



PASS

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**SECURITY-MINDED CORPORATE GOVERNANCE:
WHAT ARE THE STAKES?**

by

Roger W. Robinson, Jr.

&

C. Richard D'Amato

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Security-Minded Corporate Governance: What are the Stakes?

By Roger W. Robinson, Jr. & C. Richard D'Amato¹

BACKGROUND

The intersection of international business operations and security concerns is increasingly frequent. Moreover, the nexus between global business and national security has expanded well beyond the traditional focus on export controls and money laundering to include: corporate links to the proliferation of weapons of mass destruction and ballistic missiles; terrorist financing and infrastructure support (direct and indirect); and certain business operations in terrorist-sponsoring states. These new challenges for the world's business community call for an additional layer of due diligence risk assessment as well as corporate governance principles addressing what has been termed by the U.S. Securities and Exchange Commission (SEC) and other authoritative bodies as "global security risk."²

To validate this new market concern, last year the SEC established an Office of Global Security Risk to strengthen disclosure requirements with respect to companies seeking to list or trade on U.S. exchanges that conduct business in U.S.-sanctioned countries, including terrorist-sponsoring states. Such risks to corporate share value include U.S. sanction violations, expanded sanctions against countries in this category, negative publicity, lawsuits and shareholder activism (i.e., divestment campaigns, shareholder resolutions, etc.) The growing fear associated with the proliferation of weapons of mass destruction and their delivery systems have also heightened concerns with regard to the transfer of so-called dual-use technology and equipment (i.e., with both civilian and military applications) to these higher-risk countries as well as the potential diversion of revenues by these irresponsible governments for malevolent purposes.

DIVESTMENT PRESSURES

The combination of security-related concerns and rampant human rights abuses – emblematic of these higher-risk countries – is now exacting a substantial price for certain investors. The most egregious example today involves the activities of publicly-traded companies in Sudan. A nationwide divestment campaign in the U.S. – reminiscent of that levied against South African apartheid in the 1980's – has created downward pressure on the share value of some companies. For example, Canada's Talisman Energy Inc. eventually had to abandon its position as a 25% stakeholder in Sudan's Greater Nile Petroleum Operating Company after a sustained market discount of its stock of some 20-30%. The Chinese oil giant PetroChina (a subsidiary of China National Petroleum Company) was recently divested by Harvard and other universities in the United States, but these actions have not yet translated into a drop in its share value.

¹ **Roger W. Robinson, Jr.**, is the Co-Founder of the Prague Security Studies Institute and Former Senior Director of International Economic Affairs at the White House National Security Council; **C. Richard D'Amato**, is the Executive Committee Member of the Prague Security Studies Institute and Chairman of the Congressional U.S.-China Economic and Security Review Commission.

² Global security risk is defined as the risk to share value and corporate reputation stemming from a company's business activities in or with U.S. State Department-designated terrorist-sponsoring states or links to the proliferation of weapons of mass destruction and ballistic missiles.

State legislatures have also entered the fray regarding companies with business interests in Sudan. Divestment legislation has recently been passed into law in Illinois and New Jersey. Other states are expected to join this investment policy response to genocide. Clearly, the sale of large quantities of the stock of Sudan-tied companies in a relatively short period of time is but one illustration of how shareholders can take losses in this new risk category.

CORPORATE GOVERNANCE

Although not U.S. State Department-designated terrorist-sponsoring states, countries like Burma, Pakistan, Yemen and even Saudi Arabia are under closer scrutiny by U.S. and other investors for these types of risk. China is likewise being held to a higher standard of security-minded disclosure and corporate governance. Specifically certain Chinese state-owned enterprises that have attracted substantial funding in the U.S. debt and equity markets are being examined anew because of the links of these enterprises – often through subsidiaries – to proliferation-related activities, China's defense industrial base, technology theft, arms smuggling and operations in countries of concern like Iran and Sudan.

In this connection, the Chinese government's intention to bring two of its largest state-owned banks to the U.S. and international markets with multibillion-dollar initial public offerings early next year may prove instructive. In addition to prospective investors examining the various corruption scandals and non-performing loans that have plagued the Bank of China and the China Construction Bank, there may be increasing interest in the customer bases of these institutions. For example, which Chinese enterprises have received loans from these institutions? Do these enterprises have security-related ties that would be troubling to investors and/or could negatively impact on share value?

KNOCK-ON EFFECTS

Insurance

The emergence of global security risk in the markets and other kinds of collisions between business and security interests has led to a number of knock-on effects beyond the need for new corporate safeguards and investor due diligence procedures. The insurance industry, for example, will likely wish to satisfy itself that companies with business ties to terrorist-sponsoring states have taken steps to mitigate this special category of risk (i.e., the diversion of revenues, equipment and technology for security-sensitive purposes, etc.) Such a requirement by insurers would likely catalyze strengthened corporate attentiveness to these concerns and result in positive corporate behavior modification from the perspective of security-oriented policy-makers.

Procurement

Beyond the insurance industry, new security-related "gates" may well be erected for various procurement processes, especially with respect to institutions like the U.S. Department of Defense and other entities that are part of the global security community. In the case of the U.S. Defense Department, it presently contracts with some 15,000 foreign suppliers. Consideration is being given to screening for global security risk factors before qualifying them for contract eligibility. In the post 9/11 environment, such screens could, overtime, be adopted by certain multilateral organizations as well.

Energy

Arguably, the industry with the most prominent confluence between business and security concerns is the energy sector. With oil prices at historic highs – in part resulting from a security-related premium – the effort to secure tight supplies has led oil companies, particularly those of China, Japan and Europe, to tap into higher risk countries like Iran, Sudan and Burma. The U.S. Congress, human rights activists and security-minded groups are increasingly pointing to – and taking action against – the connectivity between the oil-related revenue streams created for these governments and their abusive human rights practices and/or WMD programs. These issues were explored in last October's successful Program for Atlantic Security Studies (PASS) Conference entitled "*Energy and Security: Global Challenges – Regional Perspectives.*"

THE STAKES

In the mid-1980s, Toshiba Corporation nearly faced a three-year closure of the U.S. market to its imports because of a \$15 million export control violation of its subsidiary Toshiba Machine Tools involving nine-axis milling machines that could quiet Soviet submarines. It reportedly cost the company hundreds of millions of dollars for Washington lobbyists and law firms to ensure that U.S. import controls were restricted to the company's offending subsidiary. In 2004, the Union Bank of Switzerland was fined \$100 million by the Treasury Department's Office of Foreign Assets Control for sending U.S. dollars to U.S.-sanctioned countries, including Cuba, Iran and Libya.

Large monetary fines and/or price-tags for protecting a violator's business interests, however, could still appear to be modest penalties when compared to the debilitating blows associated with class-action lawsuits or lasting reputational damage. For example, imagine a scenario where a dual-use, high-powered electric switch, or other component of a large electronics firm, that was sold to a terrorist-sponsoring government like that of Iran is found in the debris of a WMD detonation in the United States or Europe. A law suit by the families of the victims of the blast would be almost inevitable, particularly if a publicly traded company is identified as a "supplier" and had reason to suspect that such a dual-use item might well be diverted for such a purpose.

It is also worth noting the obvious, that international terrorism and the proliferation of weapons of mass destruction and delivery systems are the two most pressing global security concerns of our time. Any reputational linkage between a public company and these activities could place the firm's share value and corporate image in serious, sustained peril.

PASS BUSINESS AND SECURITY CONFERENCE

This year's ground-breaking session convened by PASS will seek to delineate key dimensions of the dynamic between global business and security concerns and probe the responsibilities of the former to address the latter. The reality is that our common 21st century security goals will likely not be realized without the increased sensitivity and active, voluntary counter-measures of companies – particularly those that are publicly traded – to protect their shareholders and reputations. In doing so, these firms will likewise be advancing international security interests at a time when the stakes could not be higher.

It is hoped that the mutually-reinforcing objectives of good corporate governance and a safer world can be realized in a non-disruptive and cost-effective fashion, much of it through common sense initiatives.