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The Sarbanes–Oxley Act and non-US issuers: Considerations for international companies

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Abstract

The Sarbanes–Oxley Act of 2002 was signed into law by President George W. Bush on 30th July, 2002, in the wake of an unprecedented wave of corporate governance and accounting scandals that fundamentally shook public confidence in the integrity of the US securities markets. The Act's widespread effects continue to be analysed and dissected by companies and their advisors both in the USA and abroad. One of the most controversial elements of this legislation is its impact outside the borders of the USA, which is beginning to affect some of the most basic corporate governance and disclosure practices of companies worldwide. Foreign issuers subject to the Act must now begin to review their corporate governance practices carefully in order to ensure compliance with the new rules.

Keywords: *Sarbanes–Oxley Act of 2002, corporate governance, audit committee, Management's Discussion and Analysis, auditors, Securities and Exchange Commission, GAAP, certification, financial statements*

INTRODUCTION

The provisions of the Sarbanes–Oxley Act of 2002 (the 'Act') generally apply to all US *and* non-US companies that have reporting obligations under the Securities Exchange Act of 1934, as amended (the 'Exchange Act'), or that have filed registration statements under the Securities Act of 1933, as amended (the 'Securities Act') which they have not withdrawn.[1] This specifically includes all non-US companies that file annual reports on Form 20-F, or in the case of Canadian issuers filing under the Multi-jurisdictional Disclosure System, Form 40-F. The Act does not, however, apply to non-US companies who merely furnish information to the US Securities and Exchange Commission (SEC) in accordance with Rule 12g3-2(b) under the Exchange Act.[2]

While some of the Act's provisions were effective immediately, other provisions of the Act directed the SEC to promulgate rules implementing specific sections of the legislation. This rulemaking process gives the SEC the authority to exempt foreign issuers from some requirements of the legislation, and in several cases the SEC has in fact shown some leniency towards foreign issuers in its rulemaking. However, in many instances, the SEC has provided that the same standards will apply to all issuers, regardless of their place of organisation.

In addition, historically, the rules of the Nasdaq Stock Market, Inc. and the New York Stock Exchange (NYSE) have been substantially more lenient in terms of corporate governance requirements imposed on foreign issuers than with respect to domestic issuers. In light of the corporate governance scandals that led to the passage of the Act, however, both NYSE and Nasdaq have indicated that they intend to strengthen their listing standards for foreign issuers as well.

Outlined below are certain significant changes brought about for foreign private issuers as a result of the Act, along with a description of the proposed changes from the Nasdaq and NYSE, in the following categories: changes in public disclosure; changes in corporate governance; issuers' relationships with their outside auditors; criminal provisions under the Act; and

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listing standards and exemptions. Certain suggested actions to be taken by foreign private issuers in response to these rules are set forth at the end of the article.

CHANGES IN PUBLIC DISCLOSURE

New SEC rule-making will require substantial revisions to public disclosure, especially in Management's Discussion and Analysis

One of the primary concerns of both the SEC and the US Congress, in the wake of the scandals that led to the passage of the Act, is how best to improve the public disclosure required to be made by issuers in their periodic reports. The SEC has focused primarily on three areas of concern to foreign issuers: Management's Discussion and Analysis (MD&A) disclosure, disclosure of non-GAAP (generally accepted accounting principles) financial measures, and the certifications required to be provided by chief executive and financial officers.

Management's Discussion and Analysis

Alan L. Beller, Director of the SEC's Division of Corporation Finance, has indicated that the MD&A section of a company's annual report is 'the single most important section of a public company's SEC filings, outside the financial statements themselves.'[3] The MD&A section is intended to provide investors with 'an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company.'[4]

The SEC has focused all issues surrounding liquidity

One area of particular focus for the SEC and the US Congress after Enron is in disclosures relating to a company's liquidity, and the variables and contingencies that could affect liquidity. Section 401(a) of the Act directed the SEC to finalise rules requiring issuers to disclose all material off-balance sheet transactions, obligations and other relationships of the issuer that may have a material effect on its financial condition, results of operations, liquidity or other financial measures. The SEC's final rules will require companies to include a new section in MD&A describing any off-balance sheet arrangements that either have, or are reasonably likely to have, a current or future effect on the issuer's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.[5]

The phrase 'off-balance sheet arrangement' includes any arrangement with a third party under which the registrant has:

- any obligation under a guarantee contract, including indemnification agreements and keepwell arrangements;
- a retained or contingent interest in assets that have been transferred to an unconsolidated entity, or a similar arrangement that serves as credit, liquidity or market risk support to that entity for such assets;
- any obligation under certain derivative instruments; and
- any obligation under a material variable interest held by the issuer in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the issuer, or that engages in leasing, hedging or research and development services with the issuer.

As US issuers are required to file quarterly reports with the SEC, they will be required to disclose their off-balance sheet arrangements on a quarterly basis. Foreign private issuers, however, will generally only be required to provide disclosures with respect to their off-balance sheet arrangements on an annual basis.

In addition, companies will be required to include a new table in MD&A showing the amounts of payments due from the issuer under certain categories of contractual obligations for specified time periods. These contractual obligations

include long-term debt, capital lease obligations, operating leases, purchase obligations and other long-term liabilities reflected on the issuer's balance sheet. The SEC notes that companies preparing financial statements in accordance with a non-US GAAP should include contractual obligations in the table that are consistent with the classifications used in that non-US system of GAAP.

Consistent with the existing MD&A requirement for foreign private issuers that the MD&A include a discussion of reconciliation to US GAAP if that is necessary to an understanding of the issuer's financial statements as a whole, the disclosure about off-balance sheet arrangements and the table of contractual obligations must focus on the issuer's primary financial statements presented in the document, while also taking any necessary reconciliation into account.

Under the new rules, the off-balance sheet disclosure must be included in annual reports for all fiscal years ending on and after 15th June, 2003, while the table of contractual obligations must be included in annual reports for fiscal years ending on or after 15th December, 2003.

Non-GAAP financial measures

Financial information not presented with GAAP will require additional disclosure

In Section 401(b) of the Act, the SEC was directed to issue rules relating to the use by issuers of financial information that is not presented in accordance with GAAP.[6] The SEC's rules as adopted, which became effective on 28th March, 2003, include new Regulation G, which applies to all public statements by an issuer that include a non-GAAP financial measure,[7] and a separate set of rules that applies solely to non-GAAP financial measures included in SEC filings.

Under Regulation G, whenever a company makes *any* public disclosure or release of material information that includes a non-GAAP financial measure:

- the company must also present the most directly comparable financial measure that is calculated and presented in accordance with GAAP;
- the company must provide a clearly understandable quantitative reconciliation of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure; and
- no material mis-statements or omissions may be made that would make the presentation of the non-GAAP financial measure, under the circumstances in which it is made, misleading.

If a non-GAAP financial measure is released orally, telephonically, by web cast, by broadcast or by similar means, the company may provide the information required by Regulation G by: (1) posting that information on the company's website;[8] and (2) disclosing during the presentation where the required information may be found.

When a company includes a non-GAAP financial measure *in a filing with the SEC*, it must:

- present, *with equal or greater prominence*, the most directly comparable financial measure that is calculated and presented in accordance with GAAP;
- provide a clearly understandable quantitative reconciliation of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure;
- state why the company's management believes that the non-GAAP financial measure provides useful information to investors regarding the company's financial condition and results of operations;[9] and
- to the extent material, disclose any additional purposes for which the company's management uses the non-GAAP financial measure.

Separate rules apply to the use of non-GAAP Financial measures depending on whether the disclosure is in an SEC filing or another form of disclosure

Regulation G

Regulation G applies to companies that are foreign private issuers, subject to a limited exception. Specifically, Regulation G does not apply to public disclosure of a non-GAAP financial measure by, or on behalf of, a foreign private issuer if:

- the securities of the foreign private issuer are listed or quoted on a securities exchange or inter-dealer quotation system outside the USA;
- the non-GAAP financial measure is *not* derived from or based on a measure that is calculated and presented in accordance with US GAAP; and
- the disclosure is made by or on behalf of the foreign private issuer outside the USA, or is included in a written communication that is released by or on behalf of the foreign private issuer outside the USA.

This exception for foreign private issuers will continue to apply *even where* any one or more of the following circumstances are present:

- a written communication is released in the USA as well as outside the USA, so long as the communication is released in the USA contemporaneously with or after the release outside the USA and is not otherwise targeted at persons located in the USA;
- foreign journalists, US journalists or other third parties have access to the information;
- the information appears on one or more websites maintained by the company, so long as the websites, taken together, are not available exclusively to, or targeted at, persons located in the USA; or
- following the disclosure or release of the information outside the USA, the information is included in a submission to the SEC made under cover of a Form 6-K.

In the case of foreign private issuers whose primary financial statements are not prepared in accordance with US GAAP, Regulation G provides that the term 'GAAP' as it applies to those issuers refers to the principles under which the company's primary financial statements are prepared. However, in the case of foreign private issuers that include a non-GAAP financial measure derived from or based on a measure that is calculated in accordance with US GAAP, Regulation G makes clear that, in this instance, the term 'GAAP' refers to US GAAP for purposes of the application of the requirements of Regulation G to the disclosure of that measure.

SEC filings (non-Regulation G)

In addition, foreign private issuers will be subject to the same requirements as domestic issuers with respect to the use of non-GAAP financial measures in their filings with the SEC on Form 20-F. However, filers on Form 40-F under the Multi-jurisdictional Disclosure System are not subject to those requirements.

The definition of a non-GAAP financial measure is the same for foreign private issuers as it is for domestic issuers. However, a non-GAAP financial measure that would otherwise be prohibited will be permitted in a Form 20-F filing of a foreign private issuer if the measure is:

- required or expressly permitted by the standard-setter that establishes the system of GAAP that is used in the foreign private issuer's primary financial statements; and
- included in the foreign private issuer's annual report or financial statements used in its home country jurisdiction or market.

This exception only covers situations where the foreign organisation has affirmatively acted to require or permit the measure, and not situations where the measure was merely 'not prohibited'.

CEO and CFO certification requirements

Periodic reports – Section 906 certifications

All periodic reports to the SEC must now include two separate forms of certification of the disclosure, signed by the principal financial and executive officers of the reporting entity

Effective as of 30th July, 2002, Section 906 of the Act created a new criminal statute under the US Code.[10] This section requires that each periodic report containing financial statements, such as those filed with the SEC on Forms 20-F and 40-F, be accompanied by a written statement signed by the CEO and CFO (or equivalent officers), certifying that the reports fully comply with Section 13(a) or 15(d) of the Exchange Act and fairly present, in all material respects, the results of operations and financial condition of the issuer.

In a change from the SEC's original position with respect to the Section 906 certifications that it would not comment or provide guidance on where those certifications should be filed, the SEC has now issued a final rule relating to the proper placement of Section 906 certifications.[11] The SEC will require the Section 906 certifications, along with the Section 302 certifications as described below, to be included as exhibits to the reports to which they relate. Noteworthy for foreign private issuers is that, in the final rules relating to the Section 906 certifications, the SEC specifically states that current reports on Form 6-K need not include these certifications as exhibits.

Annual reports – Section 302 certifications

The certifications required by Section 302 are broader and cover additional topics

Section 302 of the Act required the SEC to promulgate rules by 29th August, 2002, requiring CEOs and CFOs (or equivalent officers) to certify as to their annual and quarterly reports filed under Section 13(a) or 15(d) of the Exchange Act. Effective from 29th August, 2002, all US and non-US companies with classes of securities registered under Section 12 of the Exchange Act are subject to this certification requirement, as the SEC did not grant exemptive relief from this requirement for non-US companies in its implementing rules.[12] Accordingly, the certification requirement applies to annual reports filed by non-US companies on Forms 20-F and 40-F. In addition, all amendments to, and transition reports on, these reports are subject to the certification requirement. As noted above, the SEC has issued further rules relating to the placement of Section 302 certifications, which specify that they are to be filed as exhibits to the reports to which they relate.

Reports on Form 6-K, which the SEC deem not to be 'periodic reports', are not covered by the Section 302 certification requirement.

Section 302 and the new rules implementing that section require the CEO and CFO (or equivalent officers) each to certify, among other things, that the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the other statements made in the report not misleading; and the financial statements and other financial information contained in the report fairly present, in all material respects, the financial condition and results of operations of the issuer as of, and for, the period presented in the report.

In addition, the CEO and CFO must certify that:

- each is responsible for establishing, maintaining and regularly evaluating the effectiveness of the issuer's internal 'disclosure controls and procedures';[13]
- each has made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and
- each has included information in the issuer's quarterly and annual reports about his or her evaluation and whether there have been significant

changes in the issuer's internal controls or in other factors that could significantly affect those internal controls subsequent to the evaluation.

Many issuers are adopting more formal policies and procedures surrounding the preparation and execution of these certifications in response to these rules, including implementing written disclosure controls and procedures, conducting formal drafting sessions for the preparation of reports to the SEC, and requiring junior officers to provide their own certifications to the CEO and CFO as to their knowledge of the matters addressed in the certifications required to be made by the CEO and CFO. Non-US companies should consider adopting some or all of these procedures in order to provide their certifying officers with the diligence needed to support the required certification.

CHANGES IN CORPORATE GOVERNANCE

The Act and SEC rules impose additional changes on issuers' internal corporate governance practices

Another primary area of concern in the Act relates to issuers' internal corporate governance practices. Historically, in the USA, internal matters of corporate governance had either been dealt with on a state level or in the listing requirements of stock exchanges, but largely had not been addressed on a federal level. This pattern has changed dramatically with the passage of the Act, and foreign issuers are also subject to many of these new requirements.

Prohibition of personal loans to executive officers and directors

Personal loans to executive officers and directors are forbidden

Effective from 30th July, 2002, Section 402 of the Act prohibits both US and non-US issuers from extending or maintaining credit, arranging for the extension of credit, or renewing an extension of credit, in the form of a personal loan made directly or indirectly to any executive officer or director of the issuer. Loans that were outstanding on 30th July, 2002, may be maintained, but material modifications or renewals of such loans are prohibited. The prohibitions of Section 402 do not apply to loans made or maintained by the US Federal Deposit Insurance Corp. (FDIC), if the loan is subject to US insider lending restrictions. Generally, banks in the USA are insured by the FDIC. However, non-US banks (and their US branches) are generally not insured by the FDIC, and thus will not have the benefit of this exemption, unless the US branch is FDIC-insured and that branch is the lender.

Other loans that are exempt from Section 402 are home improvement and manufactured home loans, consumer credit, extensions of credit under an open end credit plan, charge cards, or any extension of credit by a registered broker or dealer to an employee of that broker or dealer to buy, trade or carry securities (other than an extension of credit that would be used to purchase stock of the issuer), in each case as long as the loan is made or provided in the ordinary course of the consumer credit business of the issuer, is of a type generally made available by the issuer to the public, and is made on market terms.

This section has been one of the most controversial sections of the Act since its passage, largely because of lingering uncertainties relating to whether commonly used arrangements such as cashless option exercise programmes and split-dollar life insurance policies are still permitted under the Act. The SEC has stated that it does not intend to provide guidance on this section, and thus US and non-US companies alike have been left to determine, with their advisers, on a case-by-case basis, whether particular arrangements comply or do not comply with this section.

Codes of ethics for senior financial and executive officers

Section 406 of the Act, and SEC rules issued under that section,[14] require all issuers, including foreign private issuers, to disclose, in their annual reports filed under Section 13(a) or 15(d) of the Exchange Act for fiscal years ending on

Issuers must adopt and publicise codes of ethics for their senior financial and executive officers

and after 15th July, 2003, whether the company has adopted a code of ethics for its senior financial and executive officers, and if not, why not. Foreign private issuers will be required to include this disclosure in their Form 20-F or Form 40-F annual report. Companies, including foreign private issuers, will also be required to make their codes of ethics available to the public, using one of three methods:

- filing a copy of the code as an exhibit to its annual report;
- posting the text of the code on its website; provided, however, that a company choosing this option also must disclose its Internet address and intention to provide disclosure in this manner in its annual report on Form 10-K, 10-KSB, 20-F or 40-F; or
- providing an undertaking in its annual report on one of these forms to provide a copy of the code to any person without charge upon request.

CEOs and CFOs will be required to disgorge bonuses and profits from sales of securities if their companies' financial statements are restated as a result of 'misconduct'

In addition, these rules require US issuers to disclose promptly, either on a Form 8-K or by posting the information on its website, any changes in, or waivers of, the code of ethics for senior financial and executive officers. By contrast, foreign private issuers will not be required to provide immediate disclosure of any change to, or waiver from, the company's code of ethics. Instead, the SEC will require foreign private issuers to disclose any such change or waiver that has occurred during the past fiscal year in its Exchange Act annual report.

Issuers must disclose whether their audit committees include an 'audit committee financial expert'

The SEC does 'encourage' foreign private issuers to provide more prompt disclosure of any waivers of, or changes to, the code of ethics. Foreign issuers should take steps now to adopt a code of ethics, including compliance with applicable laws and regulations, and should determine now whether it will provide prompt disclosure of waivers and changes on a Form 6-K current report or on their websites.

Ramifications for the CEO and CFO in the event of an accounting restatement

Effective from 30th July, 2002, Section 304 of the Act requires that if, as a result of 'misconduct', an issuer is required to restate its financial statements due to material non-compliance of the issuer with any financial reporting requirement under the US securities laws, the CEO and CFO of the issuer will both be required to reimburse the issuer for:

- any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the earlier of the first public issuance or filing with the SEC of the non-compliant document; and
- any profits realised from the sale of the issuer's securities during the same 12-month period.

This provision applies equally to both US and non-US companies. The Act does grant the SEC the authority to exempt individuals from these reimbursement provisions, as it deems necessary and appropriate, but the SEC has given no indication to date that it will act to exempt foreign issuers (or any other persons) from these provisions. A key issue for all issuers relating to this section will be the meaning and standard of the 'misconduct' that will be sufficient to trigger the provision, as this term is not defined or clarified in the Act, and the SEC is not required to promulgate rules with respect to this section in order to define any terms therein.

Audit committee financial experts

Section 407 of the Act required the SEC to finalise rules that will require both US and non-US issuers to disclose whether or not (and if not, why not) their audit

committees include at least one member who is an 'audit committee financial expert'.[14] An audit committee financial expert is defined as a person who has the following attributes:

- an understanding of GAAP and financial statements (for foreign private issuers, the applicable standard will be an understanding of the system of GAAP used by the foreign private issuer in preparing its primary financial statements filed with the SEC, and not necessarily US GAAP);
- the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- experience of preparing, auditing, analysing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

Under the final rules, a person must have acquired such attributes through any one or more of the following:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- experience of actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- other relevant experience.

If the foreign private issuer is listed on a stock exchange or Nasdaq, the foreign private issuer must disclose in its annual report whether its audit committee financial expert is independent, as that term is defined by the listing standards that apply to that issuer. If a foreign private issuer is not listed, it must choose one of the definitions of audit committee member independence that have been approved by the SEC in determining whether its audit committee financial expert, if it has one, is independent. It must also disclose which definition was used.

Foreign private issuers must comply with the audit committee financial expert disclosure requirements in their annual reports for fiscal years ending on or after 15th July, 2003, but need not disclose whether the audit committee financial expert is 'independent' from the issuer until their annual reports for fiscal years ending on or after 31st July, 2005.

CHANGES IN THE RELATIONSHIP BETWEEN AN ISSUER AND ITS ACCOUNTANTS AND AUDIT COMMITTEES

The Act restricts the kinds of relationships that may exist between an issuer and its auditors, and imposes significant new burdens on audit committees

In the Act, the US Congress also demonstrated its serious concerns that issuers' relationships with their audit committees, auditors and attorneys had become too cosy to provide a sufficient level of scrutiny and oversight. The rules adopted by the SEC in this area, which apply in most cases equally to foreign

private issuers, include the requirements below.

Independence of audit committees and auditors

Audit committee members must meet more stringent definitions of independence and assume new responsibilities relating to a company's auditors and financial disclosure

Under Section 301 of the Act, the SEC was directed to finalise rules prohibiting the NYSE, Nasdaq and other exchanges and national securities associations from allowing the continued listing of companies that do not have an audit committee that complies with the standards set forth in Section 301.[15] While historically the NYSE and Nasdaq have exempted non-US companies from many of their corporate governance requirements, there is no authority granted under the Act for the NYSE and Nasdaq to provide exemptions for non-US companies from the requirements of Section 301. Foreign issuers must be in compliance with these listing rules by 31st July, 2005.

Under these rules, audit committees must:

- consist solely of 'independent directors'. In order to be considered independent under the Act, a member of an audit committee may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee, accept any consulting, advisory or other compensatory fee from the company or be an affiliated person of the company or any of its subsidiaries;

- be directly responsible for the appointment, compensation and oversight of the work of the company's independent public auditors;

- have the authority to engage independent counsel and other advisors to the committee, the fees of which shall be paid by the company; and

- establish procedures with respect to the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, and establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters.[16]

Section 301 of the Act did not distinguish between domestic listed companies and foreign listed companies for purposes of compliance with the requirements relating to their audit committees. Representatives of foreign private issuers from several companies expressed concern to the SEC that compliance with the rules issued under Section 301 could cause foreign companies to violate the rules of their home jurisdictions, or otherwise lead to confusion or difficulties for the foreign issuers under the governing documents and laws applicable to them. In response to these concerns, the SEC has provided for certain exceptions from the rules governing audit committees for foreign private issuers, as follows:

- **Employee representation.** Some countries require that non-management employees serve on issuers' audit committees, as an independent check on management's activities. These employees would not qualify as 'independent' under the Section 301 requirements. However, the SEC will permit non-executive employees to serve on the audit committee of a foreign private issuer if the employee is elected or named to the issuer's board of directors or audit committee pursuant to the issuer's governing law or documents, an employee collective bargaining or similar agreement or other home country legal or listing requirements.

- **Two-tiered boards.** Some countries permit or require foreign private issuers to have a two-tiered board system, with one tier designated as the management board and the other tier

designated as a supervisory, or non-management, board. The SEC's final rules clarify that, with respect to foreign private issuers, the rules governing audit committees will apply to the supervisory, or non-management, board and not to the management board.

- **Controlling shareholder representation.** Many foreign private issuers allow shareholders owning or controlling more than 50 per cent of their outstanding shares to serve on their audit committees. Under the new rules, a greater-than-50 per cent stockholder would not be considered to satisfy the independence test. However, the SEC will permit such a shareholder, or the representative of an affiliate of a foreign private issuer, to serve on the issuer's audit committee if the 'no compensation' prong of the independence requirements is satisfied, the member in question has only observer status on, and is not a voting member or the chair of, the audit committee, and the member in question is not an executive officer of the issuer.

- **Foreign government representation.** Foreign governments may also have representatives serving on the audit committees of foreign private issuers, and may not qualify as independent under the new rules as a result of shareholdings or other rights. The SEC will permit representatives of foreign governments to serve on the audit committees of foreign private issuers if the 'no compensation' prong of the independence requirements is satisfied, and the member in question is not an executive officer of the issuer.

All accounting firms working with US-registered issuers must be registered with the new Public Company Accounting Oversight Board

- **Boards of auditors or similar bodies.** Some countries permit or require auditor oversight through a board of auditors or similar entity, which is not necessarily a part of the issuer's board of directors. Rather than require foreign private issuers that have such boards of auditors to establish separate audit committees, the SEC has provided an exemption from the independence requirements of the rules for foreign private issuers that have boards of auditors meeting specified requirements, including that no member may be an executive officer of the issuer, and the independence of the board must be governed by applicable home country legal requirements or listing provisions.

If a foreign private issuer chooses to rely upon any of the exemptions applicable to such issuers, it will be required to disclose such reliance in, or incorporate the disclosure into, annual reports filed with the SEC. The disclosure must include the issuer's assessment of whether and how its reliance on the exemption will materially adversely affect the ability of its audit committee to satisfy the requirements of these rules.

Non-US public accounting firms

Section 101 of the Act established a five-member Public Company Accounting Oversight Board (PAB) to oversee the audit of all public companies. The SEC will have oversight and enforcement authority over the PAB, which the SEC announced, on 25th April, 2003, has been 'appropriately organized' and as such now has the capacity to carry out its obligations under the Act. US and non-US public accounting firms alike will be required to register with the PAB. If a non-US public accounting firm elects not to register with the PAB, it will be prohibited from preparing audit reports for companies that are publicly traded in the USA. Any company that has engaged a non-US public accounting firm to prepare their audit reports should inquire as to whether or not the audit firm intends to register with the PAB.[17]

The SEC and the PAB both have broad authority to exempt any non-US public accounting firm from any provision of the Act or the rules of the PAB or the SEC that are issued under the Act.

Prohibition of certain non-audit services

The Act created new criminal sanctions and increases penalties for existing crimes

Section 201 of the Act provides that no public accounting firm that is registered with the PAB may provide certain enumerated non-audit services, as follows:

- bookkeeping services;
- financial information systems design and implementation;
- appraisal and valuation services, fairness opinions, or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources services;
- broker-dealer, investment adviser or investment banking services;
- legal services; and
- other services as may be determined by the PAB.

Other services not listed above may be provided, but only if pre-approved by the issuer's audit committee and disclosed to investors, as described below.

Pre-approval and disclosure of audit and permitted non-audit services

Section 202 of the Act amends Section 10A of the Exchange Act to require both US and non-US issuers' audit committees to pre-approve all audit services and permitted non-audit services (subject to a *de minimis* exception) be provided by a company's outside auditor. In addition, all permitted non-audit services that are approved by an issuer's audit committee will need to be disclosed to investors in a periodic report filed with the SEC.

CRIMINAL PROVISIONS OF THE ACT

In addition to the Act's enhanced disclosure and corporate governance requirements, the Act also creates new criminal penalties for certain actions by public companies, and strengthens existing criminal penalties for other actions. These penalties apply equally to domestic and foreign issuers.

Among the new crimes and enhanced penalties established by the Act are:

- knowingly *altering, destroying, or falsifying any document*, with the intent to impede, obstruct or influence the investigation of a matter within the jurisdiction of the US government (punishable by a fine, imprisonment of up to 20 years, or both);
- *retaliating or discriminating against an employee* because of any lawful act carried out by the employee to assist in an investigation regarding any conduct that the employee reasonably believes violates a rule of the SEC or any Federal law relating to fraud against shareholders (relief granted in such cases may include reinstatement of the employee, back pay, and payment of the employee's litigation costs and attorneys' fees);
- knowingly *executing, or attempting to execute, a scheme to defraud* any person in connection with any security of a registered issuer (punishable by a fine, imprisonment of up to 25 years, or both); and
- *knowingly providing a false certification* under Section 906 of the Act (punishable by a fine of up to US$1m imprisonment of up to 10 years, or both), or *wilfully providing a false certification* under Section 906 of the Act (punishable by a fine of up to

US$5m, imprisonment of up to 20 years, or both).

NEW NASDAQ AND NYSE PROPOSED LISTING REQUIREMENTS

Both Nasdaq and the NYSE have proposed changes in listing standards that would increase their influence over corporate governance practices

New corporate governance rules have recently been proposed by both the NYSE and Nasdaq, which are designed to increase accountability and transparency for the benefit of investors. Both the NYSE and Nasdaq proposals are still subject to approval by the SEC and to a public comment period before being finalised.[18]

Most of the NYSE rule proposals do not apply to foreign private issuers. In Section 11 of the NYSE rule proposals, the NYSE notes that, rather than imposing the same corporate governance requirements on foreign private issuers that it will impose on domestic issuers, it will instead require non-US issuers to disclose, in a brief, general summary, any significant ways in which their corporate governance practices differ from those followed by domestic companies that are listed on the NYSE. Non-US issuers may provide this disclosure either on their website (provided it is in the English language and accessible from the USA) and/or their annual report in the English language as distributed to shareholders in the USA.

Similarly, the corporate governance rules proposed by Nasdaq as applied to non-US issuers would require those companies to disclose any exemptions from Nasdaq's corporate governance requirements at the time the exemption is granted and on an annual basis thereafter. It appears that Nasdaq will still grant corporate governance exemptions to foreign issuers if the Nasdaq requirements would be contrary to the issuer's home country law, rules, regulations or generally accepted business practices. In addition, the Nasdaq proposals, if approved, would require all non-US companies to file with the SEC and Nasdaq a semi-annual report that includes a statement of operations and an interim balance sheet, even if such a semi-annual report is not required under home country regulations.

SUGGESTED ACTIONS IN RESPONSE TO THE ACT

The magnitude and scope of the changes to the disclosure and corporate governance requirements brought about by the Act are unprecedented in the history of securities regulation in the USA, and foreign private issuers should be taking steps now to address those changes. Set forth below are some suggestions that may be appropriate to help ensure that your company is well positioned to meet the new requirements.

Issuers should take action now to ensure their compliance with the Act

- Review the services being performed for you by your independent public accountants, and determine whether they constitute audit or permissible non-audit services, or impermissible non-audit services.

- Review your disclosure controls and procedures to determine their efficacy. Particularly important for biotechnology companies is a review of the procedures by which information relating to their intellectual property portfolios is gathered, recorded, processed, summarised and reported, since that information is likely to reflect a significant element of a biotechnology company's assets.

- Ensure that those within your company who are primarily responsible for the preparation of periodic SEC reports have been made aware of the applicable changes in disclosure requirements, especially with respect to the MD&A section.

- Decide whether to implement written disclosure controls and procedures, conduct formal drafting sessions for the preparation of reports to the SEC, and require junior officers to provide their own certifications to the CEO

and CFO as to their knowledge of the matters addressed in the certifications required to be made by the CEO and CFO.

- Determine whether: (a) your board of directors has a majority of independent members; (b) your audit committee is fully independent (taking into account any available exceptions under the Section 301 rules); and (c) your audit committee has at least one 'audit committee financial expert' serving on the committee. If not, take steps to make the necessary changes.

- Review your code of conduct and ethics to determine whether it satisfies the SEC's new rules. If you do not have a code of conduct and ethics, work with legal counsel to adopt one that meets the unique needs and demands of your business.

- Determine whether your company has any outstanding loans to officers and directors, and decide on a course of action to address those loans upon maturity (in light of the Act, such loans should not be renewed or materially modified after 30th July, 2002).

- Ensure that your audit committee has: (a) established whistle-blowing procedures relating to the receipt of complaints concerning accounting, internal accounting controls, or auditing matters; and (b) established procedures governing the pre-approval of all audit and permitted non-audit services to be performed by the independent public accountants.

- Determine whether your independent public accountants are planning to register with the PAB. If not, you will probably need to switch accounting firms.

In summary, the regulatory landscape for foreign issuers with a class of securities registered in the USA has changed significantly with the passage of the Act. Foreign issuers must review their corporate governance practices carefully in order to ensure compliance with the new rules.

References and notes

1. The Act does not contain any provisions that are specifically targeted to companies in certain industries, such as biotechnology companies. However, as noted in the text, there may be steps that international biotechnology companies, in particular, may wish to take now in order to respond fully to some of the new requirements of the Act, such as the periodic report certification requirements.
2. Rule 12g3-2(b), which requires submission of certain information to the SEC, permits nominal activities in the US capital markets without triggering registration requirements or subjecting companies to periodic reporting obligations under Section 12 of the Exchange Act. A company that furnishes information to the SEC pursuant to Rule 12g3-2(b) of the Exchange Act is not considered to be a reporting company for most purposes of the Exchange Act.
3. Speech to the Practising Law Institute's Annual Institute on Securities Regulation, 6th November, 2002.
4. SEC Interpretive Release, 'Management's Discussion and Analysis of Financial Condition and Results of Operations', Release Nos 33-6835; 34-26831; IC-16961; FR-36, 18th May, 1989.
5. These final rules are available on the SEC's website at URL: http://www.sec.gov/rules/final/33-8182.htm
6. These final rules are available on the SEC's website at URL: http://www.sec.gov/rules/final/33-8176.htm
7. A non-GAAP financial measure is a numerical measure of a company's historical or future financial performance, financial position or cash flows that:

   - excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure that is calculated and presented in accordance with GAAP in the company's statement of income, balance sheet or statement of cash flows (or equivalent statements); or
   - *includes* amounts, or is subject to adjustments that have the effect of including amounts, that are *excluded* from the most directly comparable GAAP-based measure.

8. The SEC suggests, but does not require, that companies provide website access to this information for at least 12 months.
9. The SEC noted that management's belief as to the usefulness of the non-GAAP financial measure to investors cannot be based solely on the fact that the measure may be used by or useful to securities analysts. Management must present an independent, substantive justification for the use of the measure.
10. See a discussion of the Section 906 certification requirements in the Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, PC, 2nd August, 2002, Advisory, entitled 'Update on the Sarbanes-Oxley Act,' and the 12th September, 2002, Advisory, entitled 'Update on the Sarbanes-Oxley Act (Fourth in a Series): SEC Finalizes Certification Rules for Quarterly and Annual Reports,' both of which are available on the website at URL: http://www.mintz.com/images/dyn/publications/SECAdv080202.pdf and at URL: http://www.mintz.com/images/dyn/publications/SECAdvisory91202.pdf, respectively.
11. These final rules are available on the SEC's website at URL: http://www.sec.gov/rules/final/33-8238.htm
12. These final rules are available on the SEC's website at URL: http://www.sec.gov/rules/final/33-8124.htm
13. 'Disclosure controls and procedures' is a newly defined term in the SEC's rules, meaning the controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports filed or submitted by it under the Exchange Act is recorded, processed, summarised and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in its Exchange Act reports is accumulated and communicated to the issuer's management, including its principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure.
14. These final rules are available on the SEC's website at URL: http://www.sec.gov/rules/final/33-8177.htm
15. These final rules are available on the SEC's website at URL: http://www.sec.gov/rules/final/33-8220.htm
16. For a further discussion of the audit committee requirements pursuant to Section 301 of the Act, please see the Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, PC, 29th July, 2002, Advisory, entitled 'Congress Approves Major Corporate Governance and Accounting Reform Legislation,' which is available on the website at URL: http://www.mintz.com/images/dyn/publications/SecAdvisory072902.pdf
17. For a further discussion of the Public Company Accounting Oversight Board, please see the Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, PC, 29th July 29, 2002, Advisory, entitled 'Congress Approves Major Corporate Governance and Accounting Reform Legislation,' which is available on the website at URL: http://www.mintz.com/images/dyn/publications/SecAdvisory072902.pdf
18. For further information on the Nasdaq rule proposals, please see Nasdaq's public relations website at URL: http://www.nasdaqnews.com. For further information on the NYSE rule proposals, please see the NYSE's website at URL: http://www.nyse.com