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Alert Memo

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Iran Threat Reduction and Syria Human Rights Act—Outside Directors and "Affiliate" Status

Section 219 of the Iran Threat Reduction and Syria Human Rights Act of 2012 ("ITRA")[1] added Section 13(r) to the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Under Section 13(r), any issuer of securities that is required to file quarterly or annual reports under Section 13(a) of the Exchange Act must make specific disclosure in its public filings if it or an affiliate has knowingly engaged in certain activities listed in Section 13(r).[2] The new disclosure requirement applies to all Exchange Act reports required to be filed on or after February 6, 2013.

The new disclosure requirement applies to activities not only of issuers, but also of their affiliates. On December 4, 2012, the SEC staff published an interpretation stating that the term "affiliate," for purposes of disclosure made pursuant to Exchange Act Section 13(r), is used as defined in Exchange Act Rule 12b-2.[3] Rule 12b-2 provides that an affiliate of, or a person affiliated with, a specified person, is "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified."[4] The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the "possession, direct or indirect, of the power to direct or cause

[1] Iran Threat Reduction and Syria Human Rights Act of 2012, Pub. L. No. 112-158, August 10, 2012, 126 Stat. 1214 (2012) (§ 219 codified at 15 U.S.C. § 78m(r)).

[2] *Id.* at § 219. These activities include: (1) sanctionable activities under the 1996 Iran Sanctions Act (as amended by the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 ("CISADA") and ITRA), including the provisions relating to the Iranian oil and gas industry, financial services, WMD, and other activities; (2) sanctionable activities under the provisions of CISADA and the Iranian Financial Sanctions Regulations relating to activities by foreign financial institutions; (3) sanctionable activities relating to goods, services, or technologies likely to be used for human rights abuses; (4) any transactions or dealings with Specially Designated Nationals ("SDNs"), regardless of nationality, designated for their support of WMD proliferation or terrorist activity (i.e., SDNs designated as "[SDGT]" or "[WMD]"); or (5) any transaction or dealing with the "Government of Iran" as defined in OFAC regulations, including the Iranian government, entities it owns or controls directly or indirectly, persons who are, or there is reasonable cause to believe are, acting on behalf of the foregoing, and any SDNs designated as "[IRAN]."

[3] SEC Compliance and Disclosure Interpretations, Answer to Question 147.03 (Dec. 4, 2012), *available at* http://www.sec.gov/divisions/corpfin/guidance/exchangeactsections-interps.htm.

[4] 17 C.F.R. § 240.12b-2.

the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[5]

Reporting companies subject to the disclosure requirements of Section 13(r) will have to identify their affiliates for reporting purposes. In this memorandum we consider whether outside directors and the companies on whose boards they serve should be deemed affiliates for purposes of Section 13(r). Based on relevant case law and the limited SEC guidance with respect to the definitions of control and affiliate, we conclude that (1) there is a strong basis for the view that an outside director of a company should not, based solely on her status as director, be deemed for purposes of Section 13(r) to be an affiliate of the company, and (2) a company is not required, for the purposes of Section 13(r), to treat another company as its affiliate if the only relationship between those two companies is that an affiliate of the first company is an outside director of the second.

I. Case Law Analysis of Directors as Affiliates (Control Persons)

Courts interpreting control, the lynchpin of the affiliate definition in Rule 12b-2, have long held that it must be analyzed on a case-by-case basis, based on the relevant facts and circumstances.[6] Interpretive advice on these definitions has also been sought from the SEC staff, but beginning in the late 1970s the staff ceased providing its view in response to these requests, repeatedly stating that a company and its advisers are in a better position to judge whether an individual or entity should be considered an affiliate of a reporting company.[7] In 1980, the SEC confirmed that it would no longer opine on affiliate or control status.[8]

Without a bright line test, courts have been left to interpret what constitutes control and therefore what confers affiliate status on a person or entity. As to directors specifically, courts consistently have found that an individual's status as a director alone is not sufficient to establish control person status.[9] Rather, courts have found that, to establish that a director is a control

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[5] *Id.*

[6] *See, e.g.*, In re Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 351 (S.D.N.Y. 2004) (noting that control person analysis is a "decidedly fact-based determination"). The cases addressing the Rule 12b-2 definition of control have arisen in the context of Exchange Act Section 20(a) proceedings against "controlling persons" who are derivatively liable for violations of the Exchange Act by "controlled persons."

[7] *See, e.g.*, *Books Mobile, Inc.* (avail. Dec. 17, 1979) ("This Division no longer makes determinations as to affiliate status in this context. The question of affiliate status is a factual one best resolved by counsel and the parties involved through investigations and determination of facts more readily available to them.").

[8] Procedures Utilized by the Division of Corporation Finance for Rendering Informal Advice, Securities Act Release No. 6253, 21 SEC Docket 320 (Oct. 28, 1980). This release, and the no-action letters, such as *Books Mobile, Inc.* (*see supra* note 7), that preceded it, concern the definitions of affiliate for purposes of the Securities Act of 1933, as amended (the "Securities Act"), which are virtually identical to the definition of affiliate in Rule 12b-2 under the Exchange Act. *See* Rule 144(a)(1) and Rule 405 under the Securities Act.

[9] *See, e.g.*, Burgess v. Premier Corp., 727 F.2d 826, 832 (9th Cir. 1984) (because the defendant director was uninvolved in the issuer's day-to-day operations, the court found no controlling person status and reversed lower court's decision that defendant was a controlling person); Ho v. Duoyuan Global Water, Inc., 2012 WL 3647043, at *22 (S.D.N.Y. Aug. 24, 2012) (determining that "the status of defendants as directors, 'standing alone, is insufficient

person, plaintiffs must allege facts indicating an ability to control the company that goes beyond director status.[10]

Examples of the indicia of control courts have found to be sufficient to establish control person status for a director generally fall into three categories: conduct by a director reflecting an exercise of authority over specific acts or statements by the company, such as the signing of a registration statement,[11] status of a director as chair of the company's management or executive committee,[12] or other evidence of involvement in the day-to-day operations of the company.[13]

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to establish their control.' " (*quoting* Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc., No. 05 Civ. 1898, 2005 WL 2148919, at *7 (S.D.N.Y. 2006)); Food & Allied Serv. Trades Dep't, AFL-CIO v. Millfied Trading Co., 841 F. Supp. 1386, 1391 (S.D.N.Y. 1994) ("While courts in this circuit have not always agreed on just how much beyond status as a director must be alleged to plead a Section 20(a) claim, . . . they have agreed that a bare allegation of director status, without more, is insufficient.") *See also* In re Constellation Energy Group, Inc. Sec. Litig., 738 F. Supp. 2d 614, 639 (D. Md. 2010) (noting that "an individual's position alone does not establish control person liability.")

[10] Historically, there has been some tension between cases holding that possessing the power to control was enough to establish control person status and cases requiring both possession and exercise of control. *See, e.g.*, Howard v. Everex Sys., Inc., 228 F.3d 1057, 1065-66 (9th Cir. 2000) (citing historical 9th Circuit dispute over whether mere control or exercise of control was necessary for control person status but noting that, after the decision in *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990), possessing the power to control is sufficient). A majority of the courts in other circuits require only an ability to control, not the exercise thereof, to establish control person liability. *See, e.g.*, Ho v. Duoyuan Global Water, Inc., 2012 WL 3647043, at *22 (a director's control is defined as "the power to direct or cause the direction of the management and policies of [the primary violators], whether through the ownership of voting securities, by contract or otherwise." (*quoting* SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1473 (2d Cir. 1996)); In re Constellation Energy Group, Inc. Sec. Litig., 738 F. Supp. 2d at 639 ("To plead control a plaintiff must plead facts showing that the controlling defendant had the power to control the general affairs of the entity primarily liable . . . and had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability.") (*quoting* In re Mut. Funds Inv. Litig., 566 F.3d 111, 130 (4th Cir. 2009). *But see* In re Novell, Inc. Shareholder Litigation, 2012 WL 458500 at *5 (D.Mass. 2012) (noting that the First Circuit standard for establishing "control" requires exercise of control and *citing* Aldridge v. A.T. Cross Corporation, 284 F.3d 72 (1st Cir. 2002) ("To meet the control element, the alleged controlling person must not only have the general power to control the company, but must also exercise control over the company.")).

[11] *See* In re Alstom, 406 F. Supp. 2d 433, 488 (S.D.N.Y. 2005). When a defendant director signs his name to an SEC filing, that director "can be presumed to have the power to control those who write the report." This follows because "such a person is in a position to approve the corporation's financial statements and thus has the power to direct or cause the direction of the management and policies of the corporation, at least insofar as the management and policies referred to relate to ensuring a measure of accuracy in the contents of company reports and SEC registrations they actually sign." *Id.* (*citing* In re Livent Inc. Noteholders Sec. Litig. 151 F. Supp. 2d 371, 437 (S.D.N.Y. 2001)); Jacobs v. Coopers & Lybrand L.L.P., No. 97 Civ. 3374 (RPP), 1999 WL 101882, at *17 (S.D.N.Y. Mar. 1, 1999) ("It does comport with common sense to presume that a person who signs his name to a report has some measure of control over those who write the report."); In re Philip Serv. Corp. Sec. Litig., 383 F. Supp. 2d 463, 485 (S.D.N.Y. 2004). Although courts have held that signing a registration statement or report signifies the ability of the signer to control the contents of the document, it should not be inferred from those cases that the signer has control over the management and policies of the company generally, even though a registration statement or periodic report broadly covers the business and operations of a company. That inference plainly would prove too much, because all directors are prospective signatories of Securities Act registration statements and annual reports on Form 10-K, yet the cases listed in *supra* note 9 stand for the proposition, unchallenged by the cases cited in this note 11, that status as an outside director alone is insufficient to establish control within the meaning of the affiliate definition in Rule 12b-2.

[12] *See* Arthur Children's Trust v. Keim, 994 F.2d 1390 (9th Cir. 1993) (concluding that members of the Management Committee controlled the issuing corporation "in every material respect" since the committee's decisions were binding and materially affected the business). *See also* Kaufman v. Motorola, Inc., 1999 WL 688780, at*16 (N.D. Ill.

Courts, however, have made clear that a director is not deemed to have control simply by virtue of being a member of an audit committee,[14] nominating committee or corporate governance committee.[15]

II. The SEC Position in Rule 10A-3

The case law discussed above thus provides a strong basis to conclude that an outside director, without more, is not an affiliate of the company on whose board the director serves within the meaning of Rule 12b-2. But for purposes of defining the scope of reporting under Section 13(r), the key point is not so much whether a director is an affiliate, but whether a company must treat as an affiliate those entities that may be affiliates of its outside board member. For that narrower point, we find strong support in what we believe to be a similar context—when, under Exchange Act Rule 10A-3, a candidate for the audit committee is considered independent, particularly insofar as the candidate is an outside director of another company.

Under Rule 10A-3, one factor in assessing independence is whether the candidate is an affiliate of the issuer or any subsidiary thereof.[16] In defining affiliate for the purposes of Rule 10A-3, the SEC provided a safe harbor that effectively excludes an outside director from the definition.[17]

Apr. 16, 1999) (finding that the Director and Chairman of the Executive Committee, who was also a stockholder, was a control person because of his "powers of general oversight and direction").

[13] *Compare* Burgess v. Premier Corp., 727 F.2d 826, 832 (9th Cir. 1984) (because the defendant director was uninvolved in the issuer's day-to-day operations, the court found no controlling person status and reversed lower court's decision that defendant was a controlling person); In re Constellation Energy Group, Inc. Sec. Litig., 738 F. Supp. 2d 614, 639 (D. Md. 2010) (dismissing plaintiffs' claim as to director defendants because no day-to-day direction was pleaded and "an individual's position alone does not establish control person liability"); In re Lernout & Hauspie Sec. Litig., 286 B.R. 33, 43 (D. Mass. 2002) (finding that allegations that do not go beyond "run-of-the-mill duties of a director of a large corporation" do not survive a motion to dismiss) *with* In re Royal Ahold N.V. Sec. & ERISA Litig., 351 F. Supp. 2d 334, 408-10 (D. Md. 2004) (holding that control person liability had been sufficiently alleged against director defendants who had direct involvement in day-to-day operations).

[14] *See* In re Alstom SA, 406 F. Supp. 2d at 488 (determining that membership on an audit committee alone does not constitute control); In re Livent, 151 F. Supp. 2d 371, 437 (S.D.N.Y. 2001). ("Nor does membership on an audit committee by itself confer control." (*citing* Jacobs v. Coopers & Lybrand L.L.P., No. 97 Civ. 3374 (RPP), 1999 WL 101882, at *18 (S.D.N.Y. Mar. 1, 1999)).

[15] *See* Ho v. Duoyuan Global Water, Inc., 2012 WL 3647043 at *22 (finding that a director's committee memberships, including participation on the Nominating and Corporate Governance Committee and Compensation Committee, even as chair of the Compensation Committee, was not enough alone to establish control liability).

[16] 17 C.F.R. § 240.10A-3(b)(1). Under Rule 10A-3, a director does not meet the independence test if he or she is an affiliated person of the issuer or any subsidiary thereof. *Id*. § 240.10A-3(b)(1)(ii)(B).

[17] Rule 10A-3 states that a person will be deemed not to be "in control of a specified person" for purposes of determining affiliate status if the person: (1) is not the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities of the specified person; and (2) is not an executive officer of the specified person (*Id*. § 240.10A-3(c)(2)) . In the adopting release for Rule 10A-3, the SEC explained that it provided this safe harbor "[t]o facilitate the analysis on facts and circumstances where we are presumptively comfortable…." Standards Relating to Listed Company Audit Committees, Exchange Act Release No. 34- 47654, (Apr. 25, 2003), *available at* http://www.sec.gov/rules/final/33-8220.htm.

We believe the scope of reporting under Section 13(r) should turn on an analysis similar to the Rule 10A-3 independence test, because in both cases the issue is whether an outside director's relationship to a company should cause another company with which that outside director also has a relationship to consider the first company an affiliate. The answer given by the SEC in Rule 10A-3 is no, presumably because the relationship in these circumstances is too attenuated, and we believe the same conclusion should apply to Section 13(r).

III. Conclusion

Accordingly, in our view a company is not required by Section 13(r) to report on the activities of other entities when its relationship with those entities is based on an outside directorship—whether the outside director in question is the outside director of another company or one of its executive officers or the owner of a controlling beneficial interest in that other company. Put another way, company A is not required, for purposes of Section 13(r), to treat company B as its affiliate if the only relationship between the two companies is that an affiliate of company A is an outside director of company B. Similarly, in these circumstances company B is not required to treat company A as its affiliate for purposes of Section 13(r).

Our conclusion is buttressed by the comments of Lona Nallengara and Tom Kim, Acting Director and Chief Counsel of the SEC Division of Corporation Finance, respectively, at the January 2013 40th Annual Securities Regulation Institute Conference, where they addressed the question whether company X, whose CEO is an outside director of company Y, needs to report the conduct of Company Y and vice versa to comply with Section 13(r). Although the staff did not express a view on whether the CEO should be deemed an affiliate of either X or Y, they did say that neither company should be viewed as being under common control and therefore they should not be deemed affiliates.

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