

# IMPACT OF SARBANES-OXLEY ON MULTIPLE LISTED CORPORATIONS: CONFLICTS IN COMPARATIVE CORPORATE LAWS AND POSSIBLE REMEDIES

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- I. INTRODUCTION ..... 447
  - A. *Background Conflict with Foreign Corporations* ..... 448
  - B. *Accountant Registration with the Public Company Accounting Oversight Board* ..... 450
- II. LEGAL CONFLICTS WITH THE EUROPEAN UNION IN RELATION TO REGISTRATION WITH THE PCAOB ..... 451
- III. AUDIT COMMITTEE INDEPENDENCE AND RESPONSIBILITIES ..... 452
  - A. *Conflict with Russian Law under Section 301 of the Sarbanes-Oxley Act of 2002* ..... 453
  - B. *The Conflict with German Corporate Law* ..... 454
    - 1. Dual Board System and Audit Committee Independence ..... 455
    - 2. Duty Assignments and the Whistle-blowing Process .... 455
- IV. CONCLUDING REMARKS ..... 456

## I. INTRODUCTION

In the summer of 2002, the United States Congress adopted the Sarbanes-Oxley Act of 2002 as a response to the widely-publicized financial scandals involving the corporate giants Enron, WorldCom, Tyco and others. This sweeping legislation was designed to ensure the personal liability of corporate officers for the accuracy of financial disclosures relating to public companies. The Sarbanes-Oxley Act (Sox) applies to issuers of securities that are required

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to file reports under the U.S. Securities Exchange Act of 1934 (Exchange Act). Sox will also affect over a thousand foreign companies with share listings in the U.S., as failure to comply with the laws could lead to the de-listing of firms whose shares are traded there. To a large extent, companies are flying blind because neither the Securities and Exchange Commission nor the Public Company Accounting Oversight Board has issued final regulations in some of the sections. In trying to address many key issues surrounding the current crisis of confidence in the U.S. system of corporate governance and financial reporting, Sox has created quite a gray area in its interpretation, and the legal experts, auditors, and corporate executives are scurrying to find some conclusive guidance.

Against this backdrop, this paper examines the impact of Sox as it relates to foreign listed companies or multiple-listed non-U.S. companies, as a result of legislations proposed or passed in countries outside the U.S. We will focus on some of possible conflicts between the Act and comparative corporate governance regulations, and the challenges and opportunities arising for legal scholars in the U.S. and abroad as a result of the legislation. Although this study does not propose a complete exemption for foreign issuers from coverage of the proposed rule, and questions whether such an exemption would be consistent with the policies underlying the Sarbanes-Oxley Act. However, we must investigate the scope of either a complete or broader exemption from the requirements for foreign issuers.

Given the present scope of the Act in its proposed format, would the proposals conflict with local law or local stock exchange requirements? Are the problems that the proposals are intended to address dealt with in alternative ways in other jurisdictions? Would any foreign issuers not consider a listing solely because of these requirements? Would any foreign issuers that currently maintain a U.S. listing seek to de-list their securities because of these requirements? This paper attempts to address some these important issues of today.

#### *A. Background Conflict with Foreign Corporations*

To understand the impact of Sox on foreign company, we must fully recognize the scope of the Act as it relates to a non-U.S. company. Sox's plethora of new reporting and corporate governance requirements are targeted to all reporting entities comprising of both U.S. companies and foreign private issuers filing registration statements to offer securities to the U.S. public as per the requirements of the Exchange Act. In this context, a foreign private issuer is defined in SEC Rule 3b-4, and generally includes any corporation or other organization in corporation or organized under the laws of any foreign country unless it meets the following two conditions:

More than 50% of its voting securities are directly or indirectly held of record by residents of the United States; and any one of the following applies:

- The majority of the executive officers or directors are United States citizens or residents,
- More than 50% of the assets of the issuer are located in the United States, or
- The business of the issuer is administered principally in the United States.

A foreign private issuer with 500 or more shareholders worldwide may not have made a public offering of its shares in the U.S. or listed in the U.S., but could have 300 or more shareholders in the U.S. as a result of private placements to U.S. residents or U.S. residents purchasing its shares in foreign markets. Such a company would nonetheless have to register its shares with the SEC and become a Reporting Issuer unless it takes advantage of the exemption by SEC Rule 12g3-2(b). Several hundred companies have taken advantage of this exemption, of which the SEC periodically publishes a list of exempt companies.

Although Sox does not spell out all of the stringent corporate governance measures the companies are grappling with, it manages to impose a wide range of compliance through mandated SEC and stock exchange regulations. Except for some relaxation on reporting frequency, the provisions of Sox as it stands today does not make major distinction between U.S. and foreign issuers of securities. U.S. companies file annual reports on Form 10-K, quarterly reports on Form 10-Q, and form 8-K reports to report certain specified events. Most foreign private issuers file annual reports with the SEC on Form 20-K, or in the case of larger Canadian companies, Form 40-K and do not file quarterly reports or Form 8-K reports (although some foreign companies voluntarily file on Forms 10-K, 10-Q, and 8-K, generally in order to provide a body of disclosure documents comparable to those of their U.S. business competitors). Since much of the information to be reported under Sox is required to be included in these filed reports, foreign private issuers generally are required to provide information annually, whereas U.S. companies (and foreign private issuers that voluntarily report on U.S. company forms) provide various types of information sooner or more frequently. Form 6-K reports, by which foreign private issuers furnish certain information to the SEC, are not quarterly or periodic reports are not "filed". Consequently, various requirements under Sox that apply to periodic or quarterly reports filed with the SEC do not apply to reports on Form 6-K.

Therefore, Sox is generally applicable to all companies required to file reports with the SEC under the 1934 Act ("*reporting companies*") or that have a registration statement on file with the SEC under the 1933 Act, in each case

regardless of size (collectively "*public companies*"). Some of the Sox provisions apply only to companies listed on a national securities exchange ("listed companies"), such as the New York Stock Exchange ("*NYSE*"), or the NASDAQ Stock Market ("*NASDAQ*"), but not to companies traded on the NASD OTC Bulletin Board or quoted in the Pink Sheets or the Yellow Sheets. Small business issuers that file reports on Form 10-QSB and Form 10-KSB are subject to Sox generally in the same ways as larger companies although some specifics vary (references herein to Forms 10-Q and 10-K include Forms 10-QSB and 10-KSB). Sox and the SEC's rules there under are applicable in many, but not all, respects to (i) investment companies registered under the Investment Company Act of 1940 (the "*1940 Act*") and (ii) private issuers domiciled outside of the United States (the "*U.S.*"; "*foreign issuers*"). The rules applicable to these entities differ in a number of respects from those applicable to other entities, but the differences are generally not discussed herein.

#### *B. Accountant Registration with the Public Company Accounting Oversight Board*

Section 101 of the Sarbanes-Oxley Act mandates the creation of the Public Company Accounting Oversight Board (PCAOB). The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports. The objective of this five-member board is to oversee the auditing of public companies. The PCAOB is expected to regulate public accounting firms that prepare audit reports for the companies that fall under the Exchange Act as defined earlier. The issue becomes thorny as according to the provisions of Sox, a foreign public accounting firm that prepare or furnish audit reports for an issuer and a U.S. public accounting firm is treated the same. This therefore, makes it illegal for a foreign accounting firm to participate in the preparation and issuance of audit report of an issuer without having been registered with the PCAOB. Not only does this impose restriction on activities of foreign accounting firms but also cause concern with respect to encroachment of PCAOB in their business practices, a theme we will explore in additional detail. Thus, among Sox's plethora of stringent requirements, the ones that we recognize as stumbling blocks for foreign companies to overcome are:

- Registration requirement with the PCAOB duplicates regulatory boards in other major capital markets. Regulations related to PCAOB are also at odds with those regulatory entities.

- Compels auditor independence by restricting listed activities, without developing equivalence in corporate governance activities in some of the major economies.
- Sox's auditor rotation rules differ from the approach in other vital countries, and reasonable people could disagree about optimal details.

As the corporate governance and transparency requirement of Sox unfolds for the foreign issuer of securities, we find an evolving cascade of conflicts in comparative governance, contradictions in corporate laws in differing jurisdictions. In the following we present some specific examples as to how Sox has unleashed a reign of legal dilemma and provide some suggestions to overcome those conflicts

## II. LEGAL CONFLICTS WITH THE EUROPEAN UNION IN RELATION TO REGISTRATION WITH THE PCAOB

The Sarbanes-Oxley Act has given the PCAOB a wide latitude as the U.S. government tries to enforce corporate governance by forcing compliance. However, the statute forgot to take into account that there are well recognized limits on the outreach of U.S. law and non-U.S. law. Because according to the 3rd Restatement on Foreign Relations Law of the United States, one country's law can only compel a person in another country to perform an Act "to the extent permitted by the law of his home jurisdiction". As a result, we are confronted with several areas of conflict between the comparative corporate governance regulations, some of which we will identify below.

Mandated by a European Directive, there already exists an effective, equivalent registration requirement in all the 15 Member States for all EU auditors. Although the public oversight systems in which these registration requirements are embedded varies as per the different legal traditions of the Member States, but they are fully functional and provide adequate corporate governance guidance. The PCAOB proposals therefore add an unnecessary, expensive second layer of regulatory control for those EU Audit firms that will be subject to registration with the PCAOB. Additionally, Sox's mandate on EU audit firms to register with PCAOB in order to provide audit services to EU and other companies could cause them to infringe on EU and other European national laws. This is an area that needs to be further developed in order to avoid future international relations quagmire. An effective way to circumvent this issue would be to mutually recognize each other's corporate governance regulations, and work towards a framework of equivalence, which can gradually be ratified by both jurisdictions. Anything short of this process would develop an ambience of retaliatory measures so often repeated in the international arena. For example, the EU might impose legislations whereby U.S audit firms would

have to register with all the Member States and be subject to oversight mechanisms by an EU equivalent of PCAOB.

Additionally, Sarbanes-Oxley Act of 2002 was crafted as a response to multi-billion dollar financial loss. Naturally, the overarching reach of the Act brings with it a significant number of new reporting and corporate governance requirements, that are both cumbersome and costly. The PCAOB registration process is no exception. Because of the additional cost and time involved in dealing with an added layer of governance, the smaller EU firms might very well decide not to register with the PCAOB, and thus lose business. Regardless, the chain of events would put the European firms in a competitive disadvantage with respect to their U.S. counterparts, which might eventually have a negative impact on financial markets.

Therefore, the SEC while finalizing the PCAOB rules must take into consideration these apparent conflicts with other jurisdictions. Corporate governance by compliance in this era of globalization should also not forget the accepted principles of international law. Additionally, the sweeping reforms in U.S. corporate governance in the form of Sox can be seen as a harbinger of things to come in the global arena. As we discuss this, the EU policy making board is hard at work implementing corporate governance changes, which the SEC must recognize and amend sections of Sox as it sees fit. After all, harmonization is the hallmark of globalization, and for all the economies to work in unison we must respect each other's laws and adjust ours accordingly. Therefore, the best approach to deal with this situation is to grant a moratorium for all the EU audit firms requiring registering with the PCAOB. This will allow the EU corporate governance reform process to go through and pave the way to establish a mutually accepted approach based on equivalence principle mentioned earlier.

Finally, this sentiment was expressed in a memorandum written to the Chairman of the U.S. Securities and Exchange Commission concerning the Public Company Accounting Oversight Board's (PCAOB) forthcoming rules on foreign auditor registration and oversight. The memorandum contends that the European Union supports the broad aims of the Sarbanes-Oxley Act, but expresses their concern about the draft PCAOB rules, discussed in Washington DC at the March 31, 2002. The consensus among the European Union is that the contents of the PCAOB draft rules and the registration requirements they contain will cause major difficulties for European audit firms.

### III. AUDIT COMMITTEE INDEPENDENCE AND RESPONSIBILITIES

Section 301 of Sox imposes on SEC to direct the U.S. national securities exchanges and the NASD to prohibit the listing of any issuer's security if that issuer does not have an Audit Committee comprised entirely of independent

members. Furthermore, the new listing standards must make explicit that it is the audit committee's responsibility to appoint, compensate and oversee the work of the external auditor and that the audit committee is empowered to engage independent advisors. Let us focus on this issue of auditor's independence that has come under the microscope as having conflicts with comparative corporate government legislations in other parts of the World.

*A. Conflict with Russian Law under Section 301 of the Sarbanes-Oxley Act of 2002*

Sarbanes-Oxley Act prohibits the listing of securities of an issuer if the issuer does not meet the following criteria: (i) the issuer's audit committee members are "independent" as defined by the statute as being unaffiliated with the issuer and not receiving any compensatory fee from the issuer other than for service as a director; (ii) the issuer's audit committee has established procedures for addressing complaints relating to audit issues and permitting employees to anonymously submit concerns regarding accounting or auditing matters; (iii) the issuer's audit committee is responsible for the appointment, compensation and oversight of auditors' and (iv) the issuer's audit committee has the authority to engage advisors and determine compensation for auditors and advisors. The requirement that all members of the audit committee also serve on the board of directors (see Section 10A (m)(3)(A) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")), directly contradicts Section 85.6 of the Russian law governing joint stock companies (the "JSC Law"), which prohibits members of the audit committee from serving on the board of directors as it states: "Members of a company's auditing commission/internal auditor *may not* simultaneously be members of the company's board of directors/supervisory board or hold other positions in the company's governing bodies." In this context, A joint stock company is similar to an American corporation in many respects. Under current Russian law, all Russian companies whose shares are publicly traded are open joint stock companies. Such companies generally use the abbreviation "OJSC" or sometimes simply "JSC" to indicate their corporate form. Other designations arising under earlier legislation governing similar entities are also still seen, including "OAO" and "AO".

Another area of conflict comes in with the interpretation of audit committee as per the intent of Sox. Section 205 of Sox defines the audit committee as being "established by and amongst the board of directors of an issuer" and further specifies that, in the absence of such a committee, the term refers to the "board of directors". However, under the JSC Law, the members of the audit committee are elected by the company's shareholders, not by the board of directors. The term Russian for "auditing commission" is *revizionnaya komissiya*, which could be translated as "inspection commission" as per the

Russian Federation Law on Joint Stock Companies, Section 85.6 (law N. 208-FZ of 26 December 1995, as amended) (the "JSC Law") our discussion herein assumes that, for purposes of compliance with the Act, Russian companies will treat the *revizionnaya komissiya* as the equivalent of an audit committee and that it is the activities of this body which must be brought into harmony with the Act. This has already caused confusion when compared with the provisions of Section 301. Given the fact that, the consequences of non-compliance with the provisions of various sections of Sox are severe, we are at a crossroads as how to deal with situations under Russian law referred here (Section 48.1, pt. 10 and Section 85.1 of the JSC Law give further explanation). This then again calls for revising parts of Section 301, as anything short of that will Russian issuers already listed in the U.S. to lose their listings. Another consequence will be flow of capital away from the already besieged U.S. capital markets. Under applicable Russian law, a Russian company now must be listed on a Russian domestic stock exchange before it can receive permission from the Federal Commission on the Securities Market of Russia for an overseas listing.

It is to be further recognized that the spectacular financial debacles of U.S. corporate giants has caused widespread recognition of enhanced governance and transparency in Russian corporate sector. This prompted the Russian Federal Commission on the Securities Market to adopt a model Code of Corporate Governance. Under its broad provision, the major Russian stock exchanges will be required under penalty of delisting their listed companies to adopt their own codes of governance, with the implied expectation that they track the model as closely as possible in the U.S. Finally, given the fact that Russian corporate governance and transparency is still in its infancy compared to that of U.S., attention must be given as to the evolution of this concept in Russia. In the end, it is incumbent upon the SEC to modify its requirements to accommodate some of the conflicts between Russian law and Sox so as to prevent capital flow away from the U.S.

### *B. The Conflict with German Corporate Law*

Like their European counterparts, German law presents formidable challenge for the German companies to be fully compliant with the broader provisions of Sox. The asymmetry between Sox and German commercial code makes it virtually impossible to be compliant in both jurisdictions. For example, Section 301 of Sox stipulates that a company's Audit Committee be directly responsible for the appointment, compensation, and oversight of the company's auditor. On the contrary, German law imposes on the shareholders to appoint the auditor at their annual general meeting. How can we then prevent a German company issuing shares to U.S. public from being fined by the regulatory authorities in Germany or, even from being delisted from Dax?

## 1. Dual Board System and Audit Committee Independence

To understand why it is difficult to implement Sox directives on audit committee independence, we take a closer look at Germany's two-tier board system. In the German two-tier system of corporate governance, the Management Board is responsible for running the company and a Supervisory Board that is responsible for the appointment and oversight of the Management Board. German law requires companies with more than two thousand employees to have at least six staff representatives and six shareholder representatives on the Supervisory Board. Given that Audit Committee members are typically drawn from the Supervisory Board, the Audit Committee definitely lacks the independence called for in Sarbanes-Oxley.

Thus, the governance in the German company is divided between the *Vorstand* (a management board comprising the corporate officers) and the *Aufsichtsrat* (a supervisory board comprising inside directors, outside directors, and employee and labor union representatives). Since Sox requires a completely independent audit committee, difficulty arises as how to account for that independence. If the *Vorstand* is considered to be the board of directors for the purpose of U.S. law, the *Aufsichtsrat* might come close to achieving independence requirements of the audit committee. However, if German Law's requirement of *Aufsichtsrat's* employee representation is to be complied with, it is probably not possible to exclude employee representation entirely from any *Aufsichtsrat* audit committee. Therefore, without making any adjustment to the SEC requirements, it is virtually impossible to have full compliance in both jurisdictions.

## 2. Duty Assignments and the Whistle-blowing Process

Sarbanes-Oxley requires the audit committee to appoint auditors, determine their compensation, oversee their activities, and decide what non-audit services they may perform. The German stock corporation law (*Aktiengesetz*) assigns the appointment responsibility directly to the shareholders, although the *Aufsichtsrat* selects the auditors to propose to the shareholders and negotiates the terms of engagement. While the *Aufsichtsrat* could exercise some of the auditor oversight functions contemplated in Sarbanes-Oxley, the German Commercial Code requires the *Vorstand* to review and comment on the audit report. This presents a legal dilemma under the *Aktiengesetz* whether the *Aufsichtsrat* can undertake the responsibility of negotiating non-audit services, or whether this function must legally go to the *Vorstand*.

A significant reform envisioned in Sarbanes-Oxley is the whistle-blowing protection accorded to employees. The U.S. requirement for direct audit-committee supervision of the whistle-blowing process comes in conflict with the

German law. Because, German law allows the audit committee to review auditor interim reports and statements of critical accounting prior to the review by the *Vorstand*. There is no requirement of an audit committee to supervise the whistle-blowing process directly. Again this conflict can be resolved if SEC allows the *Aufsichtsrat* to act as a general supervisory authority for U.S. law purposes. There are other aspects of German practice and U.S. law that appear incompatible, or have not been given enough time to determine if achieving compliance under both jurisdictions is feasible. One thing is thus for certain, that SEC must provide more time to German issuers to come up with structural requirements that allow them to be compliant in their home jurisdiction as well.

#### IV. CONCLUDING REMARKS

Sarbanes-Oxley Act was developed, keeping in mind, among other things, the theme of globalization in the capital markets. Although globalization is continuously striving towards achieving convergence in corporate governance across all economies and capital markets, a fundamental lesson in history is amiss here. It is a given fact that all corporate philosophies are borne out of historic domestic traditions, which in turn define the legal governance structure. Therefore, whenever, a newer norm is to be instituted the historical context and corporate norms provide organic resistance to the changes. Sox's attempt to export unadulterated U.S. corporate philosophies not only evokes national sentiments but also provokes widespread international criticism. The legal conflicts and contradictory governance issues suggest that Sox fails to harmonize corporate norms by not balancing differing jurisdictional requirements.

Problem lays in the fact that, legislative intent and resulting corporate requirements are distinctly Anglo-American. This is not just a simple matter of conflict of laws, as law comes from distinct philosophies and cultures. As we find, in some cases there are direct conflicts, such as with German commercial codes, which are embedded in very different cultural norms. Even when Sox is addressing inadequacies in some corporate governance, we find them very difficult in its applicability, such as, in case of Russia. These two provides two extreme examples, as the conflicts with other jurisdictions fall somewhere in between.

The hastily crafted provisions of Sarbanes-Oxley Act are perceived as overwhelmingly overbearing for home corporations. Because Sox is enacted with only one agenda in mind, that of maximizing shareholder profits, it comes in as out of place with some corporate governance regulations. For example, in Japan, the goal is expanding power, size and market share, goals stringent provisions of Sox may not advance. In Germany, the focus is survival, and as a result, we find the statutes of Sox probably are in sharp contradictions with German laws. We must keep in mind, that overemphasis on audit and control

might stymie the goal of expansion of capital markets. And, that is perhaps what the foreign corporations are worried about.

The Sarbanes-Oxley Act of 2002 applies not only to American issuers but also to foreign issuers subject to SEC reporting requirements under the 1934 Act. However, as we have shown in the preceding paragraphs, for many non-U.S. corporations, the fit is either superfluous or conflicting. In response to embarrassing breakdown of corporate governance norms driven by unbridled executive greed, the government hastily crafted a legislation more to save face than with much forethought. As a result, this has become nothing more than a naked exporting of U.S. corporate norms by fiat, threatening other nations bearing competing conceptions of corporate performance and ways to manage, measure, and supervise it.

Finally, globalization is nurtured via increasing interdependence of national economies. It is bolstered by cross-border financing and inter-flow of capital markets. Its dominant theme is a move toward open economy and political liberalism, which must be brought forth gradually. Sox's goal of exporting unadulterated U.S. corporate norms might cause backlash against this process. To prevent this, SEC must recognize comparative corporate governance regulation in other countries and work toward modification of Sox based on the principle of equivalence and reciprocity.