THE SARBANES-OXLEY ACT: IMPACT ON JAPANESE COMPANIES AND THEIR MANAGEMENT

DAVID SNEIDER, ALAN CANNON & TOSHIRO MOCHIZUKI[1]
SIMPSON THACHER & BARTLETT LLP

JANUARY 15, 2003

Enacted in response to the Enron and WorldCom scandals, the Sarbanes-Oxley Act of 2002 (the "Act") represents perhaps the most significant reform to the U.S. securities laws since the enactment of the Securities Exchange Act of 1934 (the "Exchange Act"). The goals of the Act are broad and far-reaching, including:

- to make executives more accountable for the disclosure that issuers provide to the investing public and prevent self-dealing;
- to enhance the quality of disclosure that issuers provide to the investing public;
- to strengthen corporate governance generally, including by adding to the duties of independent directors; and
- to eliminate conflicts of interest on the part of accounting firms and securities companies that provide services to reporting issuers.

The Act seeks to achieve these goals in part by significantly expanding the scope and severity of criminal and civil liabilities that issuers and individuals may face for violations of U.S. securities laws.

While the Act is intended to improve corporate disclosure and enhance investor confidence in the United States, its provisions have broad extraterritorial application to non-U.S. issuers registered with the U.S. Securities and Exchange Commission (the "SEC"). On its face, the Act generally does not distinguish between U.S. and non-U.S. issuers, between executives of U.S. and non-U.S. issuers, or between U.S. and non-U.S. professionals. A number of provisions, particularly the requirement that a company's chief executive officer and chief financial officer certify periodic filings made with the SEC, are already effective and do apply to non-U.S. issuers. Many additional provisions in the Act will become effective only through further rulemaking by the SEC. The SEC also has broad exemptive powers under the statutes that it

[1] The authors wish to thank Yoshimi Koshiishi for translating this article.

administers. Historically, the SEC has shown some deference to home-country regulation of non-U.S. issuers or persons. Additionally, at least one member of the U.S. Senate has stated that he did not believe the Act is intended "to export U.S. standards, disregarding the sovereignty of other countries as well as their regulators".[2]

However, the extent to which others, including the SEC, share this Senator's view regarding the Act remains uncertain. In its rulemaking completed to date, the SEC has provided only limited exemptions to non-U.S. issuers or persons from the requirements of the Act and has indicated that it is reluctant to make exceptions for non-U.S. issuers and persons in the absence of a compelling reason to do so. While the SEC may still accommodate to some extent other countries' requirements and regulatory approaches in cases of direct conflict with the Act, Harvey Pitt, then Chairman of the SEC, commented in October 2002 that the SEC "intend[s] to implement fully the Sarbanes-Oxley Act for all companies, foreign and domestic. That is our mandate. And, as we write our rules to implement the Act, foreign companies can expect that many of the new rules will apply to them."[3]

While the implications of the Act for non-U.S. issuers are significant, it is important to note that the Act directly impacts only those Japanese companies that are listed in the United States, otherwise registered with the SEC, or plan to seek listing or registration. Today over 30 Japanese companies are listed in the United States and in recent years the pace of listings on the New York Stock Exchange by Japanese issuers accelerated as a number of companies sought to expand their non-Japanese shareholder base. With regard to non-U.S. companies that do not register with the SEC, the Act is likely to have an indirect impact to the extent its requirements become new global standards that other countries seek to emulate. For example, the changes to corporate governance and disclosure practices in the U.S. brought about by the Act may influence the direction of Japanese securities regulation, as already seen in recent reports that the Financial Services Agency is considering requiring companies to disclose their codes of ethics.

The Act and the rules promulgated thereunder are very broad in scope and very complex. This article provides only a brief overview of the Act, focusing on a number of provisions that we believe may be of particular concern to Japanese companies and their senior management.

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[2] 148 Cong. Rec. S7356 (daily ed. July 25, 2002) (statement of Sen. Enzi).

3 Harvey Pitt, Remarks at the Financial Times' Conference on Regulation & Integration of the International Capital Markets (Oct. 8, 2002) (transcript available at http://www.sec.gov/news/speech/spch588.htm).

1. Holding Senior Executives Accountable

One of the keynotes of the Act is its drive to hold the senior management of issuers personally accountable for their company's disclosure and compliance with U.S. securities laws. New certification requirements and new penalties directed at chief executive officers and chief financial officers are the basic tools for doing so. These provisions apply generally to Japanese companies registered with the SEC and will require the senior executives of those companies to play a far more active role personally in their company's SEC disclosure and compliance than they are likely to have played in the past.

Certification of Public Filings

The Act contains two sets of certification requirements, one under the federal criminal laws, and one under the Exchange Act as implemented by SEC rulemaking. Both require senior management to certify as to the accuracy and compliance with U.S. law of periodic reports, which for Japanese and other non-U.S. registrants will be their annual reports filed under Form 20-F. The certification requirement under U.S. federal criminal law, called a "Section 906 certification" based on the section in the Act that mandates it, became effective immediately on July 30, 2002. A knowing violation of Section 906's requirements is punishable by up to 10 years' imprisonment while a willful violation is subject to up to 20 years' imprisonment.

The certification under the Exchange Act, referred to as a "Section 302 certification", is particularly broad-ranging and will force substantial changes in the internal procedures of SEC-registered companies. Under final rules adopted on August 29, 2002, each principal executive officer and principal financial officer of a non-U.S. registrant not only must certify that the Form 20-F does not contain a material misstatement or omission, but also that, based on the officer's knowledge, the financial statements and other financial information included in the Form 20-F "fairly present in all material respects the financial condition, results of operations and cash flows" of the registrant as of and for the periods presented.[4] This certification is not limited to a statement that the financial statements and other financial information in the report are presented in accordance with generally accepted accounting principles. The SEC has stated that it believes a fair presentation of an issuer's financial condition, results of operations and cash flows encompasses:

- the selection and proper application of "appropriate" accounting policies,

[4] Exchange Act Rules 13a-14(a), (b)(2)-(3), 15d-14(a), (b)(2)-(3).

- the disclosure of financial information that is informative and reasonably reflects the underlying transactions and events, and

- the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows.[5]

Senior management must also certify they have implemented so-called "disclosure controls and procedures" to ensure that information required for inclusion in Exchange Act submissions is recorded, processed, summarized and reported within the mandated time periods. Such controls and procedures should ensure that the required information is accumulated and communicated to the registrant's management, including its principal executive officer and principal financial officer, as necessary to allow timely decisions regarding appropriate disclosure.[6] The principal executive officer and the principal financial officer must also certify that they have both evaluated the effectiveness of such controls and procedures within 90 days prior to the filing of the Form 20-F, and presented in the Form 20-F their conclusions about the effectiveness of the disclosure controls and procedures based on such evaluation.[7] These certification requirements will require senior management to oversee personally their companies' disclosure controls and procedures on an ongoing basis.

It should be noted that the requirements for disclosure controls and procedures do not call for the timely and appropriate handling of just the information that must be filed annually under Form 20-F. Rather, they include the proper processing of material information that the non-U.S. registrant should report promptly to the SEC under Form 6-K, including material information that it must make public pursuant to the laws of its home jurisdiction or the exchanges on which its securities are traded. Thus, the certification requirement requires Japanese registrants not only to implement procedures that will ensure compliance with U.S.

[5] Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 46427 (Aug. 29, 2002).

[6] Exchange Act Rules 13a-14(b)(4), (c), 15d-14(b)(4), (c); see also Exchange Act Rules 13a-15(a), 15d-15(a). One aspect in which the Section 906 certification is arguably broader than the Section 302 certification is the requirement that a registrant's chief executive officer and chief financial officer certify that the report "fully complies with the requirements of" the disclosure requirements of the Exchange Act. See Sarbanes-Oxley Act of 2002 § 906 (emphasis added). One limitation is that a person who falsely makes this certification is subject to criminal liability only if he or she did so knowing the certification is false.

[7] Exchange Act Rules 13a-14(b)(4)(ii)-(iii), 15d-14(b)(4)(ii)-(iii); see also Exchange Act Rules 13a-15(b), 15d-15(b).

disclosure requirements, but also with the disclosure requirements of Japanese securities laws and stock exchange rules.

The Section 302 certification separately requires senior management to examine their company's controls and procedures for financial reporting and control of assets. They must certify that they have disclosed to their auditors and the audit committee of their board of directors, based on such evaluation:

- all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

- any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls.[8]

Senior management of non-U.S. registrants must also certify that they have indicated in the Form 20-F whether or not there were any significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.[9]

A willful failure to file the certification or willfully filing a false Exchange Act certification may subject the certifying officer and the issuer to potentially severe criminal penalties, as well as SEC civil enforcement actions seeking injunctions against further violations plus civil fines. Failing to file or filing false statements may also be additional factual predicates on which government authorities or private plaintiffs could bring actions for fraud.

In order to make the Section 302 certification responsibly, senior management of Japanese registrants will need to become personally involved in the disclosure controls and procedures that generate their companies' U.S. disclosure. At a minimum, they should closely re-examine and change as necessary any existing disclosure and information-gathering processes at their companies to ensure that the necessary data is collected, organized and relayed to them quickly enough for them to decide whether and how it should be disclosed. In addition, the SEC and many U.S. law firms are recommending that registrants form a

[8] Exchange Act Rules 13-a14(b)(5), 15d-14(b)(5).

[9] Exchange Act Rules 13-a14(b)(6), 15d-14(b)(6).

"disclosure committee" within their company that will be responsible for considering the materiality of information and disclosure obligations on a timely basis. Having such a committee is particularly advisable where the registrant is so large that coordination and organization will be vital to ensure timely, accurate and reliable reporting. Finally, it behooves senior management to meet regularly or review contacts with all stakeholders in their companies' disclosure -- their disclosure committee, investor relations department, auditors, audit committee, heads of business units, employees, shareholders, and even the press -- to see how their disclosure and disclosure procedures could be improved.

Prohibitions on Unjust Enrichment

The Act also requires chief executive officers and chief financial officers to refund equity- or incentive-based compensation and capital gains on their companies' securities if financial statements are restated as a result of misconduct. Section 304 of the Act, which is already in effect, states that if a registrant is required to prepare an accounting restatement due to the material noncompliance of the registrant, as a result of misconduct by any person, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the registrant shall reimburse the registrant for:

- any bonus or other incentive-based or equity-based compensation received by that officer from the registrant during the 12 months following the first public issuance or filing with the SEC (whichever comes first) of the financial disclosure being related; and

- any profits realized by that officer from the sale of securities of the registrant during the 12-month period.[10]

It should be emphasized that the chief executive officer and chief financial officer will have to return such compensation and profits even if someone other than themselves perpetrates the misconduct that results in the restatement of the registrant's financial statements. The Act thus attempts to align the interests of such officers on the one hand and employees or shareholders on the other, by preventing officers of registrants that have misrepresented their financial condition from retaining significant compensation while the employees and shareholders are left with a weakened, discredited company. As a practical matter, however, there is no clear enforcement mechanism for these disgorgement provisions in the Act and they may conflict, with laws and legal principles relating to individual liability in non-U.S.

[10] Sarbanes-Oxley Act of 2002, § 304.

jurisdictions, including possibly Japan. As a result, this provision in particular has been criticized for its extraterritorial reach.

Other Measures to Increase Accountability

The Act includes a number of other measures intended to increase the accountability of senior management and prevent self-dealing. They include:

- with certain exceptions, prohibiting registrants from extending or maintaining credit, arranging for the extension of credit or renewing an extension of credit, in the form of a personal loan to or for any director or executive officer of the registrant;[11]

- giving the SEC greater power to bar persons who have violated the anti-fraud provisions of the U.S. securities laws from serving as officers and directors of reporting companies, including by requiring the SEC to demonstrate simply that the person's conduct demonstrates "unfitness" to serve as an officer or director, rather than the previous "substantial unfitness" standard;[12]

- prohibiting registrants from retaliating against:

  - employees who report to or assist in any investigation regarding a violation of U.S. securities laws, where the information or assistance is provided to or the investigation is performed by the U.S. government or a supervisor, or who file, participate or otherwise assist in a proceeding regarding such a violation;[13] and

[11] Id., § 402. This provision became effective immediately upon enactment.

[12] Id., §§ 305, 1105. These provisions became effective immediately upon enactment.

[13] See id., § 806. This provision became effective immediately upon enactment. It is questionable, however, to what extent a corporate "whistleblower" will be able to avail himself or herself of this provision.

o persons who provide law enforcement officers with truthful information relating to the violation or possible violation of U.S. criminal law;[14]

- according to draft rules issued by the SEC, prohibiting officers and directors of a registrant, as well as persons acting under their direction, from taking any action to fraudulently influence, coerce, manipulate or mislead the auditor of the registrant's financial statements for the purpose of rendering the financial statements materially misleading;[15] and

- according to draft rules issued by the SEC, requiring U.S. and non-U.S. attorneys "appearing and practicing"[16] before the SEC to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by a registrant or any agent thereof to progressively more senior persons or entities within a registrant until the attorneys receive an "appropriate response" to the evidence. If the attorneys do not receive an appropriate response, the proposed rules require or permit them, depending on the circumstances, to take such steps as withdrawing from the representation, notifying the SEC of their withdrawal, and disaffirming any submissions to the SEC that they have participated in preparing that is tainted by the violation.[17]

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[14] See id., § 1107. This provision became effective immediately upon enactment.

[15] See Proposed Rule: Improper Influence on Conduct of Audits, Exchange Act Release No. 46685 (Oct. 18, 2002); see also Sarbanes-Oxley Act of 2002, § 303(a). The SEC must adopt the final rules on this subject matter by April 26, 2003.

[16] The proposed rules define "appearing and practicing" before the SEC to include preparing, or participating in the process of preparing, any statement, opinion or other writing which the attorney has reason to believe will be filed with or incorporated into any registration statement, notification, application, report, communication or other document filed with or submitted to the SEC or its staff. See Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 46868 (Nov. 21, 2002).

[17] See Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 46868 (Nov. 21, 2002). The SEC is required to adopt the final rules on this matter by January 26, 2003.

2. Enhancing Disclosure Requirements

Another main focus of the Act is enhancing the disclosure requirements for registrants, including by mandating more frequent SEC reviews and prompter release of information.

More Frequent SEC Reviews

First, the Act requires that the SEC review on a regular and systematic basis, and in any event no less frequently than once every three years, the disclosures, including financial statements, made by registrants that are listed in the United States or traded on the Nasdaq Stock Market. The Act requires the SEC to consider the following factors, among others, when scheduling reviews:

- the issuer has issued material restatements of financial results;
- the issuer experiences significant volatility in its stock price as compared to other issuers;
- the issuer is one of those with the largest market capitalization;
- the issuer is an emerging company with disparities in price to earning ratios; and
- the issuer's operations significantly affect any material sector of the economy.[18]

While the SEC has always reviewed a certain proportion of periodic reports each year, until recently it had tended to focus more on reviewing and commenting on filings made in connection with securities offerings; in the past, some issuers went for more than ten years without any SEC review. These provisions, however, make it certain that the SEC will review at least once every three years the periodic reports that have been certified by the principal executive officer and principal financial officer. If such a review results in the SEC requiring a registrant to correct its past disclosures, particularly its financial statements, it could raise the question of whether or not the certifications were properly made, a matter that at a minimum would be embarrassing for the company and the certifying officers.

Off-Balance Sheet Arrangements and "Pro Forma" Performance Measures

[18] Sarbanes-Oxley Act of 2002, § 408.

In responding to specific abuses encountered in the United States and pursuant to the Act, the SEC has also proposed new, stricter rules regarding the financial disclosure that registrants must provide. One of the most important would require detailed disclosure of all off-balance sheet arrangements that have or may have a material effect on the registrant. The proposals would also generally require a registrant to provide in the "Management's Discussion and Analysis of Financial Conditions and Results of Operations", or MD&A, section of its periodic reports an overview of its aggregate contractual obligations in a tabular format and contingent liabilities and commitments in either a textual or tabular format.[19] For Japanese and other non-U.S. registrants, these disclosures would be made in the MD&A sections of their Form 20-Fs.

Another set of proposed financial disclosure rules is those dealing with "pro forma" financial information, that is, financial information not presented in accordance with generally accepted accounting principles ("GAAP").[20] Under the rules proposed by the SEC on November 5, 2002, a new Regulation G under the Exchange Act would require registrants to accompany any public disclosure that includes non-GAAP financial measures, such as "EBITDA" (earnings before interest, taxes, depreciation and amortization), with disclosure of the most directly comparable GAAP financial measures and a quantitative reconciliation of the non-GAAP financial information to such GAAP financial information. Note that the public disclosure need not be something that is submitted to the SEC in order for it to be covered by this proposed rule. The proposed rules would also amend Form 20-F to require Japanese and other non-U.S. registrants to limit the types of non-GAAP financial information that may be included, and to accompany disclosure of non-GAAP financial information in such reports and filings with equally or more prominent disclosure of the most directly comparable GAAP financial information, a quantitative reconciliation to such GAAP information and a description of the purposes and reason for the use of the non-GAAP financial information.[21]

[19] See Proposed Rule: Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Exchange Act Release No. 46767 (Nov. 4, 2002).

[20] Under the proposed rules, GAAP would refer to U.S. generally accepted accounting principles, except that in the case of foreign companies whose primary financial statements are prepared in accordance with other generally accepted accounting principles, references to GAAP also include the principles under which those primary financial statements are prepared. See Proposed Rule: Conditions for Use of Non-GAAP Financial Measures, Exchange Act Release No. 46788 (Nov. 5, 2002).

[21] See id.

This proposed rule does provide some exceptions for non-U.S companies. For example, Regulation G would not apply to a public disclosure of a non-GAAP financial measure regarding a non-U.S. registrant if the registrant is listed outside of the U.S., the non-GAAP financial measure and the most comparable GAAP financial measure are not calculated and presented in accordance with generally accepted accounting principles in the United States, and the disclosure is made outside the United States or is included in a written communication only outside of the United States.[22] In addition, a non-U.S. issuer may use in its Form 20-F a non-GAAP financial measure that would otherwise be prohibited if that measure is expressly permitted under the GAAP used in the registrant's primary financial statements included in its SEC filings, and the non-GAAP financial measure is included in the annual report prepared by the registrant for use in the jurisdiction in which it is domiciled, incorporated or organized or for distribution to its security holders.

The SEC is required to adopt the final versions of the MD&A and pro-forma rules by no later than January 26, 2003. These proposals are combined with other recent releases proposing rules requiring detailed discussion of registrants' critical accounting policies, particularly key estimates and alternative accounting methods, as well as guidance calling for improvements in disclosure of such matters as liquidity and capital resources.[23] For senior management of Japanese registrants, the disclosure controls and procedures that they will implement, oversee and periodically evaluate will have to accommodate these more stringent disclosure requirements.

Accelerated Disclosure and Interim Reporting By Non-U.S. Companies

The Act requires the SEC to adopt, without specifying by when, "real-time" disclosure rules that would require registrants to disclose on a "rapid and current basis" information concerning material changes in the financial condition or operations of the registrant.[24] The SEC has previously indicated an interest in requiring companies to disclose material information more promptly, as evidenced by its shortening the period of time seasoned U.S. issuers have to

[22] See id.

[23] See Proposed Rule: Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies, Exchange Act Release No. 45907 (May 10, 2002); Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations, Exchange Act Release No. 45321 (Jan. 22, 2002).

[24] Sarbanes-Oxley Act of 2002, § 409.

file annual and quarterly reports,[25] as well as its proposal to amend Form 8-K, the form under which U.S. registrants submit current, material information to the SEC, to require companies to furnish the SEC with information regarding certain material events within two business days of the occurrence of the event.[26]

With respect to non-U.S. registrants, the SEC seems still to be considering whether to depart from the longstanding practice of not mandating interim or current disclosures separate from those of the registrants' home jurisdictions. One indication that they are considering such a departure is in the release proposing rules requiring registrants to disclose their code of ethics and the compliance with such rules. The draft rules would require non-U.S. registrants to disclose in their annual reports on Form 20-F whether they have adopted a written code of ethics that applies to their principal executive officers, principal financial officers, principal accounting officers or controllers, or persons performing similar functions, and if they have not, why not. They would also have to disclose any changes during the last fiscal year to those codes of ethics, and any waiver from those codes granted during the past fiscal year to one of the aforementioned officers.[27] In the release, however, the SEC asks for the public to comment on whether it should require non-U.S. companies to disclose such changes or waivers more frequently:

> Should we require foreign private issuers to file disclosure about ethics code changes and waivers within two days under cover of Form 6-K? Should we otherwise require a foreign private issuer to promptly disclose ethics code changes and waivers?[28]

To the extent the SEC requires non-U.S. registrants to disclose this or other information promptly regardless of whether their home jurisdiction does so, non-U.S. registrants will have to adjust to complying with the current disclosure requirements of both the SEC and their home

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[25] See Final Rule: Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Exchange Act Release No. 34-46464 (Sept. 5, 2002).

[26] See Proposed Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Exchange Act Release No. 46084 (June 17, 2002).

[27] Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 46701 (Oct. 22, 2002). The SEC is required to adopt the final rules on this subject by January 26, 2003.

[28] See id.

jurisdictions, including adopting disclosure controls and procedures that will enable them to do so.

3. Strengthening Corporate Governance

One of the most controversial aspects of the Act is its provisions mandating specific forms of corporate governance. Even with respect to U.S. issuers, these provisions represent a significant encroachment by the federal government into an area traditionally governed by state law. With respect to non-U.S. issuers, it has provoked heavy criticism of the potential extraterritorial application of U.S. regulations to matters traditionally governed by the laws of a company's jurisdiction of incorporation. In particular, the Act requires the SEC to adopt rules that will cause companies that are listed in the United States to:

- establish audit committees within their boards of directors, or have the boards themselves treated as audit committees;
- have the audit committee members consist solely of "independent" directors; and
- state whether any of those members are "financial experts".

As the SEC has yet not issued the final rules regarding these matters, it is not clear yet how these provisions will apply to Japanese and other non-U.S. registrants.

Audit Committees

Section 301 of the Act requires the SEC to adopt by April 26, 2003 rules that direct U.S. securities exchanges such as the New York Stock Exchange and national securities associations such as the NASD to prohibit the listing of any security of an issuer that does not comply with the following rules, among others:

- The board of directors must have an audit committee that is directly responsible for the appointment, compensation and oversight of its independent accountants, or the board itself will be considered an audit

committee. The independent accountants shall report directly to the audit committee.

- Each member of the audit committee must be "independent", which for the purposes of this requirement means that the member, other than in his or her capacity as a member of the board of directors or a committee thereof:

    - does not accept any consulting, advisory or other compensation from the company; and

    - is not an "affiliated person" of the issuer or any subsidiary thereof.

It is thought, however, that the rules to be issued by the SEC will likely broaden this definition.

- The audit committee shall establish procedures for the treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters, as well as for the confidential, anonymous submissions by employees of concerns regarding questionable accounting or auditing matters.

- The audit committee shall have authority to engage its own independent legal counsel and other advisors.

On their face, the requirements of this section would apply to all companies listed in the United States, whether they are U.S. or non-U.S. companies. With respect to existing corporate governance requirements of the New York Stock Exchange and Nasdaq, including requirements for audit committees and independent directors, exemptions have traditionally been available to non-U.S. corporations to the extent the requirements are not in keeping with the laws or business practices of their jurisdiction of incorporation. Japanese issuers, in particular, have typically received exemptions acknowledging their use of a board of statutory auditors *in lieu* of establishing an audit committee.

It is possible, although unlikely, that the SEC will in its rules continue existing practice but require non-U.S. companies listed in the United States to disclose in detail the differences between their corporate governance practices and those generally prescribed by the Act. Alternatively, the SEC may exempt non-U.S. issuers from the requirements in this provision where they would conflict with laws, rules or regulations of the non-U.S. company's home

jurisdiction. A third possibility is that the SEC will exempt non-U.S. issuers from certain requirements even if there is no direct conflict with the issuer's home country law so long as the home country law provides for an alternative mechanism for satisfying the requirements of the Act. For example, hopefully the SEC will allow Japanese companies listed in the U.S. to continue to maintain a board of statutory auditors rather than require them to establish an audit committee, as will be permitted under the Commercial Code commencing in 2003.

Financial Experts

Under proposed rules issued by the SEC under Section 407 of the Act, Japanese and other non-U.S. registrants must disclose in their annual reports filed under Form 20-F the names of the members of their audit committees who are "financial experts" and whether they are independent. If none of them is a financial expert, or if a financial expert is not independent, the registrant must disclose the reason why that is the case. The definition of "financial expert" in the proposed rules, however, is extremely narrow. The rules define a financial expert as someone who, through education and experience as an auditor, or as a principal financial officer, controller or principal accounting officer of a company registered with the SEC, or experience in positions with similar functions, has:

- an understanding of financial statements and the generally accepted accounting principles used in its primary financial statements;

- experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals and reserves that are comparable to those used in the registrant's financial statements;

- experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the registrant's financial statements;

- experience with internal controls and procedures for financial reporting; and

- an understanding of audit committee functions.[29]

[29] See Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 46701 (Oct. 22, 2002).

Given this definition, many Japanese registrants would not be able to claim that they have a financial expert on their audit committees. Moreover, even if the SEC grants some accommodation to Japanese issuers by, for example, permitting the use of a board of statutory auditors rather than an audit committee, it may still apply the financial expert requirement to that board.[30] The SEC will issue the final version of these rules by January 26, 2003.

4. <u>Improving Internal Controls</u>

A proposed requirement that, if adopted, may mandate very specific forms of internal reporting is one calling on non-U.S. registrants to include "internal control reports" in their annual reports under Form 20-F starting with fiscal years ending on or after September 15, 2003. The rules were proposed by the SEC on October 22, 2002 pursuant to a requirement to do so under the Act and are scheduled to be finalized by January 26, 2003. The draft rules call on an internal control report to include:

- a statement that management is responsible for establishing and maintaining adequate internal controls and procedures for financial reporting;[31]
- conclusions about the effectiveness of the registrant's internal controls and procedures for financial reporting based on management's annual evaluation of them as of the end of the registrant's most recent fiscal year; and

[30] Cf. Letter from Naohiko Matsuo, Director for International Financial Markets, International Affairs Division, Financial Services Agency of Japan, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Nov. 29, 2002), at http://www.sec.gov/rules/proposed/s74002/nmatsuo1.htm (requesting that the rules to be issued under Section 407 of the Act be applied with respect to Japanese registrants to their audit committees or boards of statutory auditors).

[31] The proposal defines "internal controls and procedures for financial reporting" to mean controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles as addressed by the Codification of Statements on Auditing Standards § 319 or any superseding definition or other literature that is issued or adopted by the Public Company Accounting Oversight Board. See Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 46701 (Oct. 22, 2002).

- a statement that the independent auditor has attested to and reported on management's evaluation of the registrant's internal controls.[32]

The independent auditors must make the attestation referred to in the third point above in accordance with standards for attestation engagements that are to be issued or adopted by the new Public Company Accounting Oversight Board. According to the proposed rules, the auditors' attestation report will be filed along with the Form 20-F.

While similar in certain respects to the Section 302 certification, one manner in which management's review and assessment of the effectiveness of internal controls and procedures for financial reporting differs is that it is subject to review by outside accountants, who must attest to and report on it. This may further enhance the quality of internal control monitoring and review by management, as the accountants will likely encourage them to examine their internal controls thoroughly given the accountants' own responsibility to review and comment on the examination.

5. Conclusion

The Act implements a wide variety of requirements to enhance corporate disclosure and deter wrongdoing by companies registered with the SEC, regardless of whether they are U.S. or non-U.S. companies. Already in force are the certification requirements that impose personal responsibility on senior management for their companies' disclosure practices. Chief executive and financial officers who fail to be adequately involved do so at significant risk, as the SEC will scrutinize the accuracy of their certifications at least once every three years through reviews of their companies' filings. Additionally, the proposed rules that mandate or encourage enhanced disclosure, changes in corporate governance as well as prevention of corporate malfeasance by employees, accountants and legal counsel are also likely to cause major changes in the practices of registrants, but it remains to be seen to what extent the SEC will respond to the increasing calls for accommodation of the conflicting or differing laws or practices that govern Japanese and other non-U.S. companies.

[32] Id.