SARBANES OXLEY AND THE GLOBAL CAPITAL MARKET

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DECEMBER 2003

It has been more than a year now since the U.S. Congress enacted the Sarbanes-Oxley Act of 2002 ("SOX"). The passage of SOX was the culmination of an intense effort on the part of Congress to restore investor confidence in the U.S. capital market in the wake of accounting, disclosure and trading-related scandals that implicated some of the nation's largest commercial and financial institutions. Swept up in that effort, and with virtually no discussion, were decisions about the role of the U.S. capital market as a global market and the way in which the U.S. Securities and Exchange Commission (SEC) regulates that global market. Specifically, decisions were taken regarding the extent to which the SEC will regulate the corporate governance structures and internal risk management and information gathering processes of foreign private issuers, the scope and nature of their relationship with outside accountants and legal counsel and aspects of their relationship with management. These issues go well beyond the traditional disclosure items that have been the focus of past concern by foreign private issuers and constructive accommodation by the SEC staff. In the process, notions of regulatory harmonization and convergence, comity and mutual recognition that have begun to spring up around the world, particularly in Europe, have been thrown into question at a time when development of these concepts seems increasingly important to enhance capital market efficiency and promote market-oriented, cross-border capital flows.

The SEC's response to the challenges presented by SOX insofar as foreign private issuers are concerned has been two-fold. First, they have made a significant effort within what they see as the legislative constraints to accommodate problems foreign private issuers have initially presented regarding their ability to comply with specific SOX requirements. Second, the Commission has made clear that, with these exceptions, SOX applies and will be applied equally to domestic and foreign private issuers. The implications of this latter approach balanced against the accommodative steps taken by the SEC staff raise important questions about the impact of SOX on the continuing development of global capital markets.

SOX was enacted against an interesting backdrop in terms of foreign private issuers that have already registered securities with the SEC. According to the latest official SEC statistics there are 1,319 foreign private issuers with registered securities that were current in their ongoing reporting obligations under the Securities Exchange Act of 1934. Of that number 498 or 38% are Canadian, 364 or 27.5% are European, 136 or 10% are Latin and South American, and 126 or 9.5% are Austral/Asian. These statistics are telling in a number of respects. First, the likelihood that real compliance is possible, although not without some grumbling, is great for at

least Canada and Europe, which represent the bulk of the issuers. Second, Latin/South America and Austral/Asia represent less than 20% and if you exclude Australia, Hong Kong and Singapore less than 15% of that total represents countries with developing economies and/or developing corporate governance regimes.

From this vantage point SOX must be viewed not just in terms of the burden it imposes on the relatively small number of foreign private issuers from developing countries presently subject to SOX but, more importantly, in terms of its impact on the populations of prospective issuers from those countries and, to a lesser extent, from developing Eastern European countries. For the former, the issue is whether, already being subject to SOX, they can really comply with the corporate governance, internal procedure and other requirements or whether apparent compliance will lead to undue investor confidence or possible liability for compliance failures. For prospective issuers, the impact of SOX on the current registrants will affect their desire to list in the United States. In any event, the absence of deep and liquid financial markets in virtually all of these developing countries provides a strong incentive to meet the new requirements. Meeting all the SEC requirements, including SOX, not only provides access to the world's largest and most liquid capital market, it provides a degree of credibility that an issuer's disclosure is transparent and its corporate governance is structured to assure that transparency.

This places the U.S. capital market and SOX squarely in competition with the only other alternative, which is London and the other European markets. To be sure, they can't presently match the U.S. capital market in size or liquidity, but they are moving in that direction.

For established European issuers the perspective is somewhat different. For most of the existing population of European registrants, the U.S. market is not the principal market and there are real cost considerations associated with SOX compliance that naturally generate questions regarding whether it is worth the effort and expense. Their reservations about continued listing in the United States will be heightened by the fact that most U.S. institutional investors have a European based trading capability and the bulk of the trading by these institutions in their shares takes place in Europe. The situation for prospective European issuers is made even more difficult by the fact that they need to comply with International Accounting Standards by 2005 and they would naturally be reluctant to engage in a U.S. GAAP reconciliation exercise at the same time. Nonetheless, the population of prospective European registrants is large and growing and their capital market choices will have a significant impact on the size, shape and role of the U.S. capital market in years to come.

The impact of SOX on European issuers will also be affected by the developing convergence that is bringing U.S. and EU regulatory and disclosure regimes closer together. Convergence reduces compliance burdens and encourages multiple market access, the range and extent of which is determined by market forces and not regulatory cost. In Europe the process of convergence is well underway. The EU's Financial Services Action Plan and the related directives are moving the EU more closely into line with the U.S. regulatory regime. On the disclosure side, the Prospectus Directive adopts IOSCO disclosure alongside SEC

incorporation of IOSCO into its disclosure and reporting regime for foreign private issuers. Concepts of periodic reporting and timely and non-selective disclosure are also working their way into the EU regime.

Most important of all in this process is the joint effort by the U.S. Financial Accounting Standards Board and the International Accounting Standards Board to harmonize U.S. Generally Accepted Accounting Principles with International Accounting Standards. The progress towards market integration and reducing the regulatory burden of multiple market access will, in large measure, turn on the success of this effort.

There is, however, a limit to that progress. The EU is bringing its member states' financial markets together under the combined principles of harmonization and mutual recognition. Mutual recognition allows issuers from one EU state to sell securities in another, while essentially remaining subject to home state regulation. The EU wishes to have mutual recognition also apply between the EU and the U.S. markets. The Commission, on the other hand, believes that the relationship between the EU market and the U.S. market should be based on harmonization and not mutual recognition, thereby creating close, but parallel, markets. The SEC view of mutual recognition is reflected in the comment of SEC Commissioner Roel C. Campos that mutual recognition would mean "having rules that differ depending on the origin of the market participant...[which would] lead to an incoherent, fragmented market."

As the EU and the U.S. capital markets converge, and the costs associated with dual compliance decline, the mutual recognition debate will recede in importance, as common sense and good judgment ought to drive the rules, as well as their enforcement, into alignment. Once that alignment occurs, some aspects of mutual recognition may, in fact, be found to enhance market efficiency without compromising basic principles, provided the necessary enforcement structure is put in place. In the meantime, and that may be some considerable time, the losers may well be the U.S. retail investors, as EU issuers confine their fund raising to the EU market and U.S. institutional investors expand their EU trading capabilities to invest and trade in securities of EU issuers. This could lead to a top-heavy shareholder mix that lacks the depth, liquidity and stability that would be enhanced by a large U.S. retail component.

Turning to the developing countries, the dynamic changes quite considerably, and the Eurocentric debate regarding harmonization and mutual recognition is muted by the less developed state of local capital markets and corporate governance structures and practices. In addition, the relative positions of institutional and retail investors move closer together as there is, in many cases, no local market that provides a reasonable alternative trading venue for either one. A cause for concern is that these markets simply may not have developed sufficiently to the point where issuers are able to comply with the full panoply of U.S. regulations.

Experience has shown that the problem is not so great in the traditional areas of disclosure or accounting. The historic SEC accommodations have worked well there. The passage of SOX has, however, added a new dimension, which goes beyond the established disclosure-based compliance architecture to regulate corporate conduct. Whether these new

requirements will act as a U.S. listing barrier to foreign private issuers from developing countries largely remains to be seen, as the application of the rules has not been fully brought to bear at this point. In the view of Commissioner Campos, different regulatory, legal, political and economic systems must be taken into account, and particularly in regards to SOX, the SEC has "…made accommodations for foreign market participants where such accommodations are necessary to avoid undue burdens or conflict of laws, while still fulfilling the letter and spirit of [SEC] legal mandates."

There is another dimension to the issue beyond those of burden and conflict with local law. This is whether there exists a corporate culture that will accept our notions of corporate governance and actually live by them and whether there are individuals within developing markets who have the background, skills, independence and, in some cases, the courage to stand up to management.

Whether we have set the bar too high or whether SOX will cause foreign private issuers to change their corporate culture and comply in substance with SOX as a prerequisite to U.S. capital market entry remains to be seen. Suggestions that liability will be imposed for violations do not present an entirely satisfactory solution, as enforcement actions will serve to further discourage foreign private issuers from entering the market.

At this point it is important to watch developments closely and possibly consider a more disclosure-oriented approach. A regulatory framework that leaves foreign private issuers paying lip service to U.S. notions of corporate governance does not serve the interests of U.S. investors, who should be realistically informed of the risks associated with the management structure of an issuer, or the interests of foreign issuers, who may be risking enforcement actions and significant personal liability as the price of market entry.

The legislative history of SOX does suggest that the Commission has the power to make accommodations to foreign private issuers. If SOX does act as a deterrent to U.S. listing, investor protection considerations may stimulate a different approach to fulfilling the "letter and spirit" of the Commission mandate embodied in SOX. A slightly tilted playing field may be better than no playing field at all for both U.S. investors, foreign private issuers and the global capital market.