is discussed in more detail in Part D(4)(E)(I) below. The instructions to Item 303(a) further clarify that “[f]oreign private registrants also shall disclose briefly any governmental economic, fiscal, monetary, or political policies or factors that have materially affected or could materially affect, directly or indirectly, their operations or investments by United States nationals.” Regulation S-K, Instructions to Item 303(a), Instruction 11. 17 C.F.R. § 229.303 (2010).

center around behavior that is inherently risky: operations in state sponsors of terrorism, manufacturing using certain chemicals, etc.

Even if a particular type of information is not required to be disclosed under a Reg S-K line item, Exchange Act Rule 12b-20 provides: "[i]n addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading." A similar gap-filling provision is included in Rule 408 under the Securities Act.

Finally, disclosure of investor priorities may be triggered by the inclusive anti-fraud provision of Exchange Act Rule 10b-5 ("Employment of Manipulative and Deceptive Practices"). Rule 10b-5 regulates the information that a company must disclose about its activities by creating liability not only for making "any untrue statement of material fact," but also for omitting "to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" in connection with the purchase or sale of a security.

4. Materiality and the Scope of Disclosure

Thus, a duty to disclose information arises when a statute, rule or regulation specifically requires disclosure, and that duty is often limited to disclosing "material" instances of the information required. In addition, more general rules and antifraud liability require companies to disclose information if needed to "cure" some other statement that the company has made that otherwise would be inaccurate, incomplete, or misleading.

Materiality, then, is a principle of distinction: material information (of various sorts) must be disclosed, while information of the same sort, which is not material, need not be disclosed. But where is the line drawn? How does materiality limit the duty to disclose?


61. Rule 408 of the Securities Act has identical wording except that it applies to registration statements instead of statements and reports. 17 C.F.R. § 230.408 (2010).


63. Id. There is no preexisting duty to disclose all material facts, but there is a duty to speak if the information disclosed would otherwise be materially misleading. So, for example, one might argue that disclosing where a company does business and omitting subsidiary operations in Iran might by negative inference cause investors to believe that there are not operations in Iran. This omission would result in liability if operations in Iran are material.

Stated most generally, material information "consists of those facts which a reasonable investor would consider significant in making an investment decision." As suggested above, the duty to disclose is limited, in the first instance, by the statute, rule, or regulation that requires disclosure. Although what is material and what must be disclosed may be difficult to distinguish, there is no general affirmative requirement that a company disclose all material information. For example, preliminary merger negotiations may be material, but do not have to be disclosed. Materiality functions as a filter, limiting the disclosure required by a rule or regulation to information that investors need to know.

Of course, materiality is not always needed. Disclosure of certain information may be required even if the information is not in fact material. Companies must make some disclosures required by Reg S-K whether or not the information is believed to be important to investors in any particular instance. The SEC has determined ex ante that many investors will find the required information relevant, and that consistent disclosure obligations make it possible to compare firms. For example, a company must disclose its expenses in connection with the issuance of registered securities regardless of the amount. The rationale behind this kind of disclosure obligation is that the information is likely to be important to investors, even though not every piece of information

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66. Donald Langevoort & G. Mitu Gulati, The Muddled Duty to Disclose under Rule 10b-5, 57 Vand. L. Rev. 1639, 1644 (2004). Contrary to popular belief, not all material information must be disclosed. Patricia Sanchez Abril & Ann M. Olazabal, The Celebrity CEO: Corporate Disclosure at the Intersection of Privacy and Securities Law, 46 Hous. L. Rev. 1545, 1582 (2010) (pointing out several media stories that assumed any material information should be disclosed); Monsma & Olson, supra note 21, at 167 (discussing this "widely held misconception").
68. Langevoort & Gulati, supra note 66.
69. Williams, supra note 13, at 1208.
70. Some scholars argue that as a system, this division makes sense, since periodic disclosure was designed to include information about events in the past that the SEC could objectively verify. Homer Kripke, Fifty Years of Securities Regulation in Search of a Purpose, 21 San Diego L. Rev. 257, 276 (1984).
73. 17 C.F.R. § 229.511 (requirement to "[f]urnish a reasonably itemized statement of all expenses in connection with the issuance and distribution of the securities to be registered, other than underwriting discounts and commissions").
required is going to be important in every instance."  

The lack of clarity about the bounds of materiality also presents opportunities. As discussed above, the idea that some things not enumerated in Reg S-K, and not affecting current accounting, might nevertheless need to be disclosed has been a critical part of what might roughly be called "social disclosure" arguments. Although some scholars consider SEC authority to require qualitatively material disclosure "quite limited," others contend that such disclosure is not only within the SEC's authority, but actually required to fulfill the SEC's statutory mandate to promulgate rules and regulations "as necessary or appropriate in the public interest or for the protection of investors."

However this academic argument is resolved, it is undeniable that the doctrine of materiality is ambiguous, and that the SEC has broad authority to shape the doctrine. Unsurprisingly, there have been considerable changes in the interpretation of materiality over the years. Congress intended, the Supreme Court articulated, and the SEC has in the past used, a broad standard of materiality. Currently, however, the SEC seems to be recognizing a reduced standard of materiality that does not require disclosure of non-quantifiable costs, and therefore does not elicit the information that investors need.

74. Langevoort & Gulati, supra note 66, at note 18.

75. Many commentators believe that the SEC has deliberately "left ambiguous the effect of applying the existing materiality standard to any specific factual situation." Joan MacLeod Heminway, Materiality Guidance in the Context of Insider Trading: A Call for Action, 52 AM. U. L. REV. 1131, 1140 and note 32 (2003) (citing a plethora of instances in which the SEC has refused to specifically define materiality). Professor Sachs has suggested that the materiality standard should measure materiality from the standpoint of the least sophisticated investor instead of the reasonable investor in order to protect unsophisticated investors who are duped by implausible falsehoods often using the internet and telemarketing technology. Margaret V. Sachs, Materiality and Social Change: The Case for Replacing 'the Reasonable Investor' with 'the Least Sophisticated Investor' in Inefficient Markets, 81 TUL. L. REV. 473, 474–481 (2006).

76. Sachs, supra note 75, at 492 (describing the TSC Indus. standard as "under siege").

77. Ferrara, Starr & Steinberg, supra note 71, at 557.

78. James D. Redwood, Qualitative Materiality Under the SEC Proxy Rules and the Fifth Amendment: A Disclosure Accident Waiting to Happen or Two Ships Passing in the Night?, 1992 Wis. L. REV. 315, 328 (1992) (noting Sections 7 and 10(c) of the Securities Act, 15 U.S.C. §§ 77g and 77j(c), and Sections 12 and 14(a) of the Exchange Act, 15 U.S.C. §§ 78l(b) and 78n(a), in the context of disclosure of information about management integrity).

79. See, e.g., H.R. REP. NO. 73-85, at 9 (1933) (including references to "moral responsibility to the public"); 78 Cong. Rec. 7696 (1934) (debating how best to serve the public interest).

B. DEFINING MATERIALITY: THE DEVELOPMENT OF THE DOCTRINE AND ITS APPLICATION TO MANAGEMENT INTEGRITY AND CLIMATE CHANGE DISCLOSURE

1. Introduction

The argument over which non-financial investor priorities are material for securities law purposes has been going on for decades. In the 1970s, there was a surge in efforts to get the SEC to recognize issues such as management integrity and environmental risks and impacts as material. In addition, in 1976 the Supreme Court provided an authoritative definition of "material" in *TSC Industries Inc. v. Northway Inc.*, which was affirmed and expanded to the antifraud context in *Basic Inc. v. Levinson* in 1988. In a 1999 Staff Accounting Bulletin, the SEC noted that materiality has both qualitative and quantitative aspects. In 2001, the SEC released a letter suggesting that an even broader materiality standard was appropriate in the context of state sponsors of terrorism. In order to understand the contrast between these interpretations and the SEC's current acceptance of a reductive definition of the materiality of companies' operations in Iran, it is helpful to review some of the key interpretations, and how the SEC handled the materiality of two other nonfinancial issues: management integrity and climate change.

2. The Supreme Court Definition: TSC Industries, Inc. v. Northway, Inc. and Basic Inc. v. Levinson

In 1976, the Supreme Court defined materiality in *TSC Industries, Inc. v. Northway, Inc.*. *TSC Industries* was decided in the context of a shareholder claim that a proxy statement was misleading because it failed to state that a transfer of interest from one company to another had resulted in a change of control transaction. In clarifying the requirements of Section 14(a) of the Securities Exchange Act, the Supreme Court ruled that, “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” The Court further clarified the definition, noting that, “there must be a
substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” The TSC Industries standard, therefore, requires that materiality be determined by looking at the objective facts in dispute and then making “delicate assessments of the inferences a reasonable shareholder would draw from a given set of facts and the significance of those inferences to him.”

The Court foresaw the difficulties that might be encountered with materiality, and specifically instructed:

Doubts as to the critical nature of information misstated or omitted will be commonplace. And particularly in view of the prophylactic purpose of the Rule and the fact that the content of the proxy statement is within management’s control, it is appropriate that these doubts be resolved in favor of those the statute is designed to protect."

The Court thus specifically instructed the SEC to err on the side of requiring disclosure, of an inclusive materiality standard.

In 1988, the Supreme Court adopted the TSC Industries v Northway, Inc. standard of materiality in the antifraud context when it considered public statements made by Combustion Engineering, Inc., and Basic Incorporated that falsely denied the existence of preliminary merger negotiations. In Basic Inc. v. Levinson, the Court held that the materiality of information about future events depends on the expected magnitude of the event in light of the probability that the event will occur.

In Basic, the Court noted that the Securities Exchange Act was enacted to protect against manipulation of stock prices, and cautioned:

Disclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress. We have recognized time and again, a fundamental purpose of the various Securities Acts, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor, and thus to achieve a high standard of business ethics in the securities industry. . . . The role of the materiality requirement is not to attribute to investors a child-like simplicity, an inability to grasp the probabilistic significance of negotiations, but to filter out essentially useless information that a reasonable investor would not consider significant, even as part of a larger “mix” of factors to consider in making his investment decision.

86. TSC Indus., 426 U.S. at 449.
87. Id. at 450.
88. Id. at 448 (emphasis added).
89. The Court considered the danger of a materiality standard that is set too low, and noted that it used the formulation “a reasonable shareholder would consider” the information important, instead of “a reasonable shareholder might consider” it important to avoid a situation in which management simply “bur[ied] the shareholders in an avalanche of trivial information.” Id. at 448–49.
90. Basic, 485 U.S. at 232 (ongoing with respect to a Rule 10b-5 claim).
91. Id. at 238. (describing the balancing test needed).
92. Id. at 234 (citations omitted). The Court also quoted the 1934 House Report which stated
Finally, recognizing again the difficulties inherent in a broad materiality standard, the Court stated:

A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress’ policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over inclusive or under inclusive.93

The Court also explicitly endorsed an earlier report of the House Committee on Interstate and Foreign Commerce’s Advisory Committee on Corporate Disclosure which had warned the SEC “against administratively confining materiality to a rigid formula.”94

3. Staff Accounting Bulletin No. 99 and Subsequent Case Law

In response to pressure for further clarification,95 in 1999, the SEC released Staff Accounting Bulletin No. 99 (SAB 99) that explained, “a matter is ‘material’ if there is a substantial likelihood that a reasonable person would consider it important.”96 SAB 99 confronted the issue of whether there could be an objective test, in the form of a numerical threshold, for materiality, and found such tests were useful as a preliminary step but not dispositive: “quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality, it cannot appropriately be used as a substitute for a full analysis of all

93. Basic, 485 U.S. at 236 (emphasis added).
94. Id. The Advisory Committee advised, “[a]lthough the Committee believes that ideally it would be desirable to have absolute certainty in the application of the materiality concept, it is its view that such a goal is illusory and unrealistic. The materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula.” Id. at note 14 (citing H. COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., REPORT OF THE ADVISORY COMM. TO THE SEC. AND EXCHANGE COMM. 327 (Comm. Print 1977))
95. Notwithstanding Basic, this included pressure to adopt a bright line rule.
96. SAB 99, supra note 81 (asserting that “qualitative factors may cause misstatements of quantitatively small amounts to be material”). Although SAB 99 did not carry the force of law, courts have relied on it as constituting “a body of experience and informed judgment” and “persuasive guidance.” See Ganino v. Citizens Utilities Co., 228 F.3d 154, 163 (2d Cir 2000) (quoting SAB 99 and explicitly rejecting using numerical benchmarks for assessing materiality). SAB 99 relied on other definitions of materiality, including the one contained in the Financial Accounting Standards Board for its Statement of Financial Accounting Concepts No. 2 which explained, “[a]n omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.” SAB 99 supra note 96 (citing FASB, Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information 132 (1980)).
relevant considerations."97

In SAB 99, the SEC recognized the broad character of materiality, stating explicitly that "[q]ualitative factors may cause misstatements of quantitatively small amounts to be material."98 SAB 99 listed a number of considerations which might make a quantitatively small misstatement in a financial statement "material," including "whether the misstatement concerns a segment or other portion of the registrant’s business that has been identified as playing a significant role in the registrant’s operations or profitability; whether the misstatement affects the registrant’s compliance with regulatory requirements; . . . [and] whether the misstatement involves concealment of an unlawful transaction."99 In addition, the SEC specifically mentioned that demonstrated volatility in share price in response to certain types of disclosures could "provide guidance as to whether investors regard quantitatively small misstatements as material."100 Overall, however, SAB 99 left unchanged the understanding of materiality addressed by the Supreme Court in TSC Industries.101

The Second Circuit opinion in Ganino v. Citizens Utilities Company102 was one of the first to apply SAB 99. The suit was brought by shareholders against a publicly traded utility company and alleged that the company had artificially inflated share prices by making material misstatements in its financial statements.103 The Second Circuit used a broad standard of materiality, noting that the determination depends on all relevant circumstances and that there is no single numerical or percentage benchmark for determining whether misstatement of revenue is material for purposes of Rule 10b-5 claim.104 Ganino further explained that, although SAB 99 did not have the force of law, it was persuasive guidance for the understanding that misstatements of quantitatively small amounts could be material for purposes of Rule 10b-5.105 Thus, a preliminary inquiry into the quantitative effect of a misstatement or, presumably, omission, must be supplemented by qualitative factors.106

The broad standard of materiality articulated in TSC Industries, Basic, and SAB 99 is frequently reaffirmed by the courts in cases alleging material misstatements or failures to disclose under the Securities Acts.107

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97. SAB 99, supra note 96.
98. Id. at 3.
99. Id. at 4.
100. Id. at 5 (reminding companies and their auditors that they should not assume that even small intentional misstatements are immaterial).
101. Heminway, supra note 75, at 1155.
102. Ganino, 228 F.3d at 163–64.
103. Id. at 158.
104. Id. at 162.
105. Id. at 163.
106. Id.
107. See, e.g., U.S. v. Ferguson, 553 F. Supp. 2d 145 (D. Conn. 2008) (holding that a misstatement
The SEC itself regularly prosecutes reporting companies for failures to disclose material information and asserts the quantitative and qualitative aspects of materiality. Most of such cases, however, center on financial information. The SEC does not seem to be as willing to assert the materiality of nonfinancial factors. This was the case with management integrity, and again, more recently, with respect to climate change.

4. Management Integrity

Management integrity is often pointed out as an example of an investor concern that is not financially significant in any easily quantifiable way at the time of reporting but that is nonetheless material. However, the sources and bounds of a reporting company’s duty to disclose information relating to the competence and integrity of its senior managers remain controversial.

a. The Doctrine Develops

In its 1964 decision, *In re Franchard*, the SEC first announced that qualitative disclosure relating to “management’s competence and integrity” was essential to an informed investment decision, and affirmed is material for purposes of the securities laws as long as investors would consider the misstated facts significant in making investment decisions, even if investors would consider other information to be more important, in a trial relating to reports filed concerning a transaction between General Reinsurance Corp. and American International Group, Inc.; ECA and Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co., 553 F.3d 187 (2d Cir. 2009) (Enron-related case citing *Ganino* for the proposition that “qualitative factors are intended to allow for a finding of materiality if the quantitative size of the misstatement is small, but the effect of the misstatement is large”).

108. See, e.g., SEC v. Escala Group, Inc., No. 09 Civ. 2646, 2009 WL 2365548, slip op. at 8 (S.D.N.Y. July 31, 2009) (in which the court agreed with the SEC that “materiality has both a qualitative and a quantitative component and it is an error to rely exclusively on a single numerical or percentage benchmark to determine materiality”).

109. See, e.g., *ECA*, 553 F.3d at 194 (relating to a mischaracterization on a bank’s financial statements).

110. See *STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS* 45 (2d ed. 2008); *HAZEN, supra* note 65, at §3.9[3] (“the [SEC] pointed out that an investor’s evaluation of management is an important part of any investment decision. Thus, facts that would be likely to indicate a possible change of management would be material to the reasonable investor”).

111. Disclosure of information generally related to management integrity seldom results from a broad appreciation of the importance of non-identifiable factors. Often disclosure of information bearing on management integrity is specifically required by SEC regulations. For example, the issue arises in the context of disclosure of all material transactions between the issuer, its affiliates, and management under Schedule A item 14; Form S-1 item 17 and Form S-2 item 12. *HAZEN, supra* note 65 at § 3.9[3] (discussing the *In re Franchard* fact pattern).

112. *In re Franchard*, 42 S.E.C. 163 (1964)

113. Redwood, *supra* note 13, at 338 (describing *In re Franchard* as the SEC’s “first foray” into the materiality of management integrity).

that "[t]he integrity of management . . . is always a material factor."115 Implicit in its determination was the idea that "quantitative" materiality, accounting, was not enough.116 Congress agreed, and in 1968, the House Committee on Interstate and Foreign Commerce released a report that asserted, "The competence and integrity of a company's management, and of the persons who seek management positions, are of vital importance to stockholders."117 Nevertheless, In re Franchard turned out to be more of the exception than the rule in the 1960s, and disclosure pursuant to the securities laws continued to have a fairly narrow, quantitative focus,118 until the 1970s. In the wake of the Watergate scandal,119 the SEC, under Director of the Division of Enforcement Stanley Sporkin, embarked on an ad hoc program requiring companies to disclose information specifically relating to the competence and integrity of corporate managers, regardless of whether such information would otherwise have been subject to disclosure.120

In a March 1974 release, the SEC articulated an expansive idea of what must be disclosed to investors by announcing additional disclosure requirements regarding illegal campaign contributions and suggesting that both adjudicated and unadjudicated121 illegal acts that reflected on management's competence and integrity might be disclosed.122 The SEC wrote:

In the Division's view, the conviction of a corporation and/or its officers or directors for having made illegal campaign contributions in violation of 18 U.S.C. Section 610 is a material fact that should be disclosed to the public and specifically to shareholders . . . . Such a conviction is material to an evaluation of the integrity of the management of the corporation as

115. In re Franchard, 42 S.E.C. at 172.
118. John M. Fedders, Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard, 48 CATH. U. L. REV. 41, 46 (1998) (arguing against qualitative materiality). See also Williams, supra note 13, at 1246–47 (dating efforts to use the federal securities laws to promote expanded social disclosure from the late 1960s anti-war and environmental movements).
119. Watergate has been termed the "Dawn of a Qualitative Materiality Standard." Fedders, supra note 118, at 49. This era has been described as a "maelstrom of moral outrage at the political and corporate abuses." H. Lowell Brown, Parent-Subsidiary Liability Under the Foreign Corrupt Practices Act, 50 BAYLOR L. REV. 1, 2–3 (1998) (discussion of the political environment at the time the FCPA was adopted).
120. Redwood, supra note 13, at 316.
121. The disclosure of unadjudicated illegal acts remains controversial.
it relates to the operation of the corporation and the use of corporate funds.\textsuperscript{123}

In a 1975 release, the SEC counseled against using its authority for the “promotion of social goals unrelated to the Federal securities law,” but noted that “in specified cases some information of this type might . . . be required in order to make the statements in a filing not misleading or to make the filing otherwise complete with respect to information investors appropriately might need to make informed investment or voting decisions.”\textsuperscript{124} Commissioner A.A. Sommer, Jr., cautioned against “The Slippery Slope of Materiality,” but extolled the fact that “the value of the concept of materiality derives from its very breadth, imprecision and defiance of exact definition. It reflects the complexity of human affairs, the multitude of situations in which human beings find themselves involved and the multiplicity of relationships that they create.”\textsuperscript{125}

As part of its efforts to expose and reduce corruption in the mid 1970s, the SEC also conducted a far-reaching investigation into questionable and illegal payments by corporations. In 1976 the SEC issued a report to Congress describing the results of an SEC program pursuant to which more than 400 companies had admitted making improper or illegal payments overseas.\textsuperscript{126} Although these payments did not always have an immediate

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123. Division of Corporation Finance’s Views, \textit{supra} note 122 (emphasis added). Director Sporkin supported using \textit{In re Franchard’s} doctrine of materiality to encourage additional disclosure relating to management integrity and competence. Redwood, \textit{supra} note 13, at 340–41.


Regarding possible disclosure of corporate behavior in socially significant areas other than the environment, the Commission concluded that no showing was made in this proceeding, particularly in light of the more than 100 areas of social information identified by persons responding to our request for comments, that disclosure of information describing corporate social practices should be specifically required of all registrants. This is not to say, however, that, in specified cases, some information of this type might not be required in order to make the statements in a filing not misleading or to make the filing otherwise complete with respect to information investors appropriately might need to make informed investment or voting decisions. The Commission’s rules already require, in addition to specific disclosures, the disclosure of any other material information. \textit{Id.}

125. A.A. Sommer, Jr., Commissioner, Address to the Practising Law Institute: The Slippery Slope of Materiality, remarks delivered at 1–2 (Dec. 8, 1975), available at http://www.sec.gov/news/speech/1975/120875sommer.pdf. Commissioner Sommer claimed that “[d]espite a constant yearning for greater precision and certainty, the statutes administered by the Commission and the rules which the Commission has adopted under them clearly evidence the Congressional and Commission conclusion that precise rules simply cannot be framed to embrace every situation.” \textit{Id} at 4. Nevertheless, Commissioner Sommer warned against the “temptation” of a “hasty expansion of materiality” that would impair the SEC’s ability to perform its traditional role of policing the disclosure system and the securities markets. \textit{Id.}

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quantitative impact, i.e., they did not “directly relate to bottom-line earnings, assets, revenues or liabilities of a corporation,” the SEC nevertheless took the position that companies were required to disclose such payments.

In 1977, Congress enacted the U.S. Foreign Corrupt Practices Act to prohibit foreign bribery and require issuers to maintain accurate books and records. The report noted that “even if questionable or illegal payments are not quantitatively material, disclosure of such payments may be required because of their bearing on management’s competency or integrity,” thus recognizing that disclosure should accommodate more than just financial matters.

Despite the TSC Industries decision and the Foreign Corrupt Practices Act, the late 1970s were a period of retrenchment with respect to disclosure related to management integrity. In 1978, the SEC, still under SEC Enforcement Director Stanley Sporkin, began an investigation into management integrity in the context of certain foreign currency transactions undertaken by Citicorp. The SEC staff recommended taking administrative action against Citicorp for failing to disclose the risks of the transactions in its periodic reports. However, the Commissioners eventually voted not to take enforcement action, stating that because Citicorp had never affirmatively stated that its directors had “honesty and integrity,” a departure from those standards did not have to be disclosed. After the staff recommendation and the Commissioners’ decision were leaked to the New York Times, Congress held hearings about the decision not to bring a case against Citicorp, and accused the SEC of “overturn[ing] long-established precedents and introduce[ing] new criteria for

128. Id. at 340.
131. SEC and Citicorp Hearings, supra note 133, at 304.
132. Other descriptions describe the staff position as “conflicting.” Fedders, supra note 118 at 43.
134. The vote was 3-1. Fedders, supra note 118, at 71.
135. SEC and Citicorp Hearings, supra note 133, at 304.
136. Fedders, supra note 118, at 71 (describing “pandemonium” in the media as the public questioned the SEC’s commitment to enforcement and disclosure).
disclosure”\textsuperscript{137} when it decided not to enforce disclosure of information relating to management integrity.

By the 1980s, the SEC was split\textsuperscript{138} about whether to require expanded disclosure of non-financial information, and it had significantly backed away from mandatory disclosure of management integrity or other “qualitative” concerns.\textsuperscript{139} In 1982, SEC Director of Enforcement John Fedders (Mr. Sporkin’s successor) famously dismissed qualitative materiality and stated that, with certain limited exceptions, the SEC “should [only] begin enforcement actions where failure to disclose unlawful conduct violates traditional quantitative standards of materiality.”\textsuperscript{140}

In 1986, in \textit{United States v. Matthews}, the U.S. Court of Appeals for the Second Circuit held that, under the proxy statement rules, a corporation was not required to disclose unadjudicated illegal conduct of an executive seeking election as a director.\textsuperscript{141} The court ruled that, without a specific SEC disclosure requirement, nondisclosure of uncharged criminal conduct cannot be a criminal violation.\textsuperscript{142} The decision has been described by former securities law regulators as “ANOTHER Drubbing of the Qualitative Standard”\textsuperscript{143} and the decision which “definitely interred”\textsuperscript{144} the qualitative materiality doctrine.\textsuperscript{145}

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\textsuperscript{139} For example, the 1980 U.S. District Court for the Northern District of Illinois decision in SEC v. Chicago Helicopter Industries also rejected a qualitative materiality standard when it refused to mandate disclosure of unadjudicated criminal behavior. SEC v. Chicago Helicopter Indus., No. 79-C-0469, 1980 U.S. Dist LEXIS 17214, at *5, *7–9 (N.D. Ill, Jan. 18, 1980).

\textsuperscript{140} John M. Fedders, Speech, Failure to Disclose Illegal Conduct, 14 SEC. REG. & L. REP. (BNA) 2057 (Nov. 26, 1982) (“[T]he Commission generally should not utilize the antifraud [sic] provisions of the securities laws where there is a failure to disclose conduct which may be considered qualitatively material.”).

\textsuperscript{141} United States v. Matthews, 787 F.2d 38, 49 (2d Cir. 1986).

\textsuperscript{142} Id. The Matthews decision was thought by some at the time to have disposed of qualitative materiality. Redwood, supra note 13, at 354–56.

\textsuperscript{143} Fedders, supra note 118, at 79 (emphasis in original).

\textsuperscript{144} Redwood, supra note 13, at 319.

\textsuperscript{145} See U.S. v. Crop Growers for a similar holding: the SEC charged three defendants with failure to disclose uncharged criminal conduct relating to illegal campaign contributions, but the court dismissed the charges. United States v. Crop Growers Corp., 954 F. Supp. 335, 340, 359 (D.D.C. 1997). This comports with United States v. Matthews. See Matthews, 787 F.2d at 49. (“[S]o long as uncharged criminal conduct is not required to be disclosed by any rule lawfully promulgated by the SEC, nondisclosure of such conduct cannot be the basis of a criminal prosecution.”)
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b. The Current Regime: Specific Disclosure Relating to Management Integrity Required by Reg S-K

Notwithstanding the debate over whether issues of management integrity and competence are of vital interest to the “reasonable shareholder,” and therefore material, a great deal of information related to management integrity must be disclosed under Reg S-K. For example, Reg S-K requires that corporate officials report self-dealing transactions and conflicts of interest with their employer, and whether they have been the subject of any criminal charges or convictions or of any civil judgments involving violations of the federal securities laws. Court review of disclosures bearing on the integrity of management has generally recognize that Reg S-K disclosure mandates are not the full extent of required disclosure in this realm, but also fail to articulate any additional information that should be disclosed on a simply material basis.

5. Environmental Information and Climate Change

a. Corporate Environmental Disclosure

Another issue of importance to a broad spectrum of investors that has tested the limits of the SEC’s interpretation of materiality has been corporate environmental disclosure, particularly the recent developments in disclosure related to climate change risks. Significant efforts to persuade the SEC to recognize the importance of environmental information date back to the early 1970s. With federal environmental legislation such as the

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146. Redwood, supra note 13, at 319–320 (urging the SEC to adopt a line item requiring the disclosure of unadjudicated business crimes committed by director-candidates).

147. But management integrity may be a place where a materiality standard is hardest to use. It is the disclosure of information about themselves that executives are confronting. In many cases, the decision may be “highly stressful” or “emotionally charged.” Joan MacLeod Heminway, Personal Facts about Executive Officers: A Proposal for Tailored Disclosures to Encourage Reasonable Investor Behavior, 42 WAKE FOREST L. REV. 749, 767 (2007) (discussing the disclosure of personal information by executive officers and how current materiality analysis fails in that context). With the corporation and its executives unable to make a materiality analysis (qualitative or quantitative) the objective line item disclosures from Reg S-K are likely to be all that is made.

148. HAZEN, supra note 65, § 3.9[3], at 142–43 (identifying the Reg S-K sections).

149. See 17 C.F.R. § 229.404.

150. See 17 C.F.R. § 229.401.

151. Abril & Olazabal, supra note 66, at 1593, 1605 (pointing to, for example, Maldonado v. Flynn, 597 F.2d 789,792–93 (2d Cir. 1979); United States v. Yeaman, 987 F. Supp. 373, 378 (E.D. Pa. 1997); HAZEN, supra note 65, at 143 (discussing the difficulties in determining the materiality of disclosures relating to the personal aspects of the lives and dealings of key personnel).

152. Questions regarding disclosure of environmental information in general, e.g., issues relating to environmental law compliance, environmental management systems or waste treatment and recycling, have been before the SEC for decades. Li-Wen Lin, Corporate Social and Environmental Disclosure in Emerging Securities Markets, 35 N.C.J. INT’L L. & COM. REG. 1, 3 (2009).
National Environmental Policy Act (NEPA)\(^{153}\) and rapidly expanding public awareness of environmental issues, companies subject to the federal securities laws began to consider whether and how they should disclose these new potential liabilities in their required periodic disclosure.\(^{154}\)

In 1971, the National Resources Defense Council, Inc. (NRDC) submitted a rulemaking petition seeking expanded civil rights and environmental disclosure under the federal securities laws.\(^{155}\) Specifically, the NRDC requested that the SEC require reporting companies to disclose the environmental impact of their products and any steps taken to mitigate that impact.\(^{156}\) The SEC refused, and after two administrative proceedings, weeks of public hearings, hundreds of public comments, a record of more than 10,000 pages,\(^{157}\) two federal district court proceedings, and a trip to the D.C. Circuit Court of Appeals, the result was little or no change in the SEC disclosure rules.\(^{158}\)


\(^{154}\) Mark Latham, Environmental Liabilities and the Federal Securities Laws: A Proposal for Improved Disclosure of Climate Change-Related Risks, 39 ENVTL. L. 647, 679 (2009). The SEC provided some guidance in a 1971 release, Disclosures Pertaining to Matters Involving the Environment and Civil Rights, which instructed reporting companies to disclose material costs of compliance with environmental laws, as well as any (material or nonmaterial) pending or threatened environmental litigation. Disclosures Pertaining to Matters Involving the Environment and Civil Rights, Securities Act Release No. 5170, Exchange Act Release No. 9252, [1971 Transfer Binder] Fed Sec. L. Rep. (CCH) ¶ 78,150, at 80,488 (July 19, 1971). See also Latham, supra, at 680 (speculating about why a materiality requirement was not included with respect to environmental litigation). The SEC’s 1971 release effectively broadened required disclosure requirements for compliance costs (to include future costs) and for litigation, since the SEC stated that any pending or threatened environmental litigation initiated by governmental authorities “shall be deemed material and shall be described whether or not the amount of any claim for damages involved exceeds 10 percent of current assets ... and whether or not such proceedings are considered ‘ordinary routine litigation incidental to the business.’” Notice of Adoption of Amendments to Registration and Report Forms to Require Disclosure with Respect to Compliance with Environmental Requirements and Other Matters, Securities Act Release No. 5386, Exchange Act Release No. 10,116, 1 SEC Docket 1, 2–3 (Apr. 20, 1973) (superseding the 1971 release). The need to disclose pending or threatened private environmental litigation would still be subject to the materiality standard, with the proviso that if a company elected to omit information relating to environmental litigation as nonmaterial, then the SEC Division of Corporation Finance would follow up with the company regarding the information and the justification for its omission. Elizabeth Ann Glass Geltman, Disclosure of Contingent Environmental Liabilities by Public Companies under the Federal Securities Laws, 16 HARV. ENVTL. L. REV. 129, 152 (1992).


\(^{156}\) Id. at 69394.


\(^{158}\) In National Resources Defense Council, Inc. v. SEC (NRDC II), the D.C. District Court reviewed the SEC’s decision not to require significant additional environmental and civil rights disclosure rules.
Although the NRDC cases ultimately upheld the SEC’s rejection of an expanded understanding of materiality, the cases affirmatively established that the SEC’s statutory authority to require disclosure is broad. Disclosure of corporate environmental information could be material, but in the 1970s it was not yet deemed important enough to investors to meet the standard. The rejection of expanded environmental and civil rights disclosure was based more on a failure to establish significant “ethical investor” interest than on a finding that such disclosure could not be material.

Over the years, however, the SEC added an assortment of line-item environmental disclosure requirements through its instructions to periodic disclosure forms and guidance documents. These requirements were organized and rationalized with the promulgation of Reg S-K and, currently, material corporate environmental information is disclosed in response to the requirements of Item 101 (Description of Business), Item 103 (Legal Proceedings) and Item 303 (Management’s Discussion and Disclosure and remanded to the SEC. 389 F. Supp. at 700 (D.D.C. 1974). The Court noted that the SEC’s statutory authority to require disclosure is broad, and ruled that if the SEC was not going to require disclosure of the information being sought by investors, it needed to determine that the information was not material within the meaning of the securities laws. Id. The Court remanded on administrative procedure grounds and the SEC went through new proceedings largely devoted to developing a more complete factual record. Notice of Commission Conclusions and Rulemaking Proposals in the Public Proceeding Announced in Securities Act Release No. 5569, Securities Act Release No. 5627, Exchange Act Release No. 11,733, 8 SEC Docket 41, 47 (Oct. 14, 1975). Then, while recognizing its broad discretion to require disclosure, the SEC decided that it would only require dissemination of economically significant information. Again the D.C. District Court reviewed the SEC decision (NRDC II) and remanded. Natural Resources Defense Council, Inc., v. SEC (NRDC II), 432 F. Supp. 1190 (D.D.C. 1977). However, on appeal to the D.C. Circuit Court of Appeals, the SEC prevailed and the Court upheld the SEC’s existing disclosure rule as “adequate” given the low level of investor interest in the issues (environment and civil rights) raised by the petition. Natural Resources Defense Council, Inc. v. SEC (NRDC III), 606 F.2d 1031, 1061 (D.C. Cir. 1979).

159. Williams, supra note 13, at 1246–52.

160. Id. As one commentator has argued, “The conclusion . . . that the [SEC] does indeed possess the power to enact rules solely in the public interest need not be limited to disclosures for the protection of the environment, but lends itself naturally to extension to other forms of qualitative disclosure.” Redwood, supra note 13, at 330–31.


162. In addition, Regulation S-X and a variety of accounting bulletins have dealt with environmental disclosure. See Latham, supra note 154, at 685–97.

163. Reg S-K requires the disclosure of environmental compliance costs in Item 101: “[T]he material effects that compliance with Federal, State and local [environmental] provisions . . . may have upon the capital expenditures, earnings and competitive position of the [company] and . . . any material capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such periods as the registrant may deem materials [sic].” Item 101(c)(1)(xii), 17 C.F.R. Sec. 229.101(c)(1)(xii). Many of the Item 101 factors are disclosed if material.

164. Item 103 requires companies to disclose material pending legal proceedings other than ordinary routine litigation incidental to the company’s business. 17 C.F.R. § 229.103. Instruction 5 states that litigation under any environmental provisions will not be considered “ordinary routine
Analysis of Financial Condition and Results of Operations).  

b. The Challenge of Climate Change Reporting

i. Investor Interest

By the mid-2000s environmental concerns, in the context of climate change, loomed large in popular consciousness. Scientific studies and international initiatives abounded. In 2007, the documentary film *An Inconvenient Truth* won an Academy Award, and the Nobel Prize in Peace was awarded jointly to the Intergovernmental Panel on Climate Change (IPCC) and Albert Arnold (Al) Gore Jr. “for their efforts to build up and comprehensively assess [climate change] risks and their potential human and economic impacts.”


167. For example, the Kyoto Protocol to the United Nations Framework Convention on Climate Change; the European Union Emissions Trading Scheme. The Climate Change Petition cited an increasing number of foreign nations that were issuing specific guidance on climate risk disclosure. Petition for Interpretive Guidance on Climate Risk Disclosure, SEC file no. 4-547 (filed 2007) [hereinafter *Climate Change Petition*], available at http://www.sec.gov/rules/petitions/2007/petn4-547.pdf.
disseminate greater knowledge about man-made climate change, and to lay the foundations for the measures that are needed to counteract such change."\textsuperscript{169} Congress introduced the America’s Climate Security Act of 2007 to direct the Environmental Protection Agency to address greenhouse gas emissions.\textsuperscript{170} The issue was debated in the 2008 Presidential campaign, and Barack Obama’s successful campaign platform included a “cap and trade” policy. Meanwhile, several state attorneys general, most notably Andrew Cuomo in New York, were also enforcing corporate disclosure requirements.\textsuperscript{171}

Nonetheless, and even though the securities laws have elicited disclosure of general environmental liabilities, reporting on the cost of climate change risk management measures was slim,\textsuperscript{172} and reporting of climate change impacts almost nonexistent.\textsuperscript{173}

Both retail and institutional investors recognized the importance of climate change. The major investment banks produced dozens of research studies, shareholders sponsored numerous corporate resolutions,\textsuperscript{175} climate-related investment advisory services developed at many large brokers and investment advisors,\textsuperscript{176} and, in the absence of accessible,
required disclosure under the securities laws, an industry of private information services developed. Trillions of dollars were invested in climate-friendly funds.\textsuperscript{177}

In addition, climate change became the focus of numerous NGOs,\textsuperscript{178} including CERES,\textsuperscript{179} the Carbon Disclosure Project,\textsuperscript{180} and the Global Reporting Initiative.\textsuperscript{181} The NGOs lobbied for regulatory reform\textsuperscript{182} and proposed guidelines for disclosure when affecting the climate.\textsuperscript{183} Many companies began making voluntary climate disclosures,\textsuperscript{184} but without a required, standardized mechanism, the disclosure was difficult to evaluate comparatively.\textsuperscript{185} The level of participation\textsuperscript{186} and the completeness of reports were variously described as “unsatisfying”\textsuperscript{187} and “inconsistent and inadequate.”\textsuperscript{188} Such private efforts increased the amount of information available to the public, but lacked the legitimacy and the authority to compel participation that official government guidance provides.

\textsuperscript{177} Climate Change Petition, supra note 168, at 37–38 (listing an assortment of market funds and indices with climate or energy mandates).

\textsuperscript{178} Historically, the global environmental movement has benefited from the activities of such organizations, and climate change disclosure has been no exception.

\textsuperscript{179} Ceres is a “network of investors, environmental organizations and other public interest groups working with companies and investors to address sustainability challenges such as global climate change.” About Ceres, CERES, http://www.ceres.org/Page.aspx?pid=415 (last visited Oct. 21, 2010).

\textsuperscript{180} The Carbon Disclosure Project is an independent organization that assembles a large database of primary corporate climate change information. CARBON DISCLOSURE PROJECT, http://www.cdproject.net (last visited Oct. 21, 2010).

\textsuperscript{181} The Global Reporting Initiative is an international network of hundreds of organizations and individuals, dedicated to creating conditions for the “transparent and reliable exchange of sustainability information.” About GRI, GLOBAL REPORTING INITIATIVE, http://www.globalreporting.org/AboutGRI (last visited Oct. 21, 2010).


\textsuperscript{184} Such disclosures “increased dramatically in volume, depth, detail, and sophistication” in the mid-2000s. Smith, supra note 164, at 152.

\textsuperscript{185} Id. (warning that “[i]t would be a mistake, however, to believe that this voluntary activity, no matter how sophisticated and well-intentioned, could become a permanent substitute for mandatory reporting”).

\textsuperscript{186} One survey of annual reports from 2001–2006 found an overall climate reporting rate of only 49%. Climate Change Petition, supra note 168, at 45–46.

\textsuperscript{187} McFarland, supra note 165, at 301 (noting as well that the number of registries and reporting systems was inefficient for investors, especially given the technical nature of the data being produced).

\textsuperscript{188} Climate Change Petition, supra note 168, at 47.
ii. The Climate Change Petition

In September 2007, a group of 22 institutional investors, governmental officials and environmental NGOs submitted a petition to the SEC requesting interpretive guidance about reporting climate change issues under the existing mandatory disclosure rules and regulations (the Climate Change Petition). The Climate Change Petition asked the SEC to clarify that material climate-related information must be included in corporate disclosures under existing laws, and asserted that “the risks and opportunities many corporations face in connection with climate change fall squarely within the category of material information that is required to be analyzed and disclosed in many corporate filings.”

In arguing for disclosure, the petition emphasized the financial impact of climate risk, which it described as “material and subject to mandatory disclosure under traditional principles of the securities laws and the [SEC’s] regulations.” The petition claimed that climate change risk disclosure was “scant and inconsistent” and failed to satisfy investors’ need for information because many companies took the position that risks associated with climate change were too uncertain or remote to their performance to meet the test of materiality. But, the petition argued, there were now significant financial risks associated with climate change and so “interest in climate risk is not limited to investors with a specific moral or policy interest in climate change: it now covers an enormous range of investors whose interest is purely financial.”

The Climate Change Petition sought recognition from the SEC that climate change was material for many, if not most, companies, and that climate change risks were important to investors. The petition seemed to ask the SEC to declare climate change risks important enough for companies to evaluate, and then relied on existing securities laws to require disclosure if the companies find material information in that evaluation.

189. Climate Change Petition, supra note 168, at 15–18.
190. Id. at 2. It is important to note that this particular request seemed to ask for almost nothing—simply that climate change should be disclosed if it is material.
191. Id.
192. Id. at 7.
193. Id.
194. The petition suggested that the SEC should clarify that companies may be obligated to make disclosures relating to (1) “[p]hysical risks associated with climate change” that are material to the company’s operations or financial condition; (2) “[f]inancial risks and opportunities associated with present or probable greenhouse gas regulation;” and (3) “[l]egal proceedings relating to climate change.
195. Id. at 7.
196. Id. at 13–14.
In many ways, by asking for the SEC to instruct companies to give “close and well informed attention”\textsuperscript{198} to climate change risks and disclose them if they are material, the Climate Change Petition simply asked the SEC to declare that companies should do what the securities laws already required them to do.\textsuperscript{199} The petition requested, “in addition to explaining that climate risk merits careful scrutiny in companies’ assessment of their financial condition, the [SEC] should clarify that, under existing law, registrants must disclose any and all material information related to climate change.”\textsuperscript{200}

The Climate Change Petition characterized the existing SEC disclosure regulations as “expansive” and “flexible,” able to “reflect the broad range of information investors consider when they assess corporate value.”\textsuperscript{201} The Climate Change Petition walked through the provisions of Reg S-K, and conducted an analysis using SAB 99, consistently making arguments based on the financial impact of climate risk.\textsuperscript{202} In arguing for the need for an interpretive release, the Climate Change Petition asserted: “Assessment of whether the registrant faces material risks requiring public disclosure does not impose any legal obligations beyond those long required under the securities laws and the [SEC’s] regulations and guidance. The assessment of materiality of climate related risks is the same process that registrants have undertaken with respect to other risks.”\textsuperscript{203} Overall, other than focusing the SEC’s attention on climate change disclosure, the Climate Change Petition sought no real changes in the law that would increase requirements regarding the rate or quality of reporting.\textsuperscript{204}

Nevertheless, the SEC was slow to respond. In fact, while the SEC considered the Climate Change Petition, Congress and the EPA continued to strengthen climate change rules and the petition had to be updated twice\textsuperscript{205} to add, for example, the Energy Independence and Security Act of

\textsuperscript{198} Climate Change Petition, supra note 168, at 56.
\textsuperscript{199} McFarland, supra note 165, at 14 (warning that companies may therefore view SEC guidance neutrally because it would “only rehash . . . the companies’ already-existing duties under the securities laws”).
\textsuperscript{200} Climate Change Petition, supra note 168, at 9 (emphasis added).
\textsuperscript{201} Id. at 13.
\textsuperscript{202} Id. at 13–20.
\textsuperscript{203} Id. at 55. The petition went on to argue that “[t]hese are risks that responsible managers would surely examine even in the absence of regulatory requirements: potential physical threats to assets and regulatory and market developments that are likely to have material effects on the company’s financial condition and operations.” Id.
\textsuperscript{204} McFarland, supra note 165, at 306 (pointing out that the same managers would be making the same decisions using the same securities laws).
2007,\textsuperscript{206} the Consolidated Appropriations Act of 2008,\textsuperscript{207} Senate Subcommittee hearings on climate risk disclosure,\textsuperscript{208} and an EPA final rule requiring large sources of greenhouse gas emissions to report those emissions annually.\textsuperscript{209} The EPA rulemaking, in particular, was described as having “change[d] the landscape of climate risk disclosure, and [made] it urgent that the [SEC] act to assure that emissions data and associated risks, opportunities and management strategies are analyzed by corporations and disclosed in SEC filings.”\textsuperscript{210}

The pressure for the SEC to recognize the importance of climate change to investors was overwhelming.\textsuperscript{211} As one commentator put it, “clearly the tide has shifted with respect to global warming and other environmental matters, which are no longer considered mere social issues.”\textsuperscript{212} At the start of 2010, the Social Investment Forum estimated that professionally managed assets following sustainable and socially responsible investing strategies accounted for approximately $3.07 trillion, 12 percent of the investment market.\textsuperscript{213}

Even though information about a company’s climate change impact was important to many investors, it appears the financial effect of climate change regulation and the actual effects of climate change pushed the SEC into action. Given the EPA rulemaking, and the “unprecedented scope and speed of change, and the market’s appetite for information,”\textsuperscript{214} it was clear that the SEC needed to clarify its disclosure expectations. However, SEC action occurred only in the wake of decisive disclosure action by the EPA. In the end, it took the SEC over two years to respond to the a petition for an interpretive release that asked for no change to the existing standard.


\textsuperscript{207} Consolidated Appropriations Act, Pub. L. No. 110-161, 121 Stat. 1844, div. F, tit. II (2008) (providing funds for the EPA to develop a rule “to require mandatory reporting of greenhouse gas emissions above appropriate thresholds in all sectors of the economy”). The Act also included a number of findings related to climate change. Id. at div F, tit IV, General Provisions, § 430(a).

\textsuperscript{208} Senate Subcommittee Hearing on Climate Risk Disclosure: Hearing before the Subcommittee on Securities, Insurance, and Investment of the Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong. 4-5 (2007).

\textsuperscript{209} Mandatory Reporting of Greenhouse Gasses, 74 Fed. Reg. 56,260, 50,267 (Oct. 30, 2009). With this data, companies would be able to assess their exposure to climate change risk more precisely, likely creating a “known trend” within the meaning of Reg S-K Item 303. Climate Risk Petition Supplemental Filing 2, supra note 205, at 3.

\textsuperscript{210} Climate Risk Petition Supplemental Filing 2, supra note 205, at 3.

\textsuperscript{211} The SEC also received 24 comments on the petition. See Comments on Rulemaking Petition: Request for Interpretive Guidance on Climate Risk Disclosure [File No. 4-547], SEC.GOV, http://sec.gov/comments/4-547/4-547.shtml (last visited Oct. 21, 2010).

\textsuperscript{212} McFarland, supra note 205, at 291(emphasis added).


\textsuperscript{214} Smith, supra note 164, at 153 (noting that the marketplace was demanding information).
The 2010 SEC Interpretive Release: The More Things Change...

The 2010 SEC interpretive release, Commission Guidance Regarding Disclosure Related to Climate Change (the Climate Change Release), was announced with extensive disclaimers. SEC Chairman Mary Schapiro was clear about the type of guidance being given: “An interpretive release... does not create new legal requirements or modify existing ones—it is merely intended to provide clarity and enhance consistency.” And, in case such an ambitious agenda engendered hope in proponents of social disclosure or greenhouse gas emissions limits, Chairman Schapiro went on:

The [SEC] is also not amending well-defined rules concerning public company reporting obligations, nor redefining long-standing interpretations of materiality. These rules and interpretations have served investors well for decades, and provide both the framework and flexibility necessary to apply to changing facts and circumstances. If something has a material impact on a company then it is something that needs to be disclosed—that has always been the case.

In short, the Climate Change Release simply provided interpretive guidance on existing SEC disclosure requirements as they apply to business or legal developments relating to climate change.

The Climate Change Release recognized climate change as the topic of “intense” public interest, and pointed to “international accords, federal regulation, and state and local laws and regulations in the United States” that address climate change. In analyzing the resulting reporting requirements, the release affirmed the traditional TSC Industries and Basic standards, particularly the TSC Industries instructions to the SEC to resolve

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215. This may be related to the fact that the guidelines were approved in a 3-to-2 vote by the SEC, which divided along party lines (Republican Commissioners Casey and Paredes voting against it). Jim Efstathiou Jr., SEC Sets Corporate Climate-Change Disclosure Standard (Update 1), BLOOMBERG, Jan. 27, 2010, available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aj7R1lg1QkliQ.


217. Id.


219. Sec. & Exch. Comm’n, Commission Guidance Regarding Disclosure Related to Climate Change, 75 Fed. Reg. 6290 (Feb. 8, 2010) (codified at 17 C.F.R. Parts 211, 231, 241) (citing “scientists, government leaders, legislators, regulators and business, including insurance companies, investors, analysts and the public at large”). Confronted with the breadth and scope of climate change issues, the SEC then acknowledged the potential impact of climate change-related matters on public companies and discussed the various voluntary and other regulatory sources of disclosure on which investors were relying. Id. at 6290–92.

220. Id. at 6290 (including recent EPA measures).
doubts in favor of requiring disclosure and thereby protecting investors.  

The Climate Change Release reviewed the “most pertinent non-financial statement disclosure rules that may require disclosure related to climate change,” highlighting areas in which climate change might trigger disclosure requirements under those provision, including, (1) the impact of climate change-related legislation and regulation, if material; (2) the impact of international accords and treaties, when material; (3) the indirect consequences for companies from climate change-related regulatory or business trends; and (4) the actual and potential material physical impacts of climate change on a company’s business.  

Significantly, however, the Climate Change Release provided almost no guidance about when climate change risks or opportunities may be “material enough” to require disclosure.  

Thus, although the Climate Change Release raised the profile of climate change impacts and risks, it did not represent an example of the SEC requiring companies to disclosure information in response to investor concerns that cannot presently be reliably quantified. It has long been true that if environmental liabilities are financially material to a company then they may need to be disclosed.  

In addition, thanks to increased investor awareness, NGOs and voluntary disclosure pressure, and stronger EPA and other administrative measures, there are now clear financial impacts on companies from climate change regulation, and in many cases demonstrable financial impacts from climate change itself. The obligation to disclose climate change information because of clear financial (quantitatively material) reasons now settles the issue of materiality.


222. Commission Guidance Regarding Disclosure Related to Climate Change, supra note 219, at 6293 (this would be Reg S-K Items 101, 103, 303 and 503(c)).

223. Id. at 6295–97.


226. Nevertheless, there have been and continue to be a number of qualitative reasons – centered around the importance of the environment in general and climate change in particular – for the disclosure of corporate environmental information. For example, a company may report its environmental accomplishments, its “green-ness” in order to attract or retain investors who value a commitment to the environmental for policy reasons. See, e.g., Rindfleisch, supra note 175, at 48. Or, a company may disclose information about its environmental record “to show that superior management is at the helm of the business and has taken concrete stops to minimize adverse environmental impacts.”
III. IRAN

A. WHAT DOES IT TAKE?

What does it take for the securities laws to require disclosure of an issue without a clear, direct financial impact? The debates surrounding disclosure of management integrity issues and climate change risks provide examples in which information was provided to investors once it was required as a Reg S-K line item, or the issue had developed a clear financial impact. In addition, disclosure requirements came in response to a substantial amount of pressure from outside the SEC in the form of legislative initiatives, NGO activism, investor interest, private disclosure services and international measures. Reporting companies did not recognize the materiality of the issues for disclosure purposes until the sheer volume of investor concern and regulatory restrictions created undeniably material financial consequences. This fact suggests that although the SEC may pay lip service to the concept that materiality is a broad doctrine, in practice SEC enforcement may be limited to financially significant information that can be quantified at present.

The conclusion that the SEC is accepting reductive interpretations of materiality and therefore not requiring complete disclosure of nonfinancial, material information is borne out in the disclosure of companies’ business operations in Iran. A survey of reporting companies’ responses to SEC questions about the materiality of their Iranian activities, discussed below in Part III.E.3, demonstrates that quantifiable, financial impact is the dispositive factor in a materiality determination. The SEC does not say “stop” until long after the car has backed into the curb.

B. INTERNATIONAL SANCTIONS

The SEC’s unwillingness to determine that information about a company’s operations in Iran is material to investors regardless of the financial magnitude is surprising given Iran’s human rights abuses, nuclear ambitions, and support for global terrorism, and the resulting level of international and U.S. censure. Between 2006 and 2008, the UN Security Council passed Resolutions 1696, 227 1737, 228 1747 229 and 1803, 230 all of

Latham, supra note 154, at 678.

227. On July 31, 2006 the Security Council passed Security Council Resolution 1696 expressing serious concern raised by International Atomic Energy Agency (IAEA) reports on Iran’s nuclear program, requiring Iran to suspend all of its uranium enrichment and reprocessing activities, and calling on other countries to ban the transfer to Iran of all items which could contribute to the enrichment of uranium. S.C. Res. 1696, ¶¶ 2-5, U.N. Doc. S/RES/1696 (July 31, 2006); see also Citing Iran’s Failure to Clarify Nuclear Ambitions, UN Imposes Additional Sanctions, UN NEWS SERVICE (June 9, 2010), http://www.un.org/apps/news/story.asp?NewsID=34970&Cpl=iran&Crl.

228. On December 23, 2006, the Security Council passed Resolution 1737 which reiterated its
which expressed concern about reports of Iran's nuclear program and sought to slow or halt Iran's uranium enrichment activities. On June 9, 2010, Security Council Resolution 1929 expanded the arms embargo and tightened restrictions on certain financial and shipping activities. Resolution 1929 also included an annex with measures directed against 41 new named entities and individuals, including enterprises linked to the Islamic Revolutionary Guard and the defense industry, as well as banks and the Iranian national shipping line. Resolution 1929 created a panel of experts to monitor implementation and triggered additional national and regional sanctions by UN member states.

C. U.S. FEDERAL AND STATE LAWS AND REGULATIONS

1. Federal Regulations

However, the most extensive sanctions on Iran have been imposed by the United States. The U.S. Department of State has identified Iran as a serious concern and again demanded that Iran suspend uranium enrichment, and required other countries to take all necessary measures to prevent the supply of goods and technologies that could contribute to Iran’s uranium enrichment. S.C. Res. 1737, ¶¶ 2–3, U.N. Doc. S/RES/1737 (Dec. 23, 2006).

229. On March 24, 2007, the Security Council passed Resolution 1747, again emphasizing serious concern about Iran’s nuclear program and demanding that Iran halt its uranium enrichment and reprocessing activities. S.C. Res. 1747, ¶¶ 1–10, U.N. Doc. S/RES/1747 (Mar. 24, 2007) (noting that Iran had ignored Resolutions 1696 and 1737, Resolution 1747 called on other countries to expand their restrictions on Iran).


231. Resolution 1929 had the support of 12 Security Council members. Brazil and Turkey voted against it, and Lebanon abstained. Citing Iran's Failure to Clarify Nuclear Ambitions, UN Imposes Additional Sanctions, supra note 227.


234. Id.

235. In July 2010, the European Union imposed sanctions on Iran including travel bans, asset freezes, a ban on new trade finance, barring insurance services, barring cargo-only flights, and prohibiting the supply of equipment and technology for oil and gas industries. David Crawford & Stephen Fidler, EU Steps Up Iran Penalties but Also Lifts Some Curbs, WALL ST. J., July 27, 2010, http://online.wsj.com/article/SB100014240527487037009045755390830497692208.html?KEYWORDS=iran (noting, however, that a concession was made with respect to the Bushehr plant in order to secure Russian cooperation with international efforts on Iran).
State Sponsor of Terrorism (SST) since 1984. Countries designated as SSTs are subject to a variety of financial and other restrictions including denial of Export-Import Bank credits and other financing guarantees.

Iran has also been subject to restrictions promulgated by the U.S. Department of the Treasury’s Office of Foreign Assets Control (OFAC) for over 30 years. The Iranian Assets Control Regulations were imposed in 1979 in response to the seizure of the U.S. embassy in Tehran. The current Iranian Transactions Regulations, first put into place in 1987, prohibit virtually all trade and investment activities with Iran by U.S. persons, defined as U.S. citizens and companies, and persons physically in the United States.

236. State Sponsors of Terrorism, U.S. DEP’T OF STATE, http://www.state.gov/s/ct/c14151.htm (last visited Oct. 17, 2010). Countries determined by the Secretary of State to have repeatedly provided support for acts of international terrorism are designated pursuant to three laws: Section 6(j) of the Export Administration Act of 1979, Section 40 of the Arms Export Control Act, and Section 620A of the Foreign Assistance Act. Currently the Department of State has designated Cuba, Iran, Sudan and Syria. Id.


238. Exec. Order No. 12,170, 31 C.F.R. § 535 (2010). OFFICE OF FOREIGN ASSETS CONTROL, U.S. DEPARTMENT OF THE TREASURY, WHAT YOU NEED TO KNOW ABOUT U.S. ECONOMIC SANCTIONS: AN OVERVIEW OF O.F.A.C. REGULATIONS INVOLVING SANCTIONS AGAINST IRAN (Oct. 15, 2010), available at http://treas.gov/offices/enforcement/ofac/programs/iran/iran.pdf. The United States later expanded the freeze into a full trade embargo, which was lifted when the Algiers Accords were signed with Iran in 1981. Id. Many U.S. nationals still hold pre-1979 claims against Iran, however, so the Iranian Asset Control Regulations remain in effect.

239. 31 C.F.R. pt. 560 (2010). The regulations were promulgated pursuant to President Reagan’s Executive Order 12613 on October 29, 1987, which found that the Government of Iran was actively supporting terrorism as an instrument of state policy. OFFICE OF FOREIGN ASSETS CONTROL, supra note 238, at 1.

240. See generally 31 CFR pt. 560. Technically such transactions are prohibited “unless licensed by OFAC.” OFFICE OF FOREIGN ASSETS CONTROL, supra note 238, at 1. Under the regulations, goods, technology, or services may not be exported, reexported, sold or supplied, directly or indirectly, from the United States or by a U.S. person, wherever located, to Iran or the Government of Iran. In addition, U.S. persons, including foreign branches of U.S. depository institutions and trading companies, are prohibited from engaging in any transactions related to goods or services of Iranian origin or goods or services owned or controlled by the Government of Iran. New investments by U.S. persons in Iran or in property (including entities) owned or controlled by the Government of Iran are prohibited. While the Iranian Transactions Regulations do not contain any blocking provisions, several Iranian banks have been separately designated under the Nonproliferation of Weapons of Mass Destruction (“NPWMD”) or Specially Designated Global Terrorist (“SDGT”) programs for their involvement in the financing of either WMD or ballistic missile proliferation or of terrorism, respectively. Finally, U.S. depository institutions, including foreign branches, are prohibited from servicing accounts of the Government of Iran, including banks owned or controlled by the Government of Iran or persons in Iran. Id. at 2.

241. The regulations apply to all “U.S. Persons,” defined as “any United States citizen, permanent resident alien, entity organized under the laws of the United States (including foreign branches) or any person in the United States.” 31 C.F.R. § 560.314 (2010).
U.S. economic sanctions against Iran have been steadily strengthened, especially in recent years. For example, the regulations were tightened in 2008 when authorization for so-called “U-turn” financial transactions (transfers involving Iran that originate and end with non-Iranian foreign banks) was revoked. In June 2010, OFAC tightened the Iranian Transaction Regulations to include the expanded list of persons that would come within the category of “the Government of Iran,” and in September 2010 it removed general licenses that had authorized certain exports and imports (for example, of foodstuffs and carpets).

In August 2010, OFAC promulgated the new Iranian Financial Sanctions Regulations, which implement provisions of the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (discussed below) by prohibiting or imposing strict conditions on U.S. correspondent accounts for foreign financial institutions that knowingly facilitate Iran’s acquisition of weapons of mass destruction or support for international terrorism. The Iranian Financial Sanctions Regulations thus apply to U.S. financial institutions. Appendix A of the new regulations lists the foreign financial institutions with which dealings are restricted.

One might assume that, since these measures prevent U.S. companies from conducting business in Iran, then there is no risk that U.S. investors could invest in companies that conduct business there. However, as noted above, the OFAC regulations do not directly apply to foreign companies, including foreign subsidiaries of U.S. companies. The only restriction in the regulations is that a U.S. person cannot approve, finance, facilitate or guarantee a transaction with Iran by a foreign person (such as a foreign subsidiary of a U.S. company) if the U.S. person cannot perform the transaction directly. Thus, a U.S. investor may buy securities in a

242. The regulations were expanded under three subsequent Executive Orders by President Clinton. Executive Order 12957 (Mar. 15, 1995) (prohibiting U.S. involvement with petroleum development in Iran); Executive Order 12959 (May 6, 1995) (substantially tightening sanctions against Iran); Executive Order 13059 (Aug. 19, 1997) (clarifying Executive Orders 12957 and 12959, and confirming that virtually all trade and investment activities with Iran by U.S. persons are prohibited). However, the 2000 Trade Sanctions Reform and Export Enhancement Act eased sanctions slightly to allow U.S. persons to purchase and import carpets and certain food products from Iran. Pub. L. No. 106-387, 114 Stat. 1549, 31 C.F.R. § 560.534 (2000) (repealed 2010).


244. 31 C.F.R. pt. 560, Appendix A To Part 560—Persons Determined To Be The Government Of Iran, As Defined In § 560.304 Of This Part, 75 Fed. Reg. 34,630 (June 18, 2010).


247. 31 C.F.R. § 561.201 (2010).

248. “U.S. financial institution” is defined in 31 C.F.R § 561.309.

249. 31 C.F.R. § 560.208 (prohibited facilitation by United States persons of transactions by foreign
foreign company that does business in Iran, or in a U.S. company with a subsidiary or an affiliate that does business in Iran.

2. Congressional Action Expands U.S. Sanctions

In 1996, the United States enacted what is now known as the Iran Sanctions Act ("ISA"). ISA prohibits investments of over $20 million a year that directly and significantly contribute to the enhancement of Iran’s ability to explore for, extract, refine, or transport by pipeline its petroleum and natural gas reserves, and instructs the President to impose sanctions on any person that the President determines has made such an investment.

U.S. companies were already prohibited from investing in Iran when ISA was passed. Its primary targets are non-U.S. companies profiting from the exploitation of the significant oil and natural gas resources in Iran. Such investment is often not prohibited under the laws of those companies’ home countries. Historically, ISA has not been enforced by the United States. As originally drafted, ISA allowed the President to waive application of sanctions if he certified that doing so was important to the U.S. national interest, and such waivers were granted to several non-U.S. reporting companies.

250. ISA was originally known as the Iran and Libya Sanctions Act (ILSA), Pub. L. No. 104-172, 110 Stat. 1541 (1996) (as codified as amended at 50 U.S.C. § 1701 (2006)), but in 2004 Libya yielded to international pressure to give up the two intelligence agents suspected in the 1988 bombing of Pan Am Flight 103, and both U.S. and UN sanctions were removed. ILSA was subsequently renamed ISA.


252. The sanctions originally included in ISA were: (1) denial of Export-Import Bank loans, credits, or credit guarantees for U.S. exports to the sanctioned entity; (2) denial of licenses for the U.S. export of military or militarily-useful technology; (3) denial of U.S. bank loans exceeding $10 million in one year; (4) if the entity is a financial institution, a prohibition on its service as a primary dealer in U.S. government bonds; (5) if the entity is a financial institution, a prohibition on its serving as a repository for U.S. government funds; (6) prohibition on U.S. government procurement from the entity; and (7) restriction on imports from the entity, in accordance with the International Emergency Economic Powers Act (IEEPA, 50 U.S.C. 1701 and following). Pub. L. No. 104-172, § 6, 110 Stat. 1545.

253. Id. at § 9(c) (for a waiver in the national interest). There are also several “exceptions” granting
However, in July 2010, following the fourth round of UN sanctions, Congress strengthened the ISA prohibitions\textsuperscript{254} by passing the Comprehensive Iran Sanctions, Accountability and Divestment Act of 2010 (CISADA).\textsuperscript{255} CISADA added new potential sanctions to the ISA list;\textsuperscript{256} added insurance, financing and shipping as services that may contribute to the enhancement of Iran’s petroleum sector;\textsuperscript{257} imposed strict conditions on foreign financial institutions that engage in business with Iran;\textsuperscript{258} restricted Iran-related activities of subsidiaries of U.S. financial institutions;\textsuperscript{259} required companies that receive U.S. government contracts to cease sanctionable activities;\textsuperscript{260} and provided procedures to restrict exports to countries designated as likely to divert products to Iran.\textsuperscript{261} In addition, the new legislation decreased the President’s discretion to waive sanctions under the ISA\textsuperscript{262} and encouraged state and local governments to divest from companies and financial institutions doing business in Iran’s energy sector.\textsuperscript{263} CISADA is expected to lead to legal challenges and fines for a number of non-U.S. reporting firms.\textsuperscript{264}

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\textsuperscript{254} E.g., The Iran Sanctions Enabling Act, H.R. 1327, 111th Cong. (as passed by House, Oct. 14, 2009) (authorizing a state or local government to adopt and enforce measures to prohibit the investment of its assets in Iran’s energy sector, and to divest its assets from or prohibit the investment of assets it controls in, persons who have investments of more than $20 million in Iran’s energy sector); The Iran Refined Petroleum Sanctions Act of 2009, H.R. 2194, 111th Cong. (as passed by House, Dec. 15, 2009) (aiming to restrict gasoline supplies to Iran and strengthen ISA).


\textsuperscript{256} CISADA, H.R. 2194 § 102(a). CISADA changed the seven potential sanctions under the ISA for investments in the petroleum sector slightly to add prohibitions of: (1) access to foreign exchange in the United States; (2) access to the U.S. banking system; and (3) transactions in U.S. property, and to remove the prohibition of a financial institution serving as a repository for U.S. government funds.

\textsuperscript{257} See id. § 102(a)(3)(B).

\textsuperscript{258} See id. § 104(c).

\textsuperscript{259} See id. § 104(d).

\textsuperscript{260} See id. § 106(a).

\textsuperscript{261} See id. § 303(a).

\textsuperscript{262} See id. § 401(b).

\textsuperscript{263} See id. § 202(a).

During the 2000s, Congress passed several more measures to isolate Iran. The 2000 Iran Nonproliferation Act provided for punitive action against foreign persons who transfer goods, services, or technology to Iran to aid in weapons of mass destruction programs. The 2006 Iran Freedom Support Act was signed into law "to hold the current regime in Iran accountable for its threatening behavior." Additionally, in July 2010, Representative Ted Deutch (D-FL) introduced the Iran Transparency and Accountability Act of 2010 which would require issuers to disclose whether they engaged in any activity that is sanctionable under ISA, violated certain sections of CISADA or have any ties to a company that the U.S. has designated as contributing to Iranian proliferation activities. Congressman Deutch explained, "by mandating self-disclosure and making this information available to the public through SEC filings, we allow not just our government, but the American people, the opportunity to ensure their investment dollars are not actively undermining our national security priorities."

3. State Measures

In addition, over a dozen states – including Arizona, California, Florida, Georgia, Illinois, Indiana, Louisiana, Michigan, Minnesota, Missouri, and New Jersey – require their state
investment boards, pension funds, or both to divest their assets from companies that do business in Iran. State insurance departments have also sought divestment by the companies that they regulate. For example, the California Insurance Commissioner announced a Terrorist Financing Probe in June 2009 to review compliance with a California law\textsuperscript{280} that prohibits insurers from investing in SSTs.\textsuperscript{281} California insurance companies were required to identify their direct investments in designated sectors of the Iranian economy and their indirect investments in companies doing business in those sectors. In December 2009, the California Insurance Department announced that although insurers reported no direct investments in Iran and therefore were in full compliance with state law,\textsuperscript{282} the Department had uncovered billions of dollars of indirect investments in companies doing business with the Iranian oil and natural gas, nuclear and defense sectors. To put an end to those indirect investments, in February 2010 the Department announced that insurers’ investments in 50 Iran-related companies\textsuperscript{283} will not be recognized on the insurers’ financial statements in California.\textsuperscript{284} In May 2010, the California Insurance Commissioner announced that 1,010 insurance companies – more than 75 percent of insurers licensed to do business in California – had agreed to forgo future investments in the identified companies.\textsuperscript{285} California published its list of 50 Iran-related companies, and it published the names of the companies that did \textit{not} agree to the moratorium.\textsuperscript{286}
D. INVESTORS ARE SEEKING INFORMATION ABOUT IRANIAN OPERATIONS BUT REPORTING COMPANY DISCLOSURE HAS BEEN POOR

1. Requests for Information

The California Insurance Department measures, particularly the public identification of companies with Iran-related operations, illustrate an important point: investors are looking for information about which companies are doing business in Iran, and that information is not being disclosed in companies’ periodic reports. Numerous institutional investors have requested that the SEC require disclosure of business operations in SSTs. For example, in June 2005, representatives of fifty public employee retirement systems, under strong pressure to divest from companies doing business in Sudan, wrote to the SEC and the Departments of State, Treasury, and Commerce and asked for “assistance in identifying any publicly traded companies that are of concern to the United States government for doing business with, or having business ties to, entities that support terrorism or threaten U.S. humanitarian goals.”

The pension funds stated that they needed information about these entities to “ensure that [they were] not inadvertently acting in conflict with the foreign policy and humanitarian goals of the United States, thereby subjecting [their] members to excessive investment risk.” A few days later, officials from national organizations representing state auditors, state retirement administrators, public employee retirement systems, state legislatures, and teacher retirement funds wrote to the same four agencies asking them to “[m]andate readily accessible disclosures” and to “[p]rovide a searchable, publicly available database . . . of publicly held companies with material business or operations in nations classified as supporting terrorism or subject to sanctions.”

2. Reporting Company Disclosure Has Been Poor

To date, U.S. securities laws have not effectively been used to require companies doing business in SSTs to disclose such business. U.S. reporting companies with subsidiaries with operations in Iran, and non-U.S. reporting companies with direct operations, have long and successfully taken the position that their business in Iran is not material, and therefore does not have to be disclosed, if it constitutes a financially insignificant

288. Id. The pension funds pointed out that “existing laws require your agencies to identify, monitor and sanction companies with business or financial ties to terrorist sponsoring countries.” Id. at 2. 289. Id. at 1–2.
percentage of the company’s bottom line.\textsuperscript{290} Without disclosure, it is
difficult for investors to find out whether reporting companies have
operations in Iran.

A 2009 empirical database created by this author found that only 49
percent of a sampling of public companies with credibly reported
operations in three SSTs (Iran, Cuba and Sudan) included any disclosure of
those operations in their periodic reports.\textsuperscript{291} In addition, many of the
companies that disclosed the operations only did so in passing (e.g., by
using the word “Iran” in the name of a listed subsidiary). If such cursory
“disclosure” was factored out, only 36 percent of reporting companies with
business operations in the three SSTs were disclosing.\textsuperscript{292}

3. Efforts to Fill the Disclosure Gap

In the absence of reliable official disclosure by companies in their
periodic reports, investors have been left to look for information from other
sources. Institutional investors often subscribe to private global security
risk assessment services such as Conflict Securities Advisory Group
(CSAG),\textsuperscript{293} MCSI,\textsuperscript{294} or World-Check.\textsuperscript{295} World-Check, for example,
provides a database of known heightened risks to individuals and
businesses and claims that its subscribing customers include more than
3,000 institutions, including over 90 percent of the world’s largest banks
and “200 enforcement and regulatory agencies.”\textsuperscript{296}

In addition to private, paid subscription services, NGOs have played a
key part in increasing disclosure about companies’ investments in SSTs,
particularly in the case of Iran. United Against Nuclear Iran (UANI), for

\textsuperscript{290} See, e.g., Letter from Frank B. Wyatt II, Gen. Counsel, CommScope, Inc., to Cecilia Blye,
Chief, Off. of Global Security Risk, SEC, Regarding 10-K for the Fiscal Year Ended December 31,
2008 (June 14, 2010), available at http://www.sec.gov/Archives/edgar/data/1035884/0001193125101
38925/filenamel.htm; Letter from Thomas A. Connell, Vice Pres. and Controller, The Goodyear Tire &
Rubber Co., to Terence O’Brien, Branch Chief, Div. of Corp. Fin., SEC, Regarding Form 10-K for the
fiscal year ended December 31, 2009 (June 9, 2010), available at http://www.sec.gov/Archives/edgar/
data/42582/000095012310056937/filenamel.htm; Letter from Alex Vanselow, Chief Fin. Officer, BHP
Billiton Limited and BHP Billiton Plc, to Celilia D. Blye, Chief, Off. of Global Security Risk, SEC,
Regarding Form 20-F for the Fiscal Year Ended June 30, 2009 (June 2, 2010), available at

\textsuperscript{291} Westbrook, supra note 5, at 1216.

\textsuperscript{292} Id. at 1217.

\textsuperscript{293} See About CSAG, CONFLICT SECURITIES ADVISORY GROUP (2010), http://www.conflict
securities.com/about/index.cfm (founded in the weeks after the September 11th attacks, CSAG is an
independent research provider that specializes in identifying and assessing publicly traded companies
that have business activities in or with countries on the U.S. State Department’s list of SSTs).

\textsuperscript{294} Overview, MCSI, http://www.mscibarra.com/about/ (last visited Oct. 21, 2010).

\textsuperscript{295} See About World-Check, WORLD-CHECK, http://www.world-check.com/overview/ (last visited
Oct. 21, 2010).

\textsuperscript{296} Id.
example, is a coalition of groups seeking to prevent Iran from becoming a nuclear power. Among other things, UANI seeks to publicize companies that are doing business in Iran, and calls on them to cease such operations. UANI has launched recent campaigns to persuade Honeywell International, Inc., Komatsu Ltd., and Maersk to cease their operations in Iran. Past initiatives have included campaigns aimed at Caterpillar, KPMG LLP, Ingersoll Rand Plc, Huntsman Corporation, and General Electric Company.

UANI uses publicity to convince companies to cease doing business in Iran. UANI maintains the Iran Business Registry, “a searchable database of reputable media and academic reports of international business in...

297. About Us, UNITED AGAINST NUCLEAR IRAN, http://www.unitedagainstnucleariran.com/about (last visited Oct. 21, 2010). The United Against Nuclear Iran coalition includes human rights and humanitarian groups, the labor movement, political advocacy and grassroots organizations and representatives of diverse ethnicities, faith communities, political and social affiliations. Id. The author is a member of the UANI Advisory Board.

298. Id.

299. For example, on July 8, 2010, UANI wrote to Honeywell to request that they cease doing business in Iran. Letter from Mark D. Wallace, Ambassador, to David M. Cote, Chairman and CEO, Honeywell International Inc., (July 8, 2010), available at http://unitedagainstnucleariran.com/sites/default/files/IBR%20Correspondence/41Letter_to_Honeywell_Sanctions_070810.pdf.


306. Some companies, for example General Electric, have signed an “Iran Business Declaration” certifying that the company is not doing business in Iran. Declaration of Brackett B. Denniston III, Senior Vice President and General Counsel, General Electric Company, Non-Engagement of Business in Iran (Sept. 18, 2009), available at http://www.unitedagainstnucleariran.com/sites/default/files/IBR%20Correspondence/Certification_IBD_GE_091809.pdf.
Iran. On January 12, 2010, UANI launched the Iran Disclosure Project which identifies publicly traded companies that have failed to disclose to investors the legal and financial issues associated with their business dealings in Iran.

Additional efforts to fill the disclosure gap come from the media and other government agencies. For example the New York Times publishes an interactive online listing of companies that do business in Iran and also have government contracts called “Profiting from Iran.” In May 2010, the U.S. Government Accountability Office released a report listing 41 foreign firms that had commercial activity in the Iranian energy sector between 2005 and 2009 and identifying seven of the firms that had contracts with the U.S. government during those years worth almost $880 million.

4. Public Awareness is High

Media coverage of Iran’s nuclear ambitions has been intense, especially following the Summer 2010 UN and U.S. sanctions. Reports of Iran’s sponsorship of terrorism abound. Similarly, the public is aware of the repressive nature of President Ahmadinejad’s regime, especially after the brutal crackdown on democratic Green Movement protesters in the wake of the contested June 2009 presidential election. On the June 22, 2010 anniversary of the murder of Neda Agha-Soltan, a global consortium of over 100 international law scholars, human rights advocates, and former government leaders released a report about the nuclear ambitions and international law violations of President Ahmadinejad’s regime called “The Danger of a Nuclear, Genocidal and Rights-Violating Iran: The Responsibility to Prevent Petition.” There is currently speculation about an Israeli or U.S. military attack on Iran. Concern about Iran is not

308. Id.
311. Id. at 5–6.
312. See supra Part C.
limited to a small fraction of the population. It is worldwide, longstanding and widespread.

Public awareness is reflected in investment patterns. “Terror-free” investment is increasingly popular. With both Sudan and Iran in the news in recent years, denying investment funds has become an accepted way for the public to help isolate terrorism-sponsoring regimes. “Modeled in part on the economic boycott of apartheid-era South Africa, ‘terror-free investing’ is designed to isolate countries on the U.S. terrorism list like Iran.” Companies such as Empowerment Financial Group advertise terror-free investment funds with names like the Roosevelt Anti-Terror Multi Cap (Fund: BULLX).

Despite their defense of their Iran business, many public companies are ceasing their operations in Iran. In August 2010, for example, LyondellBasell Industries NV announced that it would end all business in Iran in order to shield itself from possible U.S. sanctions. Of course, a company spokesperson described the move as “immaterial” to LyondellBasell’s overall operations. Of the 142 reporting companies identified by the author as having conducted business operations in Iran between January 1, 2006, and January 1, 2010, approximately half have either reported in periodic disclosure, or claimed in correspondence with the SEC or an NGO, that they have ceased or are ceasing operations in Iran.

E. THE SEC’S PERSISTENT FAILURE TO FOLLOW THROUGH

Notwithstanding the obvious importance of the Iranian situation to the international order, as well as the law of the United States, there is no express requirement in Reg S-K, and no guidance or decisions applying Rules 12b-20, 408 or 10b-5, that specifically instructs reporting companies to disclose their operations in Iran. As discussed above both generally and

320. Id.
322. Seventy-two of the 142 companies claim to be out of or getting out of Iran. More precise details available from the author.
in the context of management integrity and climate change, the general standards from Reg S-K Items 101, 103, 303 and 503(c) could require disclosure of operations in Iran if such operations are deemed material. However, until costs have already been imposed, by war or otherwise, companies consistently argue that their Iranian business is relatively insignificant to their overall bottom line and so need not be (embarrassingly) exposed to the sunshine. Materiality comes too late.

1. Chairman Unger's Letter: Backing Down

Efforts to get the SEC to recognize the significance to investors of a company's business in SSTs, and Iran in particular, have been going on for many years. In April 2001, several years before the 2005 state pension fund and auditors' letters requesting more accessible disclosure of company operations in SSTs, Congressman Frank Wolf wrote to Laura S. Unger, Acting Chairman of the SEC, to express his concerns about a recent initial public offering concluded by PetroChina Limited that had arguably included inadequate disclosure of the Sudanese operations of the state-owned parent company of the issuer. Chairman Unger's May 2001 response suggested "enhanced disclosure for foreign registrants doing business in sanctioned countries." Chairman Unger took the position that the SEC does not have the statutory authority to deny companies access to the U.S. markets on the basis of their business operations in a country subject to U.S. sanctions, but the SEC does have the "statutory authority to require that U.S. investors receive adequate disclosure about where the proceeds of their securities investments are going and how they are being used."

323. See discussion supra Part D.1.
326. See Letter from Frank Wolf, Congressman, U.S. House of Representatives, to Laura Unger, Acting Chairman, SEC (Mar. 8, 2001) (on file with author). Congressman Wolf's letter also expressed concern with respect to Talisman Energy, Inc., a Canadian company with U.S.-listed shares and operations in Sudan. See id. Talisman subsequently withdrew from Sudan. Congressman Wolf suggested, for example, that foreign companies seeking access to U.S. markets should disclose their operations in SSTs, as well as those of their parent companies, subsidiaries, and affiliates. Id. (discussing Recommendation No. 1).
328. See id., at 1121.
329. Id.
330. Id. Chairman Unger reiterated that the federal securities laws are about disclosure and making sure that investors have "access to material information about the companies and securities in which
Chairman Unger echoed the materiality language of *TSC Industries Inc. v. Northway, Inc.* and *SAB 99* stating that "the fact that a foreign company is doing material business with a [sanctioned country] is, in the SEC staff's view, substantially likely to be significant to a reasonable investor's decision about whether to invest in that company." She thus implied that such business is material *per se* and must be disclosed.

Chairman Unger's letter attached a memorandum prepared by David Martin, Director of the SEC's Division of Corporation Finance, that concluded that "existing SEC disclosure requirements might very well warrant disclosure of a foreign company's operations in, or business relationships with companies from, countries on" the SST list, depending on "the materiality of the financial impact of those operations and business relationships on the company's conduct of its business." Director Martin's memorandum stated, "We agree that a reasonable investor would likely consider it significant that a foreign company raising capital in the U.S. markets has business relationships with countries, governments or entities with which any U.S. company would be prohibited from dealing because of U.S. economic sanctions."

It was unclear whether Chairman Unger's "enhanced" disclosure "merely committed the [SEC] to more rigorous enforcement of the existing standard of materiality for a firm's data, or whether her letter effectively announced a new, lower standard for the materiality of information" about

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they are considering investing." *Unger Letter, supra* note 327, at 1121.

331. *TSC Indus.*, 426 U.S. at 449.


334. Chairman Unger's exact meaning was debated because she used the word "material" several times in her letter but did not explicitly write that such information is material *per se*. *See* generally *id.*

335. *Martin Memorandum, supra* note 58, at 1127-1128.

336. *Id.* at 1128 (discussing recommendation No. 1).

337. *Id.* at 1129. Martin continued:

> The staff will, therefore, seek information from foreign registrants about their material business in countries on the OFAC's sanctions list and their business relationships with countries, governments, or entities on those lists. This type of disclosure would make available to investors additional information about situations in which the proceeds of an offering could however indirectly benefit countries, governments, or entities that, as a matter of U.S. foreign policy, are off-limits to U.S. companies.

*Id.* Director Martin explained:

> If it is reasonably likely that U.S. governmental sanctions will be imposed on the company as a result of its operations in a particular country, this risk would need to be disclosed if the sanctions were likely to have a material impact on the company. Likewise, if it is reasonably likely that public opposition to the company would have a materially adverse effect on the operations of the company, this risk would also need to be disclosed.

*Id.* (introducing the concept of probability versus magnitude, which was also part of the materiality test articulated by *Basic Inc. v. Levinson*).
operations in sanctioned countries like Iran. Both Chairman Unger and Director Martin endorsed the *TSC Industries v. Northway* standard of materiality and the "longstanding SEC spin" on the standard that "the reasonable investor generally focuses on matters that have affected, or will affect, a company's profitability and financial outlook." However, their assertion that a reasonable investor would likely consider operations in a country subject to U.S. sanctions significant seemed to indicate a new standard under which operations in a sanctioned country would be considered material *per se*.

The question was answered a few months later, however, when Chairman Pitt replaced Acting Chairman Unger at the SEC. Industry groups opposed to additional disclosure of operations in SSTs such as Iran reported in October 2001 that Chairman Pitt had assured them that no additional disclosure would be required. The SEC stepped back from enforcing a broad understanding of the materiality of operations in SSTs.


In addition, even if some information is deemed material by reporting companies and disclosed, the information is hard for investors to find. The SEC's EDGAR database in which company disclosure is posted by the SEC is not easy to use, and only allows "full text" searches for the past four years.

The SEC has attempted to make it easier for investors to find the disclosure that companies make about their activities in SSTs, but with little result. On June 25, 2007, the SEC introduced the Software Tool for Investors Seeking Information on Companies' Activities in Countries Known to Sponsor Terrorism (the "Web Tool"). In the 22 days it was

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339. Id. at 1434.
340. Martin Memorandum, supra note 58, at 1128. Director Martin went on to write, "Because securities are financial investment vehicles, the materiality of a foreign company's operations in a particular country and its business relationships with companies from that country will generally depend on whether these operations or relationships have had, or are likely to have, a financial impact on the company." Id. at 1128–29.
342. See Gary G. Yerkey, SEC Will Not Seek New Data from Foreign Firms on Overseas Dealings, 33 Sec. Reg. & L. Rep. (BNA) 1441 (Oct. 8, 2001) (describing the triumphant demeanor of the President of the National Foreign Trade Council after meeting with Chairman Pitt and receiving assurances of SEC forbearance).
343. Press Release, Sec. & Exch. Comm'n, SEC Adds Software Tool for Investors Seeking Information on Companies' Activities in Countries Known to Sponsor Terrorism (June 25, 2007), http://www.sec.gov/news/press/2007/2007412l.htm. The Web Tool did not change the definition of what had to be disclosed. The Web Tool merely made any information disclosed by the issuer more accessible to investors. The database was organized by country (SST) and provided direct links to specific companies' EDGAR disclosures. See Paul Michalski & Kimberley S. Drexler, *A Snapshot of*
online, the Web Tool had over 150,000 hits. Iran was the country most frequently “clicked on.”

Unsurprisingly, the Web Tool was widely criticized. Many reporting companies opposed the database as a “blacklist” because simply being listed in a part of the SEC website identified with SSTs was prejudicial to them. The Web Tool was criticized as over-inclusive because “it captured (and potentially stigmatized) any issuer that disclosed even benign activities in [an SST],” and as under-inclusive because it only included issuers’ 2006 annual reports (Form 10-K or Form 20-F) and not disclosure made after those reports.

The SEC removed the Web Tool from its site after just a few weeks and issued the Concept Release on Mechanisms to Access Disclosures Relating to Business Activities in or with Countries Designated as State Sponsors of Terrorism (the “Concept Release”). In the Concept Release, the SEC set out its understanding of the disclosure requirements with respect to business activities in or with SSTs:

The federal securities laws do not impose a specific disclosure requirement that addresses business activities in or with a country based upon its designation as a State Sponsor of Terrorism. However, the federal securities laws do require disclosure of business activities in or with a State Sponsor of Terrorism if this constitutes material information that is necessary to make a company’s statements, in the light of the circumstances under which they are made, not misleading.

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345. Congressman Barney Frank, Chairman of the House Financial Services Committee, wrote to Chairman Christopher Cox of the SEC that “I hope you will give serious consideration to devising either a more rigorous, materiality-based methodology for developing the list you are presenting to investors or else eliminating the webpage entirely.” Press Release, House Comm. on Fin. Servs., Frank Letter to Cox Regarding SEC List of Terrorist-Financing States (July 13, 2007), http://www.house.gov/apps/list/press/financialsvcs_dem/press071307.shtml; See also Rachelle Younglai, SEC Member Criticizes ‘Terrorist’ Watch List, REUTERS, July 19, 2007, http://www.reuters.com/article/governmentFilingsNews/idUSN1920647120070719 (reporting that Commissioner Paul Atkins had stated in an interview with Reuters that the SEC needed either to fix or to withdraw the Web Tool as soon as possible).

346. In almost all cases, the activity described was lawful under applicable, usually non-U.S., law. In some cases (for example, Western Union) the activity was explicitly licensed by OFAC.


350. Id. at 65863 (citing Rule 408 and Rule 12b-20).
The Concept Release reiterated the SEC’s commitment to the *TSC Industries Inc. v. Northway Inc.* and *Basic Inc. v. Levinson* definition of materiality ("[T]he Supreme Court has determined information to be material if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision or if the information would significantly alter the total mix of available information").\(^3\) Even in the context to activities in SSTs, the Concept Report stated:

The materiality standard applicable to a company’s activities in or with State Sponsors of Terrorism is the same materiality standard applicable to all other corporate activities. Any such material information not covered by a specific rule or regulation must be disclosed if necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. The materiality standard’s extensive regulatory and judicial history helps companies and their counsel to interpret and apply it consistently, and we remain committed to employing this standard to company disclosure regarding business activities in or with State Sponsors of Terrorism.\(^3\)

Comment letters varied, but those submitted by larger companies and trade groups generally praised materiality as a standard that elicited needed disclosure, while those submitted by institutional investors and individuals generally favored a more explicit statement of the materiality of such operations, and increased disclosure.\(^3\) The Comment period ended on January 22, 2008, but the SEC has not followed up on the Concept Release.

3. *Survey of SEC Inquiries and Company Responses: One Step Forward and Two Steps Back*

The most obvious example of the SEC’s failure to enforce the full (i.e., both qualitative and quantitative) meaning of materiality, however, can be found in the correspondence it exchanges with reporting companies with business activities in Iran. SEC staff members frequently send letters to reporting companies with inquiries regarding their periodic disclosure documents. Some of those letters ask companies about their reported operations in SSTs.

The number, although not necessarily the effectiveness, of such letters has increased since the 2004 establishment of the SEC Office of Global

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352. *Id.* The Concept Release asked whether the SEC should continue to interpret materiality in the context of SSTs in the same way it does when reviewing disclosure related to other corporate activities that are not covered by a specific rule or regulation and whether information about companies’ activities in, or with, SSTs was important to investors in making investment decisions. *Id.*

Security Risk (the OGSR). The OGSR was tasked with increasing “the investing public’s access to the information it needs about any public company to make an informed investment decision, including material information about global security risk” by ensuring that companies listed on U.S. exchanges disclose whether they are doing business in SSTs such as Iran.


The duties of this office shall include, but not be limited to: (1) establishing a process by which the SEC identifies all companies on U.S. exchanges operating in State Department designated terrorist-sponsoring states; (2) ensuring that all companies sold on U.S. exchanges operating in State Department-designated terrorist-sponsoring states are disclosing such activities to investors; (3) implementing enhanced disclosure requirements based on the asymmetric nature of the risk to corporate share value and reputation stemming from business interests in these higher risk countries; (4) coordinating with other government agencies to ensure the sharing of relevant information across the Federal government; and (5) initiating a global dialogue to ensure that foreign corporations whose shares are traded in the United States are properly disclosing their activities in State Department-designated terrorist-sponsoring states to American investors.


356. New SEC Office to Ensure Firms Disclose Connections to States Sponsoring Terrorism, 36 Sec. Reg. & L. Rep. (BNA) 241 (Feb. 9, 2004). On March 31, 2004, then-SEC Chairman William Donaldson described the OGSR’s objectives, “to identify companies whose activities raise concern about global security risks that are material to investors; to obtain appropriate disclosure where merited; and to share information as necessary and appropriate with other key government agencies responsible for tracking terrorist financing.” Departments of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations for 2005: Hearing Before the Subcomm. on Commerce, Justice, and State, the Judiciary, and Related Agencies of the H. Comm. on Appropriations 108th Cong. 488 (2004) (statement of William H. Donaldson, Chairman, SEC). Chairman Donaldson also testified:

[T]he Office of Global Security Risk will focus on asymmetric risk by assisting review staff in giving consideration to whether U.S. or foreign companies that are registered with the SEC have operations or other exposure with or in areas of the world that may subject it and its investors to material risks, trends or uncertainties. This consideration would include whether a company has operations in a country or area of activity where political, economic or other risks exist that are material, or whether 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.

Id. In 2005 the OGSR began sending letters to companies asking about their operations in SSTs such as Iran, and the disclosure that the companies were making. Between September 1, 2006 and September 1, 2010, the OGSR sent over 300 letters inquiring about operations in Iran. Note, however, that in many cases multiple letters were sent to the same company.

See Full -Text Search, SEC EDGAR DATABASE, http://searchwww.sec.gov/EDGARFSCClient/jsp/EDGAR_MainAccess.jsp?search_text=%22office%20of%20global%20security%20risk%22%20AND%20Iran&sort=Date&formType=FormUP
The SEC often requests that a company analyze the materiality of its contacts with Iran, and instructs:

You should address materiality in quantitative terms, including the approximate dollar amount of your revenues, assets and liabilities and associated with . . . Iran . . . . Please also address materiality in terms of qualitative factors that a reasonable investor would deem important in making an investment decision, including the potential impact of corporate activities upon your reputation and share value.\(^{357}\)

Some of the SEC inquiry letters also include language such as:

As you may be aware, various state and municipal governments, universities, and other investors have proposed or adopted divestment or similar initiatives regarding investment in companies that do business with U.S.-designated state sponsors of terrorism. Your materiality analysis should address the potential impact of the investor sentiment evidenced by such actions directed toward companies that have operations associated with Iran . . . . In this regard, we note that this investor sentiment does not turn solely on the legality of the operations associated with those countries.\(^{358}\)

In order to evaluate the arguments that reporting companies are (apparently successfully) making about the lack of materiality of their Iranian operations, a survey of company letters\(^{359}\) was undertaken for this Article. The survey reviewed 421 letters written by reporting companies to the SEC between September 1, 2006 and September 1, 2010, in response to SEC inquiries about Iranian operations. The letters are all publicly available on the EDGAR database.\(^{360}\)

Of the 421 letters, 160 (the Responses) discussed the materiality of their activities in Iran. Not a single Response identified the operations as material. Ten of the Responses stated that the company earned no revenue at all from Iran. Of remaining 150 Responses, 140 (93 percent) of them argued explicitly that their operations in Iran were not material because

\(^{357}\) Memorandum from Schlumberger Limited (Schlumberger N.V.) to The Securities and Exchange Commission, (June 22, 2010) available at http://www.sec.gov/Archives/edgar/data/87347/000119312510145145/filenamel.htm (reprinting the question to which the company is responding). The Schlumberger memorandum is also typical in that a great deal of its response was kept confidential. Nevertheless, in November 2010, it was reported that Schlumberger, believed to be the last Western oil services firm working in Iran, had privately pledged to U.S. State Department officials that it would pull out of Iran when its current contracts are complete. Farah Stockman, Oil Firm Says It Will Withdraw from Iran, BOSTON GLOBE, Nov. 12, 2010, http://www.boston.com/news/nation/articles/2010/11/12/oil_firm_says_it_will_withdraw_from_iran/?page=full.


\(^{359}\) On file with the author.

\(^{360}\) They are, however, difficult to identify and search using EDGAR, which continues to be a cumbersome tool.
they represented a small percentage of company’s overall revenue.

The Responses also made other, non-quantitative, assertions related to the materiality of Iranian operations. These discussions tended to be less frequent, and were often brief and conclusory. The most common arguments or answers to SEC questions that did not focus solely on percentage of total revenues were as follows:

- 39 Responses (26 percent) claimed that the company’s investors do not care about its operations in Iran. As evidence of investor apathy, the Responses cited things like the lack of inquiries by investors, the lack of investor questions on the subject in conference calls, the lack of follow up by investors on inquiries that they did make, the lack of investor divestment. Some responses claimed that investors understand or expect that the company’s business would include operations in Iran.

- 69 Responses (46 percent) asserted that the Iranian activities posed no risk to investors.

- 84 Responses (56 percent) mentioned the lack of reputational risk of the company’s operations in Iran.

361. See, e.g., Letter from Fabio de Oliveira Barbosa, Chief Financial Officer, Vale S.A., to Cecilia Blye, Chief, Office of Global Security Risk, SEC (Apr. 6, 2010), available at http://www.sec.gov/Archives/edgar/data/917851/000090342310000207/filename1.htm (“In both quantitative and qualitative terms, we believe our contacts with Iran and Cuba are not material and do not constitute an investment risk for our security holders. Due to the routine nature and extremely limited extent of these contacts, we believe they are not qualitatively material to our reputation or our share value. . . . In each of the past three fiscal years, . . . our aggregate sales to Iranian customers have represented less than 1% of our total operating revenues . . .”).


68 Responses (45 percent) mentioned the potential impact on share value from the Iranian operations. All but two of them, however, concluded that there was no potential impact on share value.

44 Responses (29 percent) claimed that the company was operating in compliance with all applicable laws.

29 Responses (19 percent) asserted that the particular products or services that the company offers in Iran are innocuous or even helpful.

20 Responses (13 percent) clarified that the company has no dealings with the Iranian government.

As an emblematic example of the Responses, BHP Billiton’s May 2010 letter noted:

We believe that BHP Billiton’s contacts with Cuba and Iran do not constitute a material investment risk to BHP Billiton securityholders. . . . the nature and value of these contacts is not significant to the results or prospects of BHP Billiton’s business. . . . We do not see evidence that any significant portion of our global investor base would regard our dealings with Cuba and Iran described above as important in making an investment decision. We do not believe that the disclosure of such activities is likely to adversely affect our reputation or the value of our securities.

In February 2010, France Telecom, responding to a similar request for information, asserted:

France Telecom’s contacts with Iran, Syria, Sudan and Cuba are a de minimis part of France Telecom’s activities. Accordingly, we do not believe that a reasonable investor would consider France Telecom’s current business activities in the four countries to be material from either a quantitative or qualitative standpoint. We note that U.S. sanctions programs related to each of the four countries permit, to varying degrees, activities in connection with the provision of telecommunications services related to these countries.

Overall, the Responses seem to be controlled by a small estimated financial impact of the activities in Iran. The small financial impact leads
to a determination that the activities are not material, and therefore do not need to be disclosed. In the Responses, the quantitative materiality analysis is dispositive.

In addition, there is no indication that SEC correspondence is having any impact on the level or quality of disclosure by reporting companies with operations in Iran. The SEC rarely suggests that a company add any disclosure of operations in Iran. It is conceivable that the SEC letters bring the issue to the companies’ attention and subtly encourage a change in policy. However, it is also possible that SEC’s continuing acceptance of companies’ narrow materiality arguments in the letters, and the resulting incomplete disclosure, is counterproductive. The letters neither aspire to nor succeed in applying a broad standard of materiality to the challenge of company operations in Iran.

4. Now What?

Thus, companies may use the materiality standard to avoid disclosure of their operations in Iran. In response to questions during her July 2010 testimony before the House Committee on Financial Services, Chairman Schapiro reportedly stated that a company’s “contacts with Iran that may lead to liability or community sanctions are something that would need to be disclosed.” In response to questions about why the Web Tool had been removed, Chairman Schapiro noted that the tool had been over-inclusive, but that with respect to the newest Iran sanctions, “Do nothing is not in our vocabulary.”

The SEC is again under pressure to require disclosure of operations in Iran from legislators. Rep. Gary Ackerman (D.-NY) sent Chairman

371. See generally Westbrook, supra note 5. As a matter of general guidance, however, the letters are worth little; they are not meant to apply to any company except the one to which they are addressed, they are not always uploaded onto EDGAR, and they are frequently redacted.
372. The SEC contends that it is operating within the traditional meaning of materiality. As a matter of practice, this is financially determined.
374. Fawn Johnson, SEC Writing Disclosure Rules in the Wake of Iran Sanctions Law, DOW JONES NEWSWIRES, Jul. 20, 2010, available at http://www.foxbusiness.com/markets/2010/07/20/sec-writing-disclosure-rules-wake-iran-sanctions-law/. Chairman Schapiro also reportedly said that the SEC is writing rules to make it clear that investors and companies cannot be sued for divesting from firms that do business in Iran. Id.
375. Id.
Schapiro a letter on July 20, 2010, stating that “U.S. investors need to know if the companies and funds in which they are investing face potential Iran-related sanctions, and U.S. firms need equally to recognize their fiduciary obligations to investors.” Rep. Ted Deutch, who introduced the Iran Transparency and Accountability Act in July 2010, also sent a letter to Chairman Schapiro urging the SEC to clarify or strengthen reporting requirements for companies doing material business in Iran, or to create new reporting requirements that would force companies to disclose ties to Iran. Congressman Deutch noted that current regulations allow companies to claim their business dealings in Iran are not “material” and therefore, not required to be reported. There have also been calls for the SEC to issue an interpretive release, presumably along the lines of the one issued for climate change risks.

At least for the present, the bottom line is that a company’s operations in Iran are material and must be disclosed, if, and when, sanctions in the regulations impose a significant and quantifiable financial risk. There is also, now, an undeniable reputational risk that is linked to the risk that a company’s share price will fall if any, even de minimis, activity by a company in Iran is made public. There is a duty to disclose such risks if

376. Oversight of the U.S. Securities and Exchange Commission, supra note 373 (statement of Rep. Gary Ackerman, Member, H. Comm. On Financial Services). Rep. Ackerman noted: A nuclear Iran poses an existential threat to the United States and its allies, and companies must be held accountable for assisting Iran in its determination to develop nuclear capabilities and shun the international community. So what does Iran have to do with our capital markets? The potential for American investors to suffer material losses if their investments are in firms determined to be in violation of the new sanctions is very real. As Chairman Schapiro knows, the SEC has a very important role to play under the Comprehensive Iran Sanctions Accountability and Divestment Act. American investors need to know if the companies and funds in which they invest face potential -- and substantial -- Iran-related sanctions. As the watchdog of our markets and exchanges, the SEC will be tasked with ensuring that investors have ready access to information pertaining to any potential sanctions the U.S. exchange-listed firms and funds with which they have investments will be subject to. Madame Chairman, this morning I presented you with a letter asking for your attention to this issue and to ensuring that American investors are forewarned about potential exposure to significant losses.

Id.; see also Press Release, Congressman Gary Ackerman, Ackerman Calls for SEC To Empower American Investors, Prevent Americans from Investing in Iran (Jul. 20, 2010), available at http://ackerman.house.gov/index.cfm?sectionid=194&sectiontree=4,194&itemid=1176.


379. The SEC endorses market reaction as an indicator of materiality, which allows management and financial advisors to be "second-guessed" after the fact for their materiality judgments. Ching Ling Lee, supra note 57, at 669. Materiality determinations are therefore "subject to scrutiny with the gloss of hindsight." Marc I. Steinberg & Jason B. Myers, Lurking in the Shadows: The Hidden Issues of the Securities and Exchange Commission's Regulation FD, 27 J. CORP. L. 173, 189 (2002). The effect on
they are material, and they are now likely to be material because of the amount of money it can cost a company to conduct business in Iran. But by waiting until doing business in Iran imposes costs in fact, the securities laws have failed to serve the investing public.

IV. CONCLUSION: THE PROBLEM WITH A REDUCTIVE STANDARD OF MATERIALITY AND WHAT CAN BE DONE

A. THE BIG PICTURE: WHY A REDUCTIVE STANDARD OF MATERIALITY IS WRONG

1. Materiality Should Reflect Real Investor Concerns

Reasonable investors consider more than current accounting important. A review of the manner in which the securities laws dealt with management integrity and climate change and are dealing with business in Iran suggests, in practice, that only information that has an undeniable, significant, and presently quantifiable financial impact is required to be disclosed. Under the SEC’s current, reductive interpretation of the doctrine, materiality is a fig leaf for secrecy.

This is a problem. Investors care about more than presently quantifiable risks, and the SEC is failing investors by excusing companies from disclosing issues for which accounting is uncertain.

Of course, at some point, investor, governmental, international, and NGO action with respect to Iran becomes overwhelming. A company’s activities in Iran become such a financial and legal risk and such a reputational liability, that they do have to be disclosed. This is due, however, to the clear financial impact of such operations on a company’s

market price is a standard of materiality in a number of foreign jurisdictions, including Australia, the European Community and Hong Kong. Li-Wen Lin, supra note 152, at 3-5 (noting that corporate social and environmental disclosure requirements have been introduced into corporate or securities laws in France, Denmark, Norway, and the United Kingdom).

380. Of course, climate change and management integrity are just two examples. Investor demand has triggered disclosure of a host of other corporate social responsibility (or “corporate social and environmental”) disclosures. Social information that is being disclosed includes, for example, issues concerning labor rights, human rights, community relations, consumer protection, philanthropy, or political contributions. Li-Wen Lin, supra note 152, at 3. Voluntary corporate social responsibility reporting has surged. John M Conley & Cynthia A. Williams, Engage, Embed, and Embellish: Theory Versus Practice in the Corporate Social Responsibility Movement, 31 J. CORP. L. 1, 4-5 (2005) (focusing on new UK CSR disclosure requirements).

381. As it has been phrased, “it is not plausible that a citizenry that votes across a political spectrum reflecting all combinations of narrow self-interest and altruism should, upon calling its brokers, become a purely profit-driven mass.” Note, supra note 338, at 1438.

382. At which point many public companies cease their operations in Iran. See discussion and notes infra Part III.D.4.
bottom line, to simple quantitative calculations.

Some scholars would not find this a problem. Historically some have held the view that stockholders "conform to the rational wealth-maximizer paradigm of neoclassical economic theory." John Fedders, Former Director of Enforcement of the SEC, argued for a strictly economic approach to mandatory disclosure and materiality, asserting in 1998 that investors are:

[I]n it for the dollars. Ordinarily, investors dismiss ethical and moral norms when saving and investing. . . The common interest of investors is a reasonable return on savings: this economic interest is their sole focus. Thus they are concerned with information that helps them make decisions that they believe will add value to their portfolios. Consequently, the SEC’s disclosure policies must be oriented to regulating according to quantitative standards, not standards based on morality.

But these views fail to account for the motivations and requirements of modern investors. After 9/11, a terrorism-sponsoring nearly nuclear regime in Iran is not a vague distant threat for the public. With trillions of dollars invested in socially responsible funds, it is evident that reasonable investors consider more than current financial performance important. In arguing that there are no purely economic or purely social investors, Professor Williams suggested that even the most profit-driven shareholder would balk at investing in a slave-labor camps, assuming such camps were legal in another country. The reasoning in the surveyed Responses suggests that a company with a non-U.S. subsidiary that operates or does business with such a camp would not disclose such activities unless the resulting income was a significant part of the company’s overall revenue, or clearly, imminently likely to attract costly regulatory sanctions or widespread share price-destroying divestment.

2. Limiting Materiality to Significant Effects on Revenues Undercuts Other U.S. Policies

Limiting materiality to significant effects on revenues may also undercut fundamental policies of the United States. Laws such as ISA and CISADA, the Secretary of State’s designation of Iran as an SST, and the OFAC regulations were all put into place to isolate the Iranian regime. Helping companies who do business in Iran get access to capital in the United States, without disclosing that business, runs counter to U.S.

384. Fedders, supra note 118, at 89.
385. Williams, supra note 13, at 1276.
386. Hopefully, this is an exaggeration, but it is not encouraging to watch what it takes to trigger disclosure of investment that aids the Iranian regime. See, e.g., Goldberg, supra note 314 (arguing that an Israeli attack on Iran may be imminent).
policies and laws which U.S. investors (primarily citizens) presumably support.

3. Exclusive Reliance on Quantification Implausibly Presumes Sound Accounting and Efficient Markets

The SEC’s acceptance of the Responses, and their reductive view of materiality, places a great deal of faith in corporate accounting, and assumes that all information important to investors will be correctly reflected in share prices. The last decade, from the implosion of Enron Corporation to that of American International Group, Inc., has demonstrated the weakness of those assumptions.

The 2001-2002 corporate accounting scandals involving Enron, WorldCom, and Adelphia Communications Corporation were a grim reminder that financial statements may misrepresent the results of operations to shareholders and investors. Arthur Andersen, a prestigious accounting firm that had been founded in 1913, was liquidated and became a symbol of fraud perpetrated through financial statements. Congress responded with the Sarbanes-Oxley Act to restore legitimacy and reliability to financial statements, and the accounting profession was subjected to new regulatory oversight.387 Despite these measures, accounting practices have again come under fire with the recent financial crisis. Now more than ever, investors recognize that there is more relevant information than what appears in the financial statements.

Of course, any disclosure-based system operates on the assumption that better information, including financial information, will help buyers and sellers of securities make better judgments and therefore produce more accurate prices.388 However, the financial crisis in recent years also confirmed suspicions389 that the price mechanism simply does not work that well.390

387. For example, the Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB), a private sector, not-for-profit organization designed to oversee auditors of public companies. See generally About the PCAOB, PCAOB, http://pcaobus.org/About/Pages/default.aspx (last visited Oct. 21, 2010).


389. See generally DAVID A. WESTBROOK, OUT OF CRISIS: RETHINKING OUR FINANCIAL CRISIS (2010). A full analysis of the problems with the hope for efficient markets is beyond the scope of this Article.

390. The efficiency of capital markets has, of course, always had a significant number of critics, notably Warren Buffett, who has repeatedly mocked the efficient market theory in his writings to the Berkshire Hathaway shareholders. See, e.g., WARREN E. BUFFETT, THE ESSAYS OF WARREN BUFFETT;
In addition, allowing companies to disclose only limited information based on current quantifiable effect on revenues or profits supposes an efficient market that the recent financial crisis and subsequent volatility has shown to be a myth. Without regulatory enforcement of disclosure of information that is important to investors, though not likely to affect prices until the medium to long term, there is no reason to think that the risk of regulatory sanctions, divestiture, public shaming, or even war will be accurately incorporated into share price.

4. *A Limited Interpretation of Materiality Is at Odds with the Statutes, the Supreme Court and the SEC’s Own Guidelines*

The legislative history and Supreme Court rulings have historically emphasized the broad character of materiality. As this article has demonstrated, Congress enacted the securities laws in an effort to protect investors by providing information and prohibiting fraud. The 1929 Stock Market Crash amply demonstrated the manipulation and misrepresentation possible in the securities markets, and Congress intended to require “sunlight” on corporate behavior, not a simple spotlight. The plain meaning of the statute argues for more than a reductive understanding.

The Supreme Court clarified in *TSC Industries Inc. v. Northway Inc.* and *Basic Inc. v. Levinson* that materiality is broad in scope, and that doubts as to the materiality of information should be decided in favor of disclosure. Ease of application is not an excuse for ignoring the purpose of the securities laws.

In the same vein, SAB 99 explicitly explains that there are both qualitative and quantitative aspects of materiality, and that numerical, bright line tests of financial impact cannot be dispositive. Recognizing only issues that are significant on a company’s financial statements is just the kind of bright line approach that the Supreme Court warned against and SAB 99 rejected. A limited interpretation of materiality is at odds with the statutes, the Supreme Court and the SEC’s own guidelines.

5. *A Narrow Standard Absolves the SEC of Its Core Responsibilities*

Although a narrow, limited definition of materiality might at first glance seem like the more conservative approach on the part of the SEC, it is actually just the opposite. Keeping information out of the marketplace increases risk, and represents a subtle abdication by the SEC of its

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LESSONS FOR CORPORATE AMERICA (Lawrence A. Cunningham ed., 2d ed. 2008) at 87–88 (calling the theory “foolish”).

391. *TSC Indus.*, 426 U.S. at 446, 448.

responsibilities to protect investors. By not requiring companies to disclose information until there is a clear financial impact, the SEC “outsources” doctrinal interpretation to the array of accountants and attorneys hired by the reporting companies. In addition, by waiting to act on non-quantifiable information, the SEC also allows other institutions to take the lead in assessing what information is important to the markets. The SEC has passed the buck to EPA regulations, U.S. sanctions, OFAC designations, state pension fund investment guidelines, and NGO initiatives. By waiting until costs have already been imposed by other institutions or regulations, so that the impacts of ongoing operations in Iran are undeniable, the SEC avoids its responsibilities.

6. A Reductive Standard of Materiality Does Not Protect Investors in Changing Circumstances

A narrow approach to requiring disclosure of investor priorities means that non-financial investor priorities are recognized only after the concerns become undeniably financially significant to the company, and therefore material in accounting terms. As a result, and as described by Professor Williams, there is a recurring “logical difficulty” that compromises the rather uncontroversial investor protection purposes of the federal securities law. If a concern is “merely social” concern, it is deemed beyond the scope of the SEC mandate, but if it rises to the level of an economic concern, it is deemed properly handled by the existing regulations/scope of materiality and must be disclosed. But what about the investors who are caught when a social concern becomes an economic concern?

By not requiring disclosure of information about a company’s operations in Iran until Iranian operations are such a liability that they significantly impact risk and share price, the SEC enables companies to attract investors who are not adequately apprised of issues until those costs are imposed. This means that investors who buy when an issue is “merely” social do so without the benefits of disclosure. Only after costs have been imposed on the company, and investors harmed thereby, does such an issue become material.

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393. And, therefore, proponents of social concerns quite logically emphasize the economic impact in order to obtain disclosure. See supra Part II.B.5. for a discussion of this in the context of climate change disclosure petitions.
394. Williams, supra note 13, at 1252.
395. Indeed, this is what happened to investors in Barclays Bank Plc. See discussion supra note 7.
B. **RECOMMENDATION: THE SEC SHOULD REAFFIRM ITS TRADITIONAL BROAD UNDERSTANDING OF MATERIALITY**

The SEC should reaffirm its traditional broad understanding of materiality as information that there is a substantial likelihood that a reasonable person would consider important. At a minimum, the SEC can cease accepting the quantitatively determined materiality analysis like those surveyed in the Responses. In addition, the SEC might wish to consider issuing an interpretive release or amending Reg S-K to require specific disclosure of business operations in Iran.\(^{396}\)

The U.S. federal securities laws have been held up as a model of disclosure-based regulation, of a flexible and effective way to discipline a market and protect investors. However, a disclosure system is only a strong and successful form of regulation if companies have to disclose important information. If companies are allowed to refuse to disclose, then a disclosure-based system is investors’ worst enemy. They have no substantive protections and no information. The system fails them.

The SEC undoubtedly has the power to enforce a broader understanding of materiality. The SEC can determine that operations in Iran are material to investors, regardless of whether an adverse financial impact is currently demonstrable. The statute allows this, the legislative history encourages it, the Supreme Court has clarified it, and the SEC has done it in other contexts. The 2000s provided tough lessons for financial regulators and investors, many of which related to being ill-informed. We should all understand the damage that can result from a reductionist, non-interventionist approach to information for investors.

The SEC should assert its broad understanding of materiality, and evaluate company disclosure accordingly, for reasons beyond investor protection (as important as that is). A broader standard will produce disclosure, and likely cessation, of company operations in Iran, and may well help to slow, or even dissuade, Iran in its quest for destabilizing nuclear weapons. The broader standard may even help to avoid more bloodshed.

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\(^{396}\) In fact, a logical amendment would require disclosure of any operations in any country that the Secretary of State has designated a state sponsor of terrorism. This is a request that UANI has made to the SEC in the past. Letter from Amb. Mark D. Wallace, *supra* note 378 (including a model Reg S-K provision).
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