

The Impact of Sarbanes-Oxley on Foreign Private Issuers, Private Equity Funds and Their Counsel

by Michael P. Kelley

Not long before the Enron and WorldCom scandals took front and center stage in the press, the U.S. Securities and Exchange Commission (SEC) touted its goal of making the SEC more sensitive to foreign relations. After indications that U.S. securities regulation would soften toward non-U.S. companies, foreign issuers and their legal and financial advisors expected a more sympathetic understanding of the reporting problems facing publicly traded non-U.S. companies, as well as a more welcoming atmosphere for investment banks bringing their capital-raising efforts to the U.S. However, over one year later—and as a result of much corporate bloodletting—foreign private issuers and their counsel now face, under the Sarbanes-Oxley Act of 2002, a new set of stringent and, from the perspective of foreign issuers, often contra-

dictory U.S. securities regulations. Will these regulations impede foreign investors' access to U.S. capital markets?

Scope of Application to Foreign Private Issuers

The Act's provisions generally apply to all U.S. and non-U.S. issuers that have registered securities under Section 12 of the Securities Exchange Act of 1934 or that are required to file periodic reports with the SEC pursuant to Section 15(d) of the Exchange Act. This includes all non-U.S. companies filing their annual reports on Form 20-F.¹ The act does not apply to non-U.S. companies furnishing information to the SEC according to Rule 12g3-2(b) of the Exchange Act. It is unclear which of the Act's provisions apply to foreign governments and governmental entities subject to Exchange Act requirements. The Act's provisions relating to auditor oversight and independence, however, apply to all accounting firms—U.S. and foreign—that audit non-U.S. public companies required to file financial statements with the SEC. The issue of foreign auditor registration with the Public Company Accounting Oversight Board has been pushed to the forefront recently by the accounting debacle at Royal Ahold NV, the Dutch food group that owns Giant Food.

It is surprising that the U.S. Congress has elected to include non-U.S. issuers within the scope of the Act. The SEC's traditional approach was to provide exemptions to non-U.S. issuers that meet the SEC definition of a "foreign private issuer"² from rules and procedures that otherwise might impose an undue burden on such non-

U.S. issuers and discourage them from accessing the U.S. capital markets.³ Despite precedential exemptions, it appears most non-U.S. issuers will be subject to the Act.

Key Provisions of the Act Affecting Foreign Private Issuers

Numerous provisions of the Act run counter to home country laws and practices governing many foreign private issuers. Parts of the Act may affect companies unaccustomed to the new regulatory regime. Senior management, together with in-house and outside counsel, will have to navigate carefully in order to avoid unintended consequences that, while not problematic in their home countries, risk liability under the Act. Some of these provisions are as follows:

Audit Committees and Audit Services Provisions

Section 301 of the act requires U.S. national securities exchanges and national securities associations to prohibit the listing of any security of a company whose audit committee is not:

- composed solely of independent directors;⁴
- directly responsible for the company's auditors;
- without established procedures to collect complaints regarding accounting and related matters;



- authorized to engage independent advisors; and
- appropriately funded.

An independent director may not receive any compensation from the company, other than payment for board services, and he/she cannot be an affiliate. Under rules promulgated by the SEC earlier this month and imposed by requiring U.S. stock exchanges to adopt them as listing standards, foreign issuers may have labor and government members on audit committees. In addition, shareholders of foreign issuers may conduct auditor hiring. Publicly listed companies will be required to comply with the new rules by their first annual meeting after Jan. 15, 2004, but no later than Oct. 31, 2004. Foreign private issuers and small businesses will have until July 31, 2005, to comply.

Under proposed rules in conformity with Section 407 of the Act, each annual report of a foreign private issuer must disclose the name of each independent “financial expert” on its audit committee or explain the absence of one. Generally, only those with experience as a public accountant, principal financial officer, controller or principal accounting officer for a company reporting under the Exchange Act will qualify as a financial expert. The requirements of understanding audit committee functions and experience in reconciling financial statements according to U.S. GAAP may create difficulties for some foreign issuers which must find financial experts to serve on their audit committees who meet the Act’s standards.⁵

As an example of the extraordinary extraterritorial application of the Act, foreign auditors whose only connection to the U.S. is providing services to foreign companies listed on a U.S. exchange are included within the reach of the Act’s provisions. Foreign auditors who provide such services will be prohibited from providing most non-audit services, will have to rotate at least once every five years and will have to give certain audit reports directly to the audit committee. Moreover, audit committees will have to pre-approve all services provided by the auditors.

Certifications, Control and Procedures

Sections 302 and 906 of the Act mandate that each periodic report containing financial statements filed with the SEC⁶ be accompanied by CEO and CFO written statements certifying the report complies with the Exchange Act and fairly presents the financial condition and results of operations of the company.⁷ Each Form 20-F/40-F report must contain a CEO and CFO certification that:

- They have reviewed the report;
- The report is not false or misleading and fairly presents the company’s financial condition and results of operations;
- They have designed and maintained proper and effective disclosure controls and procedures⁸ to ensure that material information is made known to them on a timely basis; and
- They have made certain disclosures relating to internal controls to the company’s audit committee and external auditors.⁹

Complying with certification and disclosure controls and processes may be time-consuming, although not especially burdensome for sophisticated foreign issuers. However, CEOs and CFOs are at risk for increased liability under the certification requirements—especially those senior officers who are not accustomed to signing their companies’ Forms 20-F/40-F.

Disclosure Obligations More Burdensome

Section 409 of the Act permits the SEC to issue rules requiring companies to make “real time disclosure” of changes in their financial condition or operations. It is not clear whether foreign issuers will be subject to such disclosure. If so, it will create additional burdens on non-U.S. companies regarding time zone differences, document translation and other considerations.

In addition, recently proposed SEC rules provide that whenever a non-GAAP financial measure is included in an SEC filing or

made publicly available by a reporting company, the filing or disclosure must reference the most directly related GAAP financial measure and a reconciliation of the GAAP and non-GAAP financial measures. For foreign issuers, the rules define GAAP to include the generally accepted accounting principles under which the issuer’s primary financial statements are prepared.

Finally, under Section 401 of the Act, the SEC proposed rules requiring each foreign issuer to provide detailed disclosure in its annual 20-F/40-F report of all material off-balance sheet arrangements. Such arrangements include any obligation or liability that is not fully reflected in the company’s financial statements. The rules also require increased disclosure of contractual obligations such as debt, operating and capital leases and unconditional purchase contracts.

Other Provisions Impacting Foreign Issuers

Other provisions of the Act to which foreign issuers should pay particular attention include prohibitions on extending, maintaining or renewing personal loans to officers or directors. Such loans may be interpreted broadly to include use of company credit cards and the cashless exercise of stock options. Given the uncertainty of Section 402, companies should consult with their legal and financial advisors before extending credit to any executive officer or director. Another potential set of rules that would contain obligations inconsistent with foreign issuer practices is the requirement that Form 20-F/40-F be amended to require foreign issuers to disclose written codes of ethics applicable to the CEO and senior financial officers and, if a company does not have such code, the reasons why it does not. Foreign issuers would be required to attach a copy of the code of ethics to their annual report and to disclose changes to the ethics code or waivers granted. The SEC has also indicated it may encourage foreign issuers to promptly disclose changes to its code and any waivers. Finally, Section 408 of the Act requires the SEC to review each listed

company's SEC reports at least once every three years. Foreign issuers, therefore, should expect periodic scrutiny of their filings for compliance with the Act.

The Effect of Sarbanes-Oxley on Private Equity Funds

The Act's effect on private equity funds may be felt in three principal areas: board composition and committees; increased time commitments by directors; and director risks versus observer rights.

In the case of listed issuers that are not controlled companies,¹⁰ it is clear such issuers are required to have a majority of independent directors and fully independent audit, compensation and corporate governance committees. However, for non-listed companies or controlled companies considering listing in the future, they, too, may feel it necessary to have independent directors on their boards. Private equity funds that are not affiliates of the issuer may feel compelled to sit on boards as "independent" directors, as well as on the various board committees.

New rules imposed by the SEC, NYSE and NASDAQ increase the time commitments and participation by directors in board and committee meetings. They are expected to analyze data provided by the company's management, and its auditors. While directors may still rely on the company's management, and its auditors and counsel, individual directors must ensure they have a reasonable basis for their reliance.

Finally, for portfolio companies that are subject to the Act or that may become public, private equity funds should consider the risks of sitting on boards. Minority investors should consider observer rights in lieu of board seats or observer rights that can convert into board seats. Observer rights permit a private equity fund to appoint a representative to attend, in a non-voting capacity, any board and committee meeting, to participate in

the discussions and to receive copies of all materials, including financial statements, presented to the directors at the same time they are provided to the board.

New Burdens for Attorneys Representing Foreign Issuers and Private Equity Funds

The new securities regulatory environment will have a direct, as well as indirect, impact on attorneys representing foreign issuers and private equity funds. In effect, Section 307 of the Act—one of the most controversial sections—results in federal regulation of attorney conduct. Specifically, Section 307 requires both in-house and outside counsel to report evidence of a material violation of securities laws or breach of fiduciary duty by a company or one of its agents to the company's chief legal counsel or the chief executive officer. If the officials do not respond appropriately,¹¹ the attorney must report the evidence to the company's audit committee or to its board of directors. The SEC's position on this issue dilutes earlier proposals that would have required an attorney to make a "noisy withdrawal"—essentially quitting and informing the SEC of the reason—if the directors of the company did not act appropriately after learning of the violation.¹²

In addition to this direct reporting requirement, counsel to U.S. or non-U.S. companies alike must assist clients in complying with the Act. Counsel should be able to answer the following:

- Does the company's reporting system contain "checks and balances"?
- Is the disclosure process interactive?
- Do systems gather information in a timely, complete and reliable way?
- Is disclosure information reviewed and crosschecked frequently?
- Does the company's system substantiate information included in disclosure documents?

- Has the company experienced disclosure failures or lapses? If so, what remedial steps can be taken to ensure complete and timely disclosure in the future?
- Are the tone and policies for reporting, as well as review of key disclosure items, led by senior management?

The same questions should be posed by private equity funds in the process of their due diligence inquiries for portfolio company mergers and acquisitions or when contemplating the listing of such companies.

Counsel who may be involved in ensuring compliance by the foreign issuer with the Act's disclosure and reporting requirements may consider implementing the following framework for the company:

- **Incorporate New Certification Requirements Into Home Country Compliance Processes.** Foreign issuers must already comply with the laws and regulations of their own home country and stock exchange, as well as implement their own internal control and processes to effect compliance in their home jurisdiction. Since each company's and country's requirements differ, counsel should conduct a review and analysis of existing procedures to determine how to supplement them rather than to build a separate Section 302 certification framework.
- **Form a Disclosure Committee.** The committee should consider the materiality of information and determine the foreign issuer's disclosure obligations on a timely basis. Moreover, it should oversee the company's disclosures in the following areas:
 - SEC filings, including annual reports, registration statements and prospectuses;
 - Correspondence with shareholders;
 - Private placement memoranda;
 - The company's corporate and investor relations Web site;

- Financial and other press releases disseminating material information; and
- Presentations to investor conferences, analysts, rating agencies and lenders.

The committee should also assist the CEO and CFO in establishing, maintaining and evaluating the company's disclosure controls and procedures.

• **Document Disclosure Controls and Procedures.**

Counsel to foreign issuers should assist the CEO and CFO in documenting the existing disclosure process, describing how the company records and verifies its financial and business information, processes the information received, summarizes the information and determines whether and how to report the information.

• **Create Time and Responsibility Schedules.**

Counsel should also encourage companies to create detailed time and responsibility controls to identify key dates and deadlines in preparing annual reports and other disclosure documents and to set forth the key persons and activities involved in the preparation of those reports and documents.

• **Designate a Disclosure Controls Monitor.**

Companies should designate their in-house legal counsel or the corporate secretary as the person responsible for documenting the review process for each filing. This individual would also be responsible for maintaining records of meetings of the disclosure committee by preparing a written summary of the review process followed by the committee,¹³ for tracking the company's public disclosures and for reviewing materials provided to the board of directors to assure consistency between public disclosures and board materials.

• **CEO and CFO Meetings with the Disclosure Committee.**

Given their close perspective on risks and trends that may affect the company's business,

it is important to involve the CEO and CFO early in the process of preparing SEC reports. Initial meetings between the CEO, CFO and disclosure committee, and possibly outside auditors and legal counsel, should focus on critical accounting issues, significant risks and uncertainties and important business outcomes that would make the drafting process more efficient and lead to better disclosure. Senior management should also be urged to participate in MD&A review, including disclosure regarding critical accounting policies and trends that might affect financial conditions and results of operations.

• **Meet with Audit Committee.**

Section 302 certifications require the CEO and CFO to certify they have disclosed to the company's auditors and the audit committee all significant deficiencies or material weaknesses in the design or operation of the company's internal controls and any fraud involving management or others with significant roles in the internal control structure. The CEO and CFO should meet with the audit committee to review the certifications and to explain the procedures taken to support making the certifications.

• **Convey Relevant Information to Disclosure Committee Members.**

Legal counsel and accounting representatives have the responsibility for providing disclosure committee members sufficient information about applicable reporting and disclosure requirements to enable them to fulfill their obligations. Such information should include SEC developments and financial reporting changes. The committee should also

be encouraged to review analysts' reports on the company and the industry as well as disclosures by like companies. Formal training in SEC matters, financial reporting and disclosure would reflect well on the company—especially foreign private issuers—whose basic knowledge of SEC matters may be limited to the press.

Next Steps

Although some rulemaking under the Act remains to be finalized, such as research analysts' conflicts of interest and whether attorneys will be required to alert the SEC of corporate wrongdoing, most implementing rules under the Act are final.

In many aspects, the Sarbanes-Oxley Act of 2002 is a departure from traditional U.S. securities regulation of foreign private issuers. Prior to the Act, U.S. regulators, acknowledging that regulations and practices relating to corporate governance and auditing in many countries are different from U.S. law and practice, had not sought to regulate corporate governance matters of foreign private issuers. Traditionally, U.S. stock exchanges and NASDAQ have granted waivers to non-U.S. companies when conflicts arose.

However, in the new U.S. regulatory environment, foreign private issuers and private equity funds investing in such companies are likely to be challenged as they attempt to reconcile requirements with their countries' regulations. In many cases, the new rules will be inconsistent with home country requirements.

continued on page 32



Michael P. Kelley has nearly 20 years of experience in finance and law. Through his private practice, he serves as counsel to Emerging Markets Partnership, principal advisor to six private equity funds around the world with more than \$6 billion in committed capital. Prior to his present responsibilities, he served as corporate vice-president and general counsel to a large international industrial and technology group headquartered in Caracas, Venezuela, with offices in Europe, Canada, Mexico and the United States. A former adjunct professor of international finance at George Mason University's master program in international transactions, Kelley has a Ph.D. from the London School of Economics.

Kelley *continued from page 27*

Consequently, many foreign private issuers and their advocates will argue the Act is more onerous on non-U.S. companies than their U.S. counterparts. We do not yet know what effect the Sarbanes-Oxley Act of 2002 will have on the volume of foreign private issuers seeking to access the U.S. capital markets.

(Author’s note: The above article is intended to provide general guidance, but in no way should be construed as providing legal or financial advice. Given the evolving nature of the subject matter, readers of this article should consult with their own legal counsel and financial advisors for advice on particular situations and circumstances.)

Endnotes

1. The act also applies to Canadian issuers under the Multi-jurisdictional Disclosure System (“MJDS”) filing Form 40-F.
2. A “foreign private issuer” is a company that is incorporated outside the United States and in which:

- A. U.S. residents do not hold a majority of the shares; or
- B. If U.S. residents do hold a majority of the shares, then:
 - a majority of its directors and officers are not U.S. citizens or residents;
 - its business is administered from outside the United States; and
 - a majority of its assets are located outside the United States.
3. For example, the SEC has exempted non-U.S. issuers from U.S. proxy rules, “short swing profit” recovery rules, share ownership disclosure rules applicable to officers, directors and ten percent shareholders and requirements to file most periodic reports under the Exchange Act such as those on Forms 8-K, 10-Q and 10-K.
4. An independent director may not receive any compensation from the company, other than payment for board services, and he/she cannot be an affiliate.
5. The NASDAQ’s proposed listing standards require a “financial expert” serve on a listed company’s audit committee.
6. Such reporting includes annual reports on Form 20-F/40-F, but is probably not required for Form 6-K reports, which are not filed with the SEC and are considered to be current, and not periodic, reports.
7. A false certification exposes the officer to a fine of up to \$5 million and imprisonment for up to 20 years.

8. Disclosure controls and procedures are broader than a company’s traditional internal controls and are intended to ensure that information required to be disclosed in reports filed with, or submitted to, the SEC is recorded, processed, summarized and reported within the applicable time period.
9. Even reviewing the Form 20-F/40-F report may be problematic for the CEO and CFO, for whom English may not be their first language.
10. A controlled company is a company in which an individual, group or another company holds more than 50 percent of the voting power. Controlled companies are subject to the audit committee requirements discussed above.
11. In one of a number of ambiguities, it is not clear what actions will satisfy an “appropriate response” standard.
12. The SEC has not abandoned this idea, but will consider additional comments during the next 60 days before making a final ruling. Apparently, it is also proposing alternatives, whereby the company—and not its counsel—would have to publicly disclose either the attorney’s withdrawal or the attorney’s written notice that he or she was not satisfied with the response the company made to a possible material violation. Such disclosure would be made via forms 9-K, 20-F or 40-R.
13. Care should be taken in the preparation of this written summary because it would, most likely, be discoverable in litigation.