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Sarbanes-Oxley and All That: Impact Beyond America's Shores

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THE TIMES

The late 1990s was a period of expansion and innovation that comes once a generation. Technological exploitation enabled widespread Internet use and proliferation of telecom infrastructure. In 1996 hardly anyone used email and a minority used cell phones; by 2000, nearly everyone used both regularly.

Heady financial times draw to investing millions of people who lack business knowledge and to business thousands who lack moral scruples. The combination produces exaggeration of achievements and obfuscation of setbacks. With flushness fueling financial fantasies, accounting and governance become obstacles to overcome or burdens to meet, not tools to promote quality financial reporting or disciplined management oversight. The spirit of the times overcomes the spirit of the rules.

The hallucinations of the late 1990s began to end in March 2000, when investors recognized that a financial bubble had arisen and drove stock prices plunging. The unraveling of Enron, a direct product of the era's financial fantasia, began in late 2001 and escalated in 2002. An accounting meltdown at Global Crossing began to tip the dominos in February 2002.

A wave of reported debacles followed in the Spring, but characterized by distinct misbehavior. The widely-publicized cases, Adelphia and Tyco, involved sweetheart insider loans, stories of greed not accounting, except in the same sense that Al Capone's schemes were about tax evasion.

Other accounting corruption stories long in the background became front-page news, including household names like AOL Time Warner, Rite Aid, and Xerox. The parade of disparate, illicit, and over-exposed tales ran to ImClone Systems, whose CEO allegedly told his father and daughter about company prospects in violation of federal securities law.

Investors may have been able to properly classify these unrelated events for a while. Enron and the other ongoing accounting scandals were about ways companies dress up accounts to obscure the truth; the self-dealing loans at Adelphia and Tyco were relatively ordinary (if despicable) incidents of corporate misconduct; events at ImClone concerned arcane regulations governing insider trading. But non-experts in accounting, corporate governance, and securities law aren't good at maintaining these distinctions (especially when they've just lost enormous investment capital).

The gales of Enron and Global Crossing were strong and these other episodes amplified them. The tipping point arrived in June with a pure accounting deception so large there was no turning back from an Act of Congress, even for President Bush and other free-market Republicans–I'm referring to WorldCom, as well as at its capacity-swap trading partner Qwest.

Not coincidentally, several characteristics adorned each of the four massively scandal-ridden companies—Enron, Global Crossing, WorldCom, and Qwest. Most important but least noted is that they were all new: WorldCom went public in 1995, Global Crossing and Qwest both went public in 1997, and Enron revolutionized during the late1990s from a stodgy natural gas company into a broadband and risk management mirage. Also, these four companies, which I call the Big Four Frauds, used more appalling accounting and showed more shocking governance laxity, than other aggressions of the period (or any other). Third, all used as their outside auditor the once-venerable and now dead Arthur Andersen.

The multi-billion dollar scale of the Big Four Frauds wrought proportional personal losses for millions, all amid the imploding financial bubble that stripped several trillion dollars more. The combination produced a natural tendency to overreact, provoking wholesale questioning of the quality of American financial reporting, all around the world.

Some perspective was in order, but rarely broke through. One would have classified the disparate scandals better. This would have emphasized that Enron was essentially a Ponzi scheme, diabolically engineered and disguised by a few pathological fiends; that the other companies suffered from tele-dot-com mania going into the balloon, and tele-dot-com fever when it deflated. More broadly, everyone could have been reminded that when the balloon held helium, few complained of manifestly aggressive accounting when business performance was measured by revenue not earnings, eyeballs hitting Internet sites not dollars customers paid. But victims don't like to be blamed.

SOX

In short, the scandals were neither unique to the US, unprecedented in world financial history, nor unlikely to recur, in the US or elsewhere. Despite such perspectives—unpopular but plausible—cries to do something were loud and could not be ignored. The result was the Sarbanes-Oxley Act of 2002, non-affectionately known abroad as SOX, intended to convey a whiff of its perceived noxiousness. SOX was a populist political response to the scandals just in time for November's mid-term elections.

In the rush to do something, Congress neglected to recognize that it was for the first time both (a) regulating amid globalization and (b) injecting itself into internal governance matters previously articulated by bodies other than Congress or the SEC—both inside and outside the US.

Globalization means that US capital market regulation addresses the world. Ten percent of SEC registrants are foreign, commanding market capitalizations boasting about 20% of the US total. Sixty countries are represented, home to 1400 non-US companies operating in every nook of the globe, triple a decade ago.

When US regulation enters internal governance of SEC registrants, as SOX does, it is no longer purely domestic policy but assumes an international relations dimension. This subtly profound point was missed by US lawmakers who rushed SOX into the global landscape.

Political blindness to the international relations viewpoint was evident from the US failure to consult regulatory counterparts abroad and from the heated political rhetoric accompanying SOX, advertised as the most sweeping reform of American business practices since the 1930s. By US standards, SOX is a codification, fitting easily if clumsily into the US corporate template, more nearly incremental tinkering than substantive reform. This rhetoric-reality gap reflects uncertainty about how bad things were on the one hand and public perceptions that they are certainly awful on the other. Sweeping rhetoric lets the public think Congress is doing something; limited substance enables regulators to hold back in case less is wrong than many think.

SOX IN THE WORLD

For many non-US corporations, the fit is alien, superfluous or conflicting. In exporting US corporate norms by fiat, SOX threatens other nations bearing competing conceptions of corporate performance and ways to manage, measure, and supervise it.

Globalization's hallmark is increasing interdependence of national economies. Its vehicle is cross-border financing, led by US capital markets. Its dominant motif is a move toward traditional liberalism—democracy in politics, capitalism in economics. A requisite for success is gradualism. The greatest risk of exuberant exporting of US corporate norms—the most significant thing SOX does—is backlash against this process. Derivative risks are backlashes against US norms.

Globalization drives some degree of pressure towards global convergence in corporate governance Yet all systems tenaciously cling to historical domestic traditions and corporate philosophies. SOX's attempt to export US corporate norms in the face of such national organic resistance to harmonization provoked international criticism. The protests suggest that SOX threatens varying conceptions of corporate missions.

With few exceptions, SOX's provisions bear conceptions of the corporation that are distinctly Anglo-American. This is not just a simple matter of conflict of laws. True, in some cases there are direct conflicts—as for German corporations under SOX's audit committee rules. But even where SOX is in harmony with home country rules, as in France, SOX bears a cultural emblem that translates poorly.

At stake is how SOX is seen to bear on the varying missions designated for home corporations. US/UK companies share the goal of maximizing shareholder profits, which SOX embraces. In Japan, the goal is expanding power, size and market share, goals SOX-type provisions may or may not advance. In Germany, the focus is survival, a feat threatened by imposing non-German corporate norms. In France, the corporate orientation supports sovereignty enhancement, of boosting the French state, also a conception threatened by US-style norms.

SOX's thrust is audit and control, tools bearing formal resemblance in all vital countries. But audit and control address, test, and verify different underlying accounting data, that is in turn driven by finance and governance peculiarities. They confront different pressure points. Changes in audit and control can drive changes in corporate purpose and governance and maybe this is what SOX's foreign foes fear.

This concern remains credible despite evidence that harmonization movements to date concerning audit and control are capacious enough to sustain competing purposes and governance structures. Examples include EU Directives on the nature of auditing and the true and fair view requirement in financial reporting—both of which SOX affects.

Among SOX's plethora of changes:

- It creates the Public Company Accounting Oversight Board. Peak-A-Boo duplicates regulatory boards in other vital countries, but is likely to develop regulations at odds with those of such bodies;
- SOX compels auditor independence by restricting listed activities, resembling—but not matching—those in other vital countries;
- SOX's auditor rotation rules differ from the approach in other vital countries, and reasonable people could disagree about optimal details.

SOX codifies US norms concerning audit committees, imposing specific mandates and independence requirements differing from those of other vital countries.

SEC BACK-PEDDLING

Following US custom, the Congress directed most of these and other provisions to be implemented by rules of the SEC. During the year following SOX, the SEC produced rules containing accommodations to address its incompatibility for non-US registrants.

Among leading examples: SOX required the SEC to adopt rules requiring disclosure of whether at least one audit committee member is a "financial expert" and, if not, why not, and told the SEC to define the term. For foreign private issuers whose financial statements are prepared in accordance with their home-country accounting principles rather than US GAAP, the SEC makes clear that these provisions refer to that set of accounting principles. So non-US issuers need not worry about having an expert in US GAAP.

SOX required the SEC to adopt rules governing the role and independence of audit committees, many of which conflicted with the law and practice in other countries, including concerning appointing auditors, member independence. SEC rules permit compliance with home-country requirements on these matters, including permitting non-management employees to serve on audit committees, allowing shareholder selection or ratification of auditors rather than the audit committees, and permitting alternative bodies such as a board of auditors to fulfill auditor oversight roles.

SOX required the SEC to promulgate rules requiring publicly-disclosed pro forma financial data to be presented in non-misleading ways with full reconciliation to GAAP. As with the financial expert rules, for non-US issuers preparing financial statements in accordance with their home-country accounting rules, those rules rather than US GAAP are the relevant touchstone. Various provisions of Regulation G exempt non-US issuers if its securities trade on a non-US securities exchange, the non-GAAP measure is not derived from or related to US GAAP measures and the disclosure is made outside the US.

Accompanying regulations expressly prohibit some non-GAAP measures, such as leaving out expenses or liabilities that must be paid in cash. For non-US issuers, the regulation permits non-GAAP measures otherwise prohibited if they are required or permitted by the issuer's home-country accounting rules used to prepare its primary financial statements and the measure is included in its home-country financial statements.

SOX forbids officers and directors to trade securities received by them as employees when the company's pension plan participants are restricted. Violations call for forfeiture of the profits made to the company without regard to intent. The SEC's Regulation BTR implementing this provision makes accommodations for non-US issuers. First, it only applies to foreign private issuers with sizable employee-bases in the US (the number of affected employees located in the US must be greater than either 50,000 or 15% of the registrant's total). Second, it shrinks the pool of persons subject to the provisions by defining officers and directors more narrowly than for US registrants (directors are defined as those who are also managers and officers as limited to the principal executive, financial and accounting officers of the registrant.

Non-US registrants face compliance costs and liability risks. The usual costs of compliance are (1) legal, accounting and exchange fees; (2) registration and periodic disclosure; and (3) reconciliation with US GAAP—most of which rise under SOX, directly in compliance costs and indirectly in liability risks.

Those costs must continue to be compared to the benefits, which are considerable. Chiefly, SEC registration can lower a company's cost of capital by broadening an issuer's investor base. A US listing with SEC registration also furnishes a currency to effect acquisitions in the US and to pay US employees.

GLOBAL MARKETS AND FUTURE US REGULATION

The cost-benefit calculus is increasingly compared to those of alternative international listings, such as the London Stock Exchange, a form of potential backlash. This adds another vector to seeing US corporate regulation as a matter of international relations after globalization, as matters of both comity and competition.

Congress and the President failed to appreciate this new horizon in US corporate regulation. But SOX's relative modesty teaches a relatively cheap lesson. The SEC is learning the lesson as it works to respond to intense lobbying with exemptions of the kind just mentioned. But in the future such steps should not be left to the SEC to take after an Act takes effect—they should be addressed as part of the legislative process. That will pave a smoother road towards global harmonization than attempting to export US corporate norms by fiat.

To implement this view in future US corporate regulation entails several practical requirements. Despite globalization, US securities regulation's traditional dedication to investor protection must not be undermined. Congress and the SEC must conduct vigilant oversight of US capital markets and modify the regulatory environment in accordance with institutional judgments concerning investor protection goals. After all, 90% of SEC registrants are US entities, for which only that supervisory framework is relevant in the US. Whatever one's views on the prudence or scope of SOX, Congress and the SEC properly exercised their prerogatives and mandates in responding to felt needs for US capital market regulation to protect investors.

Injecting an international relations viewpoint into the process would call for Congressional committee hearings to include examination of the global effects of US corporate legislation. In the case of SOX, however, beyond this it need not change anything Congress or the SEC did with respect to those registrants. To recognize this dimension would have meant simply doing before SOX became effective for non-US SEC registrants exactly what the SEC belatedly did after enactment. It took several quarters to do so, but the SEC eventually gave hearings to non-US representatives and exemptions from various requirements of SOX for foreign private issuers for whom those elements were unsuitable from the issuer's viewpoint and unnecessary to achieve the US goal of investor protection.

These steps should be taken beforehand. This can be accomplished with no other change in the legislative process (apart from committee examination of the collateral effects). In the case of SOX, exactly the same process would have been followed, except an additional provision in the Act would have rendered it ineffective as to non-US SEC registrants. The provision could stay effectiveness indefinitely or suspend it until either the SEC elects to declare it effective or until Congress does so following reports from the SEC—a simple reversal of the existing framework that gives the SEC general authority under Section 36 of the Securities Exchange Act of 1934 to exempt issuers and transactions (including non-US issuers individually or as a class) from any Exchange Act provision or SEC rule or regulation if it determines doing so is in the public interest and consistent with investor protection.

The determination to stay or impose effectiveness would depend on a finding that all or some non-US registrants undergo adequate comparable regulatory supervision in their home country so that US investor protection goals are deemed satisfied by compliance. The determination should also ascertain that exemptions would not alter the competitive advantages of US versus non-US companies in raising capital in the US markets or confuse US investors. This determination could be made on a country-by-country basis for most companies ("favored nations") or for particular companies operating in countries that otherwise lack requisite controls but which voluntarily comply with specified international standards ("world class companies"). Canada already functionally has this status through the SEC's multijurisdicitonal disclosure project. The "favored nation" approach would have the virtue of encouraging local corporations concerned with dual regulation in the US and at home to promote home requirements that meet requisite US standards. The key international relations benefit of such a measure is the result creates a measure of voluntary compliance compared to that generated by unilateral fiat such as SOX.

The favored nation approach would also neutralize any risks of US corporations pursuing forum shopping as a way to benefit from temporary or permanent stays of regulatory effectiveness. The minor risk would remain that US corporations could still shop for jurisdictions that while qualifying as recognized foreign jurisdictions remain more attractive for idiosyncratic reasons. The solution to prevent this is simply to develop the federal equivalent of the pseudo-foreign corporation rules of some states (such as California or New York) or the siege social rule of Europe. Nominal incorporation in a foreign state would be ignored for corporations that are functionally US corporations. Measuring this functionality would be done by similar tests, including headquarters location, employee or shareholder or base, or history (for example any company having been created in a US jurisdiction or existing as one during the prior five years would be treated as a domestic corporation without regard to its country of incorporation).

This approach would create a recognized institutional structure through which Congress and the SEC pursue regulation of US capital markets in the future. Non-US registrants would be assured of getting a fair and up-front shake in the regulatory process. The US instantly benefits from the expression of comity it extends. The US may be the host of the party and can certainly invite who it wishes and lay down the etiquette. But part of being a good host is recognizing the right guest list and treating guests with respect. Taking these steps is at bottom a far more common-sense approach than the arrogant hue of SOX, and ultimately far simpler and inexpensive than the very complicated process the SEC was sent through in SOX's choppy global wake.

NOTES ON EUROPE

The European Union's reception of SOX included a blistering list of seven points of objection and produced lobbying effort seeking exemptions. Even so, the criticism from Brussels appeared less intense than that emanating from local European capitals, especially Paris and Frankfurt. Three possible explanations appear.

First, the European Union's willingness to accept some of the rules may be a simple recognition of the governance sense of many of them. Second, SOX's threat is less acute to Brussels at the moment than to Paris and Frankfurt, simply because there are French and German SEC registrants but as yet no SAs in existence let alone listed in the US. The third possibility contains both a speculation and a normative point.

Whether European Union leaders are conscious of it or not, SOX's mandates reflecting rules oriented toward advanced capital markets can be helpful to Europe as she steers her capital markets in that direction. The external imposition of internal uniformity can be a force the various European countries working with one another have failed and never may through those means be able to achieve. It creates an opportunity to generate long-sought harmony for a centralized or at least integrated European stock market, putting together disparate powerhouses in London, Paris, Frankfurt, Zurich, Milan and other capital cities. On the downside, of course, those standards are US products rather than products of international or European development.

There is no doubt that Europe is eager to integrate and deepen its public capital markets, however. The EU steers away from imposing uniform corporate regulations on member states. Doing so through Directives is a cumbersome process. But some degree of uniformity will ultimately be necessary and more of it may be desirable for capital formation, capital cost reductions, and greater competitive power Union-wide. To the extent this must be done by Directive, prospects are not high; to the extent it can be done through securities market regulation, they are much higher. To the extent SOX offers a mechanism to aid the process—directly or through rallying European member states to oppose it in favor of pan-European solutions—Europe may benefit, giving it a source of thrust in the endless give and take that characterizes European corporate harmonization efforts.

Moreover, national legislatures in Europe need not fear that development of European capital market regulation will be used to impose discipline on member states, a feature of US capital markets that keeps Delaware and other competitors for state charters in check in their race to the bottom or top in chartering corporations and regulating their affairs. The risk of such a race in the US is a product of the US conflict of laws principle called the internal affairs doctrine. Corporations can locate and operate anywhere in the US and be governed by the corporate laws of another state entirely. Capital market discipline—through investor action and federal regulatory supervision—keeps states in check.

Europe takes a different view, holding that the law of the corporation's principal place of operations or business governs (the siege social rule). There should be no race to the bottom through simple reincorporation to member states offering favorable charters. There is no need to develop capital markets to impose constraints on such a race. That is a selling point for harmonization efforts through capital markets. The remaining risk of a race to the bottom in Europe is continued fragmentation of her capital markets. That risk emboldens the movement towards linking European bourses, another force given potential power by the controversy over SOX.

European capital market competition—internal and external—thus raises direct issues of modern US international relations. From the US point of view, is it better to advance US norms into Europe or have Europe choose her own? It may be better to allow for experimentation with alternatives that may become attractive for importation into US markets. But if it is better to advance US norms, then is it better to attempt to do so by fiat, as under SOX, or with consultation? European exchange leaders may be more likely to cooperate when the US is cooperative, moving her member states along. They—and more importantly the states—are less likely to do so when the US acts unilaterally.

More broadly, what does the US seek in its relationship with Europe? What outcomes best serve its interests? To see European stock markets driving ahead as competitors, to promote a Pan-Atlantic alliance, to keep European stock markets relatively shallow and illiquid? This is the same recurring debate concerning trade and agriculture, where the US and Europe could together embrace Mercosur or the US could let opportunity slip from its grasp and see a Euro-Mercosur bloc outfox it. Markets will influence this evolution but politics and diplomacy play an important role. The US's stance should be part of the policy process, a key point overlooked by the lawmakers who sped SOX into the world.