

Sarbanes-Oxley Section 404: Compliance Challenges for Foreign Private Issuers and Their Counsel

by Michael P. Kelley

Few provisions of the Sarbanes-Oxley Act of 2002 (SOX Act) are more challenging to companies, especially foreign companies, than compliance with Section 404. This section requires management to file an internal control report with its annual report. The internal control report must articulate management's responsibilities to establish and maintain adequate internal controls over financial reporting and management's conclusion on the effectiveness of these internal controls at year end. The report must also state that the company's independent public accountant has attested to and reported on management's evaluation of internal controls over financial reporting. In addition, the internal control report must be disclosed in the company's annual report. The U.S. Securities and Exchange Commission's (SEC) implementing rules also require management to disclose certain material changes to internal controls over financial reporting occurring during the most recent quarter.

Section 404 applies to companies filing annual reports with the SEC under either Section 13(a) or 15(d) of the Securities Exchange Act of 1934. These companies include banks, savings associations, small-business issuers and non-U.S. companies. Under the SOX Act, an "issuer" has a class of securities registered under Section 12 of the Exchange Act or is required to file reports under Section 15(d) of the Exchange Act or files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 that has not been withdrawn. Section 404's internal control report requirement applies to all issuers because they are required to

report under the securities laws. Foreign issuers (including Canadian issuers) must comply as well.

The original compliance deadline for "foreign private issuers" (*i.e.*, non-U.S. companies that file annual reports on Form 20-F or, for Canadian companies, Form 40-F) (FPD) was July 15, 2005. Earlier this spring, the SEC extended this deadline until July 15, 2006.

Corporate Governance Becomes A Matter of Federal Law

The Securities Act of 1933 and the Securities Exchange Act of 1934 protected U.S. capital markets through registration and financial disclosure requirements and through broad antifraud provisions. On the other hand, state law has largely dictated the organization of business entities. The legal and accounting professions have largely been self-regulating. However, a spate of corporate scandals, including Enron, unveiled some of the weaknesses inherent in the powers of boards of directors to govern corporations and the failures of accountants and attorneys to identify and report corporate improprieties. Congress drew from these large-scale corporate scandals to develop a framework of corporate government under federal regulation that would effectively create a floor for good governance of public companies. By imposing board audit committees, auditor service restrictions and attorney conduct standards, the SOX Act filled the gap between federal securities regulation, state law concerning corporate governance and professional self-regulation.

Prior to the SOX Act, foreign private issuers could get access to the U.S. capital markets by complying with registration and disclosure requirements. Following SOX, access to these markets further requires foreign corporations to reorganize their organizational structures and business practices in ways that may conflict with the requirements in their home jurisdictions and at great cost in terms of time and money. In essence, SOX requires foreign companies to opt into U.S. congressionally mandated corporate governance parameters or be excluded from access to U.S. capital markets.

SOX's Deterrent Effect on Foreign Private Issuers

Historically, foreign private issuers have hesitated to list in the United States out of concern over disclosure standards, accounting reconciliation requirements and costs in terms of time and money of maintaining their U.S. listings and liability. SOX has exacerbated these concerns. Although foreign companies have continued to list in the United States, there have been exceptions that have decided not to list, citing SOX. For example, Porsche and the Benfield Group Ltd. refused to list in the United States. Others, such as Daiwa Securities, originally postponed their listing to see how Sox caps would be finally implemented. LVMH decided to de-list in the wake of SOX. On the other hand, many other prominent foreign issuers have stepped into the U.S. market after passage of SOX. China Telecom listed after SOX was passed. Telkom SA Limited, a South African company, issued an initial public offering on the New York Stock

Exchange in 2003 after SOX became effective.

Recent studies have shown substantial compliance costs under Section 404 requirements. The Business Roundtable recently reported that 47 percent of 106 companies surveyed this year were reporting estimated costs of more than \$10 million to implement Sarbanes-Oxley requirements. This number represents a substantial increase over the 22 percent reporting such compliance costs of \$10 million or more in 2004.

SEC Approves One-Year Compliance Extension for Foreign Private Issuers

The SEC has recognized the potential deterrent effect SOX has had on foreign private issuers and has been working to reconcile conflicts between SOX and foreign private issuers' home country regulations and practices. In the context of Section 404, the SEC recognized last March the need for additional relief for foreign companies to overcome obstacles such as language, culture and organizational structures that are far different from what is typical in the United States. The SEC has also explicitly recognized the special burden on European companies having to comply simultaneously with the European Union's International Financial Reporting Standards, which came into effect on January 1, 2005, and Section 404 requirements.

Consequently, the SEC decided in March of this year to extend the compliance deadline for foreign private issues under Section 404 from July 15, 2005, until July 15, 2006. The SEC's decision to postpone foreign private issuer compliance with Section 404 recognizes the substantial compliance costs in terms of time and money for such companies.

Despite this respite, foreign private issuers face a number of significant compliance challenges that will keep them busy even under the new timetable. These challenges include:

- Creating and maintaining appropriate audit committees
- Developing effective financial closing and reporting processes
- Controlling service organizations
- Creating and maintaining effective internal audit departments
- Monitoring controls in multi-location environments (affiliates)
- Shortage of U.S. Generally Accepted Accounting Principles competencies
- Developing managerial experience in assessing internal control over financial reporting
- Language considerations
- Creating and maintaining information technology controls
- Assessing internal control in multiple geographical locations
- Designing effective fraud prevention programs

The SEC's one-year compliance extension for foreign private issues should not lead to complacency for affected companies and their legal counsel. The SEC has repeatedly suggested the extra year should help ensure "quality compliance." Consequently, counsel to foreign private issuers must maintain efforts to help their clients achieve compliance by July 15, 2006. Counsel should:

- *Monitor and participate in the SEC rule adoption process.* Although the landscape of SOX compliance has largely been set, counsel should constantly exchange interpretative guidance as to the scope and effect of Section 404. Counsel should also be aware of enforcement actions that have been initiated against corporate counsel in order to improve the provision of their services.
- *Establish appropriate controls and procedures for SEC disclosures.* Counsel must work with internal staff and external auditors to review internal controls to ensure comprehension and implementation of SEC disclosure requirements. The target should not be minimal compliance, but rather "quality compliance."
- *Prepare for new audit committee requirements.* Counsel should understand and review with management and the board all aspects of audit committee requirements, including independence and "financial expert" standards.
- *Discuss requirements with auditors.* Counsel should not be complacent by relying on guidance from auditors. Rather, counsel should proactively seek out an active and ongoing dialogue with the auditors and be prepared to question and document challenges to auditor guidance and conclusions. In other words, counsel should be a cooperative, but independent, source for the company regarding compliance obligations.
- *Evaluate compensation arrangements to ensure compliance.* Discovering and challenging compensation arrangements can be especially sensitive for counsel. Nevertheless, counsel should insist on disclosure and full understanding of all compensation arrangements to ensure full compliance with SOX requirements.
- *Review restrictions on insider transactions.* Much like compensation arrangements, it is essential for counsel to evaluate "insider" transactions. Counsel must be able to determine which insider transactions are appropriate under SOX and which need to be modified or terminated to achieve full compliance.
- *Ensure corporate governance provision implementation occurs prior to first IPO filing.* Counsel must make sure that corporate government compliance occurs *before* the first IPO filing. While this seem obvious, the desire to "rush to market" may drive management to push for IPO filings with not all corporate

governance compliance measures fully implemented under the argument that they will be implemented shortly thereafter. However, SOX requires these measures to be in place prior to initial IPO filings. Moreover, it must be recognized that delays in implementation after filing will put the corporation at risk.

- *Review document retention.* SOX establishes new document retention rules. Counsel must understand the new requirements and take steps to develop appropriate guidance and protocols for all employee levels to ensure full compliance with such requirements.
- *Anticipate heightened SEC review.* Given the federalization of corporate governance inherent in SOX, counsel must anticipate even greater levels of SEC review. Consequently, once initial compliance is established, counsel cannot become complacent. Counsel must constantly monitor SEC directives and interpretative guidance, as well as changes within the company, to ensure the company would withstand SEC scrutiny.

Conclusions

Section 404 compliance requires the active engagement of counsel to the foreign private issuer. Cost and time issues, as well as the “rush to market” thinking of management will require counsel to adopt unpopular positions. However, enforcement actions against foreign private issuers under Section 404 requirements have yet to get under way and counsel will continue to face a compliance “moving target.” Consequently, counsel should focus on achieving quality compliance and not basic compliance. In addition, counsel must ensure that management does not become complacent under the one-year compliance extension. Most companies will find quality compliance much more time consuming and expensive than they originally budgeted. 🔄



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.