

Purposes of the Report

- Examine application of SEC Disclosure rules to homeland security matters; determine degree of compliance
- Examine the use of SEC disclosure rules as a market-based mechanism for homeland security

Focus on SEC Rules

- Rules already exist
- Already require disclosure of material information, including homeland security information
- Value beyond specific disclosures—the process can inculcate security into core business functions, drive C-suite involvement
- Existing practice creates market failures, which are disincentives to better security—at minimum this needs to be fixed
- Market-based measure advantages
 - Flexibility
 - Cost efficiencies
 - Political advantages
 - Self reinforcing/private enforcement
 - Broad application
 - Absence of line drawing problems

While highly advantageous, market-based measures for homeland security are not a silver bullet

In some instances the threat or risk is such that greater surety and certainty is required

Even in such cases, however, there are advantages to using market-based measures in conjunction with other types of interventions

Key SEC Rules: Item 101— Description of Business

- General development of business
- Narrative of business
 - Sources and availability raw materials
 - The dependence of the segment upon a single customer, or a few customers, the loss of any one or more of which would have a material adverse effect on the segment
 - Competitive conditions in the business involved including, the identity of the particular markets in which the registrant competes

Key SEC Rules: Item 103— Legal Proceedings

- Any material pending legal proceedings, other than ordinary routine litigation incidental to the business
- Includes agency proceedings
- Includes known contemplated proceedings

Key SEC Rules: Item 303— Management Discussion & Analysis (MD&A)

- Narrative historical and prospective summary of the opportunities and risks (short- and long-term)
- Changes to operations
- Trends and uncertainties
- Hot button issues
 - uncertainty with respect to suppliers
 - planned capital expenditures and related financing (e.g., capital requirements to maintain a growth trend if discontinuation of the trend would be materially adverse)
 - uncertainty created by recent legislation/rules & pending legislation/rules
 - impairment of goodwill and uncertainties affecting its recoverability
 - the potential impact of government investigations on expenditures, earnings or competitive position within the industry
 - Insurance issues

Current Practice

- Specifically analyzed over 40 companies from sectors, including:

Freight rail	Airlines	Hospitals
Nuclear Power	Maritime shipping	IT
REIT's	Retail	Chemicals
Insurance	Food service	Security
- Actual application of these provisions to homeland security matters is little understood and less followed
- Current disclosures vary wildly in quantity and quality, both across and within sectors
- Few companies substantively disclose homeland security matters
- Where such homeland security disclosures are made, they are, generally speaking, grossly inadequate for both the shareholder and national security
- No disclosures addressed comparative or competitive advantages in security
- No disclosures discussed “control measures” or security enhancements to address or mitigate risks—companies hurt themselves
- ***There is very little homeland security in securities***

Example 1: Chemical Industry

- Companies face potentially large liabilities from an attack
- Many companies already face new security rules (e.g., MTSA)
- Companies face likelihood of new security legislation that would materially impact operations
- None of the publicly-held companies perceived most at-risk substantively addressed these issues
- Only 3 even alluded to threat

Example 2: Disney

- Iconic company heavily identified w/ American culture
- Risk to company enough to justify “no fly” restrictions—on par w/ chem weapon facilities, nuclear sub bases, White House, Crawford ranch
- Cruise operation under MTSA
- Food service operations fall under CFSCAN guidance
- Disney Form 10-K makes no mention of terrorism, homeland security matters

Example 3: Entergy Nuclear Power

- Serious questions about security at nuclear plants remain
- Entergy operates controversial, high-risk Indian Point Plant
- 2002 study: 81% facility's own guard force believed they could not adequately defend the plant
- USG worst case scenario estimate: 221,000 casualties and up to \$314 billion
- 10-K mentions terrorism only once in laundry list—no discussion; one mention of federal insurance scheme for accident/attack

Example 4: Insurance Industry

- Large losses on 9-11; many also lost employees/offices in WTC
- Aon
 - 10-K makes no mention of risk of terrorism
 - No mention of potential impact of TRIA nonrenewal pre-2005
 - In lobbying Congress for TRIA renewal Aon stated “. . . the private insurance market cannot operate without some form of public backstop against catastrophic terrorism losses.”
 - Post renewal no mention of 2007 TRIA challenge.
- Marsh, McLennan
 - Owns Kroll; CEO, Cherkaksky, former Kroll CEO—“has advise[d] Fortune 500 clients that they will likely be targets of terrorist attacks, both at home and abroad, for the foreseeable future.”
 - One laundry list mention of terrorist threat
 - No TRIA discussions

Improving Homeland Security Disclosures; Options for SEC Action

- Bully pulpit (e.g., hot button listing)
- Review specific filings; comment letters
- Interpretative guidance
- Enforcement actions
- Issue new S-K rules specific to HS
 - Akin to environmental disclosure rules

Extraordinary opportunity for Chairman Cox to put his imprint on SEC/markets

What Should and Should Not Be Disclosed

- Material information concerning:
 - Threats
 - Liabilities
 - Impacts
 - Precautions
 - Market Impact
 - Comparative Advantage and Disadvantage
 - Compliance
 - Impending Legal and Regulatory Issues
 - Spending
- Disclosures should be strategic not tactical
- Classified information should not be disclosed
- Judgment calls will require agency input
- Guidance on materiality issues would be helpful

SOX

- Requirement to have internal controls to ensure full and accurate reporting
- Material event and contingent liability disclosure requirements
- What security systems/controls must companies have to comply w/ SOX?
 - Committee of Directors
 - Ongoing audit and oversight function
 - Sect. 404 internal control reports in each annual report
 - CSO
 - IT security systems

Other Issues Discussed

- Need for better government/industry cooperation and information sharing to make disclosures effective
 - Disclosures may force government to be a better partner
- Need for audit shield protections [Ostrich dilemma]
- Foreign ownership issues