The Brave New World Of Sarbanes-Oxley

By **Harvey Pitt** and **Suzanne Dans**

In 1993, a wise Japanese observer euphemistically, but accurately, characterised serving as a corporate executive as a '10,000-aspirin job', which makes one wonder how high the aspirin count has soared in the intervening decade. The implosion of so many companies in recent years, and the legislative, regulatory and prosecutorial responses to them, give cause for all of us to head for our medicine cabinets. So, take two aspirin before reading this article, which discusses the Sarbanes-Oxley Act of 2002 and its global ramifications.

To respond to a series of critical business failures, S-Ox, as Sarbanes-Oxley is affectionately known, imposes stringent new requirements on public companies whose securities are listed on a US market. And, for good measure, S-Ox deliberately applies to non-US companies and professionals having some nexus to US markets. In the short term, therefore, more than a few non-U.S. companies have rejected listing their shares in the US – citing the high compliance costs imposed by S-Ox, as well as the fertile field for litigation it facilitates, among other reasons. These are rational business decisions based on logical cost-benefit analysis. In the long-term though, compliance costs will decrease, and the greater transparency that these regulations bring about will permit markets to value a company's stock more precisely. The cost-benefit analysis will undoubtedly change. In fact, companies that don't provide the same level of transparency as their counterparts listed on a US market may find their stock prices discounted.

BACKGROUND ON SARBANES-OXLEY

Shortly after I became Chairman of the Securities and Exchange Commission (SEC) in August 2001, we were confronted with the tragedy of September 11th. Although occurring in the US, capital markets around the world felt its effects, demonstrating their interrelationship and mutual dependency. This despicable act of terrorism was followed by breathtaking US corporate collapses, reflecting a failure of corporate governance as well as corporate malfeasance, misfeasance and nonfeasance. The first in a series of corporate implosions occurred with the dramatic demise of Enron Corporation, and didn't stop there. Companies like Royal Ahold, Parmalat and MobilCom proved this wasn't a phenomenon limited to the US.

In the US, these scandals produced adverse investor reactions, and the value of world equity securities fell. The stunning scandal and top-line financial fraud of WorldCom provided the climax. At that point, the magnitude of the corporate implosions was staggering. It was front-page news everyday. It occurred as more Americans than ever before were invested in the stock market. More than 53% of American households participate in our securities markets, and they demanded action.

FOR THE US, THIS IS THE MOST IMPORTANT SECURITIES LEGISLATION AFFECTING PUBLIC COMPANIES SINCE THE SECURITIES AND EXCHANGE COMMISSION WAS ESTABLISHED SEVEN DECADES AGO

They also voted with their feet — in 2002, for the first time in a decade-and-a-half, US investors withdrew more money from stock mutual funds than they deposited.

Americans also voted through their elected representatives. S-Ox was overwhelmingly passed into law. For the US, this is the most important securities legislation affecting public companies since the SEC was established seven decades ago. The reforms wrought by S-Ox are broad ranging, including provisions affecting the regulation and governance of the accounting profession, disclosures by public companies, corporate governance and enhanced criminal penalties for securities fraud. Of course, everything uncovered since Enron's fall was already illegal. The malefactors have been confronted with an onslaught of civil and criminal prosecutions, all of which claimed legitimacy in laws already on the books before the dastardly deeds occurred. But that didn't mean there was no need for new regulations or regulatory activity. Government helps ensure market participants operate in an environment in which certain fundamental principles that benefit the markets, and our economies, as a whole apply. When a crisis of confidence occurs, it is critical to provide assurances that we've learned from history and won't repeat it. Thus, legislation like S-Ox, and the extensive rulemaking it obligated the SEC to undertake, were necessary – not to ensure conduct that was already illegal became even more illegal, but rather, to ensure that excuses, ambiguities, oversights, inattentiveness and venality had even less justification.

IN THE LONG RUN CORPORATIONS THAT CHOOSE NOT TO RAISE CAPITAL IN US MARKETS BECAUSE OF THE CONCOMITANT S-OX OBLIGATIONS WILL DO SO AT THEIR PERIL

EXTRATERRITORIAL REACH OF SARBANES-OXLEY

S-Ox extended the reach of US regulatory jurisdiction, and this caused consternation, especially in the EU. Thus, it's essential to understand *why* US rules have extraterritorial reach, and the extent to which that's appropriate or critical. To be sure, the primary focus of US securities laws is to protect US investors and promote the quality and performance of US capital markets. But, when entities transact business in a foreign country, by definition they subject themselves to the possible jurisdiction and oversight of foreign regulators. We saw that when the EU prevented two US companies — GE and Honeywell — from merging due to European competitive considerations.

Equity capital is finite. Since a US investor can invest in US or foreign companies, there's competition for every one of his or her equity dollars. Competitors for those dollars should compete pursuant to the same general standards. If not, some will have an unfair competitive advantage. Worse, disparities in regulatory constraints may cause those subject to higher standards to seek to evade them. A statute with extraterritorial reach isn't, therefore, uncommon or even unjustified. Those who play in the same market should be bound by *similar* standards. Of course, the emphasis should be on developing and applying 'similar', not *identical* standards. That's because global markets, governed by global regulators, require global accommodations. The US in general, and the SEC in particular, has frequently recognised this principle and continues to do so. For example, the SEC extended the deadline for non-US companies to comply with certain of its new rules under S-Ox to July 2005, while most US companies must begin complying by October 2004. Similarly, the SEC granted a series of exemptions regarding membership of listed company audit committees, to accommodate foreign practices that would have made it impossible for companies that trade American Depository Receipts (ADRs) in the US to follow S-Ox's black letter requirements.

IMPACT OF SARBANES-OXLEY ON GLOBAL LISTING AND M&A ACTIVITY

One of the largest impacts of S-Ox is its effect on strategies for corporate global expansion: to acquire or not to acquire a company subject to US jurisdiction; to list or not to list on US stock exchanges. At a minimum, the law heightens the level of due diligence required in any merger or acquisition involving a company subject to US jurisdiction. The disparity created by S-Ox between the US's corporate regulatory scheme and that prevalent in the rest of the world is not without precedent. The Foreign Corrupt Practices Act (FCPA) of 1977 created similar ripples. In fact, in the early 1980s, a US company (Ensearch) attempting a hostile takeover of a UK company (Davy) was thwarted after the British Monopolies and Mergers Commission recommended against the proposed merger, in part due to the fact that, after the merger, the UK company would be subject to the FCPA. The Commission feared compliance with the FCPA might place the new company at a competitive disadvantage, compromising "business prospects in certain countries, particularly as European and Japanese competitors will not be subject to the same legal constraints".

Similar concerns are arising today as companies consider global expansion. US companies must be certain that any company they intend to acquire can and does live up to the letter and spirit of S-Ox, for they would run a risk of weakening themselves if those they acquire do not comply with S-Ox. This places a premium on being satisfied *before* acquiring a non-US company that the combined entity will not thereafter run afoul of S-Ox's stringent requirements. One of the consequences of this new fact of life is that it makes hostile acquisitions of non-US companies far more risky than previously was the case. Conversely, non-US companies that acquire US companies may find that, as a result, they are now subject to US jurisdiction and must comply with S-Ox. Otherwise, investors in the acquired companies may be left with an interest in a company not as well governed. At a bare minimum, this will alter the disclosure dynamic applicable to such acquisition efforts.

One conclusion is that, after S-Ox, cross-border acquisitions aren't as simple as they once were. This is a whole new environment. And, apart from the protagonists in a cross-border acquisition effort, the SEC's enforcement proceedings against J.P. Morgan Chase and Citigroup in July 2003, and the massive Citigroup class-action settlement of nearly $3 billion, must mean that financial institutions asked to raise money for these transactions, or opine on their economic fairness, will have even more hurdles to surmount in the face of the application of S-Ox.

So what's a corporate executive to do – besides taking more aspirin? In the short-term, one answer is to adopt a wait-and-see policy. The deadline for most US companies to comply with certain S-Ox rules is October 2004. After a reasonable period has passed, it will be easier to assess the costs of complying with all the new regulations. Since the merger and acquisition market has been relatively weak of late, the cost of complying with S-Ox takes on even greater significance.

While non-US companies wait, many are choosing the known versus the unknown. Listings on the London Stock Exchange through non-US-based IPOs were up significantly, to almost $9 billion in 2003, versus $4.5 billion on the New York Stock Exchange and almost $3 billion on the Nasdaq. Over the past two years, many high-profile companies have rejected listing in the US, including Germany's Dr. Ing. h.c. F. Porsche AG, Japan's Fuji Photo Film, and Russia's United Heavy Machinery. Other non-US companies have sought to de-list from US markets and deregister from the SEC.

To examine why, consider Porsche, which decided in October 2002 not to list on the NYSE, having been invited to do so at the beginning of the year. In a press release, the company cited S-Ox's requirement that CEOs and CFOs attest to the accuracy of every financial statement as the 'crucial factor' or the '[knock out] criterion' that prompted the decision not to list in the US markets. The release explained that Porsche's 'annual financial statement is passed on by the entire Board of Management and is then presented to the Supervisory Board, after being audited and certified by chartered accountants…. therefore there is an overall responsibility covering several different committees and, as a rule, involving over 20 persons, including chartered accountants'. While this was Porsche's business judgment, the release may have left investors questioning why the CEO and CFO refused to attest to the accuracy of their financial statements, including quarterly, and not just annual, statements.

There were other factors of course. Elsewhere, a Porsche spokesperson explained, "We didn't need to boost our already strong image in the US, had no need for stock options, and aren't considering a takeover in the US". These are pragmatic considerations. The high cost of complying with S-Ox §404 — requiring certifications and auditor assessments of every public company's internal controls — was also cited as a factor prompting the decision to eschew US listing. Of course, the §404 rules ensure that corporate constituencies can trust what companies say about their financial performance. Certainly the cost of Directors' and Officers (D&O) ' insurance also must have been a key factor. D&O insurance premiums have risen significantly in the US since 2001 due to increased claims. If S-Ox works as intended, however, the number of claims should decrease along with the costs of coverage.

GOING FORWARD IN THIS NEW ENVIRONMENT

A recent Bank of New York survey of 143 ADR issuers 'found that ADR issuers are complying with [S-Ox] corporate governance standards, and generally view the strict regulations as a positive market development'. While it is surely prudent for non-US companies to see how the effects of S-Ox play out, in the long run corporations that choose not to raise capital in US markets because of the concomitant S-Ox obligations will do so at their peril. US markets remain the deepest and most liquid in the world. Perhaps more to the point, in the future, a deliberate decision not to list in the US may raise eyebrows, while a decision to list in the US may demonstrate strength. As Barron's Market Week recently reported, 'Chinese and other Asian companies … are beginning to list in the U.S., [S-Ox] or no, to convince global investors they can live up to the strictest regulatory standards in the world'.

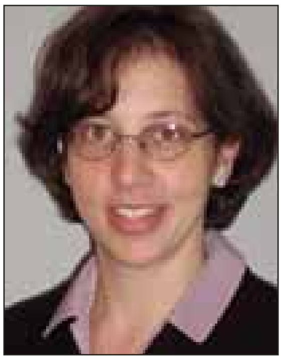
EQUITY CAPITAL IS FINITE. SINCE A US INVESTOR CAN INVEST IN US OR FOREIGN COMPANIES, THERE'S COMPETITION FOR EVERY ONE OF HIS OR HER EQUITY DOLLARS

While S-Ox was prompted by problems encountered in the US, these problems are global in dimension. As a result, numerous other jurisdictions are considering regulatory reforms patterned after, or even more demanding than, those in the US. Many EU countries and the European Commission are re-examining their existing oversight and governance systems. Whether or not foreign regulators follow suit, forces within the marketplace will *require* companies to pursue investor confidence through good corporate governance. For example, rating agencies have indicated they will rate governance in determining debt ratings. This, of course, will have a direct, bottom line, impact on the cost of raising capital in non-equity markets. Similarly, insurance companies, which have been hit hard in making payments on behalf of those companies that have surfaced with problems, will condition the grant of Directors' and Officers and, Errors and Omissions insurance policies, and the premiums for those policies, on the extent to which good governance prevails.

What this means is that, one way or another, wittingly or not, corporations will be compelled to meet new governance standards in order to survive; once they do, our capital markets will again function efficiently as the engines of growth and prosperity they were meant to be.

CONCLUSION

Although complying with S-Ox will be a painful process, at least at the outset, the end results make it worthwhile. With proper planning, the critical information needed to run the business intelligently will flow efficiently from throughout the organisation up to the executive management. The speed and reliability of information that is collected and disseminated should improve, and management will have greater confidence in the numbers upon which they base their decision-making. In a difficult environment, tough standards, exacting procedures, and rigorous policies will be rewarded. You can count on that.



Harvey is the Chief Executive Officer of the global business consulting firm, Kalorama Partners, LLC. Prior to founding Kalorama Partners, Harvey was appointed by President George W. Bush to serve as the twenty-sixth Chairman of the United States Securities and Exchange Commission. He can be contacted at Harvey@kaloramapartners.com

Suzanne joined Kalorama Partners in June 2004. Previously she worked at the Securities and Exchange Commission in several different capacities, including Counsel to the Chairman. She can be contacted at Suzanne@kaloramapartners.com