2003

Regulating Corporations: Who's Making the Rules

Roberta S. Karmel

REGULATING CORPORATIONS: WHO'S MAKING THE RULES?

Remarks by Hannah Buxbaum*

Dean Nye, in his lecture on American power,[1] asked us to visualize a three-layered chess game in which geopolitical strategies were played out. Most of the discussions at this meeting have, for obvious reasons, focused on the top board in that game, the one on which military power is exercised. This panel looks instead at the middle board, where economic regulatory power is exercised, focusing on the power of states to regulate corporations and their activity on securities markets.

Questions of U.S. power and U.S. policy in this area are not new. Both the Securities and Exchange Commission (SEC) and the courts have addressed the extent to which foreign countries should be subjected to U.S. disclosure requirements and antifraud provisions. But the questions of power and policy have been sharply focused by recent events. In 2002, in the wake of Enron's collapse, Congress enacted the Sarbanes-Oxley Act. This legislation goes further than other securities laws both in its explicit application not only to foreign issuers but also to foreign auditing firms and in its regulation not only of securities activities but of some areas of internal corporate governance.

Our distinguished panel will discuss U.S. regulation of corporate activity in light of this new legislation. The panelists are Paul Dudek, previously with Cleary Gottlieb Steen & Hamilton and now chief of the Office of International Corporate Finance at the SEC; Roberta Karmel, formerly an SEC Commissioner and now professor at Brooklyn Law School and codirector of its Center for the Study of International Business Law; and Edward Kwalwasser, group executive vice president at the New York Stock Exchange.

Remarks by Paul Dudek**

In discussing how the Securities and Exchange Commission (SEC) regulates foreign companies whose securities trade in the United States, it may be useful to begin with some background on the kinds of companies we are talking about.

There are three ways foreign companies can access the U.S. securities markets. The first is to have their securities trade in the over-the-counter market. This is basically a market between brokers; it is fairly illiquid and often not very transparent. There is minimal contact with the SEC, and these companies do not have to comply with SEC disclosure requirements. Because they do not comply with our requirements and make filings with us, they do not really have the benefits of our market. These companies cannot raise capital in the United States in a public offering and are not permitted to trade on our most liquid markets: the New York Stock Exchange, the American Stock Exchange, and the NASDAQ Stock Market.

The second way for companies to access the U.S. market is to do a private placement in the United States—the company raises capital privately in the United States. Again, there is minimal SEC regulation: a private placement does not have to comply with our disclosure requirements, although there must be some compliance with our procedural requirements relating to private offerings. These securities are sold only to larger

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[1] Joseph S. Nye, Jr., *The Information Revolution and the Paradox of American Power*, 97 ASIL Proc. 67 (2003).

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institutions, so there is no retail distribution. The most important aspect of privately placed securities is that they are not freely tradeable within the United States, so if one of the goals of the foreign company was to diversify its shareholder base, more likely than not, those securities are going to end up back in the home market because it is not really possible to create a liquid market in the United States for privately placed securities.

Finally, the third way foreign companies can access the U.S. market is through a full SEC registration. This entails a public offering just like one by a U.S. company, and a full listing on a market like the New York Stock Exchange. This is the universe of companies we will be talking about today, companies that are registered with the SEC and that trade on markets like NASDAQ or the New York Stock Exchange.

The SEC has long-standing initiatives designed to facilitate foreign issuer access to the U.S. markets. The SEC views foreign listings in the U.S. market as benefitting several constituencies. I think of it as a win-win-win situation: Investors win because they have increased investment opportunities. They can more easily diversify their investment portfolios while buying and selling securities on a regulated market in the United States. Foreign issuers win because they have access to a liquid and deep capital market in the United States; they also can diversify their shareholder base and more easily use their stock to effect acquisitions in the United States. Markets also benefit because cross-border listings increase the integration of the entire global economy.

Although there are accommodations the SEC has designed to make it a little easier for foreign companies to register with the SEC, by and large, the disclosure and general requirements that apply to U.S. companies apply to foreign companies as well. The annual report of any U.S. company and the annual report filed with the SEC by any foreign company will give largely the same kind of disclosures. In the business discussion of what the company does, or in the results of operations section explaining why a company made or lost money, the same kinds of things are disclosed by a U.S. company or a foreign company.

One important area where there is a need for comparison is the area of financial statements. A foreign company that registers with the SEC is required to prepare its financial statements and have them audited by an accounting firm that is independent by U.S. standards. The financial statements must be audited in accordance with U.S. generally accepted auditing standards (GAAS), and they must have been prepared in accordance with either U.S. generally accepted accounting principles (GAAP), foreign GAAP (home-country GAAP), or a set of principles known as International Accounting Standards (IAS). In the last two cases, the financial information from home-country GAAP or IAS must be reconciled with U.S. GAAP. This is a numerical reconciliation so that investors can see what net income is, or what shareholders' equity is, under home-country GAAP and can then see the adjustments that would be made under U.S. principles and a bottom-line net income number in accordance with U.S. GAAP.

For several reasons it is fairly important in this era to hold foreign companies to the same basic disclosure standards as U.S. companies, not only for textual disclosure but also in the financial statements. One reason is investor protection. It is important that investors have comparable information about the companies in the same industry. If a U.S. investor is looking to invest in an automobile manufacturer in the United States, on the New York Stock Exchange you will certainly find Ford and General Motors but also Daimler-Chrysler, Fiat, and Toyota. U.S. investors should be able to compare all those companies on the same basis. From the flip side, those companies are competing for the same pool of investment capital. To maintain a level playing field between foreign and U.S. companies, they must all be held to the same disclosure standards, especially in the area of financial statements.

Even though the same broad or general disclosure principles apply to foreign companies as to U.S. companies, the SEC has fashioned various formal and informal initiatives to make the SEC registration process a little bit more palatable for foreign companies. Let me review some of them quickly.

Foreign companies are exempt from the proxy regime that U.S. companies are subject to. Foreign companies also have more time to file their annual reports with the SEC; U.S. companies must file three months after the fiscal year end (the end of March for a calendar-year company). Foreign companies have six months.

Another significant accommodation is that interim reports can be made on the basis of home-country rather than SEC disclosure requirements. A U.S. company must file quarterly reports with the SEC and give notices and file reports when certain events happen, such as a change of auditors or a significant acquisition. For foreign companies, however, we rely on the home-country reporting regime: For a UK company listed on the London Stock Exchange, we would get during the year the interim reports the company filed with the London exchange; for a Canadian company, those filed with a Canadian exchange such as the Toronto Stock Exchange; for a Hong Kong company, those filed with the Hong Kong Stock Exchange. In this way, the secondary market information that is available in the home country supports the secondary market in the United States, because for the vast majority of foreign companies, the United States is a secondary and not the primary listing.

Another area where there is a significant accommodation relates to disclosure of executive compensation. When the rules were first developed by the SEC some decades ago, there was concern that they were very intrusive; that executive compensation was very personal information and that one thing that would deter a CEO from deciding that his company should list on the New York Stock Exchange would be having to reveal his salary. That is why foreign companies have been exempt from the general requirement to disclose compensation of executives by name. Interestingly, through the 1980s and certainly through the 1990s and the early 2000s, there has emerged a trend around the world for more executive compensation disclosure, most notably in Canada and gradually in Europe. From a governance point of view, other countries seem to be following the U.S. lead on disclosure of executive compensation, realizing that it is useful information for making investment decisions.

The U.S. market has been very successful in attracting foreign listings to the United States. In 1981, there were 173 foreign companies registered with the SEC. In 1991, there were 439, and right now there are just over 1,300 foreign companies registered. The range has also changed dramatically. Twenty or even ten years ago, most of the foreign companies registered with the SEC were from Canada, along with some of the big companies from Europe. Now there are listed companies from all over Latin America, many from Asia, some from Eastern Europe and Africa, and there are a lot more from countries where we in 1990 had almost no listings, like Germany and Switzerland.

There are at least two or three reasons why more foreign companies are coming here, especially through the 1990s. The first is supply and demand. There has been a demand from U.S. investors for foreign securities, and foreign companies have wanted to tap into this U.S. investor interest and to raise capital here. It also has helped that we have had a high-quality market, not only in terms of SEC standards but also with respect to our regulated exchanges, such as the New York Stock Exchange.

The Sarbanes-Oxley Act passed last year in response to corporate scandals entails reforms that are far-reaching and very dramatic, perhaps stronger than in any period since the SEC was formed and the federal government first got into the business of regulating the securities industry in the 1930s.

The Sarbanes-Oxley Act sets many new requirements. Some provisions are self-operative, but many required SEC rule-writing to implement. In many cases, the SEC was faced with the question of how the rules implementing the Sarbanes-Oxley Act should affect registered foreign companies. Many foreign companies and many foreign constituents started commenting early on, even before the legislation was signed into law. As the SEC went forward with implementing the statute, we stated that we would be fully faithful to its letter and spirit, we would also be mindful of the impact of regulation on both U.S. and global markets, and, in so doing, we were continuing a tradition of many decades. As we went through the rule-writing, we worked toward a better understanding of how this new law would apply to foreign companies.

The SEC is now basically finished with Sarbanes-Oxley rule-writing, and I think that we have been true to our statement and have enacted the letter and spirit of Sarbanes-Oxley with appropriate accommodations for foreign issuers. In areas where the act increased disclosure by U.S. companies, there is also to be increased disclosure by foreign companies in areas such as whether a company has a financial expert on its audit committee, whether a foreign company has a code of ethics, and, more important perhaps, off-balance sheet transactions. This last is a whole new section of disclosure that U.S. companies and foreign companies must make in their annual reports and their prospectuses.

For disclosure-based matters, then, the same standards have been applied to foreign and U.S. companies. Where there is some accommodation for foreign companies is in areas that really would affect the internal corporate operations of a company, based on a recognition that foreign companies have different governance structures than U.S. companies. Sarbanes-Oxley is modeled on Delaware corporate law, which is fairly typical in the United States. Foreign law allows for much different board structures and different internal arrangements. There was much concern among foreign companies about Sarbanes-Oxley specifically detailing what an audit committee must do and that its members have to be independent, because those requirements were inconsistent with foreign arrangements. Japanese boards really have no audit committees. Nor do Brazilian companies; they have something called a statutory board of auditors, but it is a completely independent group of nondirectors. In addition, in some European countries there is a requirement that employees be on the board of directors and also on the audit committee. Under Sarbanes-Oxley, the only people who can be on the audit committee are those who are independent of the company, which would seem to exclude employees. The SEC took the reasonable approach that what we and the Congress were really focused on was senior management—the CEO, CFO, the chief accounting officer—not just on any employee. To the extent that there are lower- or mid-level employees on a board of directors under local law, as is true in Germany, Switzerland, and other European countries, the SEC has accommodated that practice under Sarbanes-Oxley.

REMARKS BY ROBERTA KARMEL*

Le me try to put these problems in a broader perspective that may resonate with some of the general themes of this conference. I am going to paint with a very broad brush, going back all the way to 1933 and 1934, when the federal securities laws were passed, because this history is of some importance in the current situation. From the 1930s until the late 1970s or early 1980s, the SEC took what I would call an isolationist approach to problems posed by foreign issuers and the sale of their securities to U.S. nationals.

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A lot of people over the years have suggested that Congress never even thought about foreign issuers when it passed the 1933 and 1934 Acts, but that is not true. Americans lost considerable amounts of money in the late 1920s and 1930s because they bought foreign bonds, among them sovereign debt. Congress was aware of this when it passed the 1933 Act, and provided for it to some extent by having a special registration form for foreign sovereign debt and by defining interstate commerce to include commerce between states and foreign jurisdictions.

The attitude of the SEC staff for more than forty years after the 1933 Act was passed was that if a foreign issuer was going to tap the U.S. capital markets, it should play by our rules. This attitude was manifested in such policy initiatives as the Canadian and then the foreign restricted list to keep out unregistered foreign companies. The SEC also made very aggressive claims of extraterritorial application, and a whole series of cases was brought under the antifraud provisions of the Securities Exchange Act of 1934.

I became a commissioner in the late 1970s, which, for certain business and political reasons, was the end of this period. At that time, European investment bankers were up in arms about the SEC. The Japanese were also quite appalled by the SEC because the Lockheed scandals, involving sensitive payments to foreign officials, had actually led to the fall of a Japanese government. The high-water mark in terms of the staff's attitude may have been the rule-making initiative on what became the primary registration form for foreign issuers. A staff member came to the Commission table and asserted that the only comments the Commission reviewed against this proposal were all from foreign companies, so the SEC should not pay any attention to them.

This antiforeign attitude changed, for many reasons. As the Euro securities market began to grow, the U.S. government came to appreciate that perhaps it was not such a positive development to have a viable global market operating in London in competition with U.S. capital markets. Another factor in making the SEC more tolerant of internationalism was the beginning of an era of much greater cooperation between the SEC and foreign regulators and the emergence of a truly international regulatory body in the form of a changed International Organization of Securities Commissioners (IOSCO). Previously, IOSCO had been just an inter-American regulatory group, but with SEC encouragement it was transformed into a worldwide group of securities regulators. In part, too, the evolution of IOSCO and an SEC framework for dealing with foreign issuers was related to privatization programs in many European countries and to an interest on the part of the governments of those countries in better securities disclosure and regulatory systems.

This was all part of the background for a period of what I would describe as a comity or an internationalist approach to securities regulation, rather than an isolationist approach. The SEC revised its forms for foreign issuer registration. Beyond that, the staff began to try very hard to accommodate the needs of foreign issuers that were listing or raising capital in the United States, although it did continue to insist on the reconciliation of foreign accounting statements to U.S. generally accepted accounting principles (GAAP). During this period of accommodation, the staff drafted Regulation S, which redefined the parameters of offshore offerings. It also wrote Rule 144A to assist private placements to institutions by foreign issuers. One consequence of this change in attitude and the changes in the global markets was a great increase in foreign issuer registrations with the SEC and in U.S. stock exchange listings of foreign companies. There were significant improvements in many foreign regulatory systems, too, which laid the foundation for an international securities regulatory regime.

The Sarbanes-Oxley legislation enacted in 2002, in contrast, reflects a unilateralist approach to foreign issuer registration. I hope this approach does not persist, and that the

SEC quickly returns to a more internationalist approach. The statute by and large makes no real exceptions for foreign issuers and applies on its face to foreign issuers that have securities registered with the SEC. A few months ago, I also would have said the statute had wholly unrealistic time frames for rulemaking, but somehow the SEC staff, in a very professional manner, managed to meet all those deadlines.

The SEC was in a very difficult situation, under political attack from all quarters in the aftermath of many serious financial scandals. This made it extremely difficult for the SEC to do much to accommodate foreign issuers—or for that matter, U.S. issuers—who had serious problems with the Sarbanes-Oxley mandates. In the short term, this has led to frustrated and angry comment letters from European commentators and a sharp decline in the number of foreign listings. On the other hand, there is a worldwide recession, so the economy probably is also a factor in the decline in the number of foreign listings. Nevertheless, the extraterritoriality of Sarbanes-Oxley has ironically created a political obstacle to foreign regulators and the SEC cooperating in creating a global framework to prevent the sorts of corporate governance problems that led to Sarbanes-Oxley.

Sarbanes-Oxley imposes bureaucratic solutions and prescriptive rules upon public corporations, U.S. and foreign, in an attempt to impose blame for past failings on specific companies and also to prevent future financial debacles. Some parts of Sarbanes-Oxley were well-considered; for example, the creation of the new Public Company Accounting Oversight Board as a new regime for regulating auditing firms. Other provisions were included either to address matters the SEC had wanted to regulate for a long time or in response to the headlines of the day—for example, a provision preventing companies from making loans to officers, which has rankled many foreign issuers as well as caused problems for U.S. companies.

The model that Congress had in mind in enacting Sarbanes-Oxley was the U.S. public corporation, but many corporations in other jurisdictions have very different corporate governance models and very different systems of corporate finance. It is difficult, if not impossible, for those companies to comply fully with Sarbanes-Oxley. The SEC has done what it could to make accommodations in the corporate governance area, but it has been under such intense political pressure that it did not really have a chance to fashion accommodations for all the foreign interests that were seeking such flexibility. The SEC did have a number of roundtables to listen to the complaints and requests of foreign issuers. My hope is that the agency will be able to determine which new provisions can, in fact, be honored by foreign issuers and which cannot, and will make the necessary accommodations so that the statute is not honored in the breach. Particularly troublesome aspects of the statute are the requirements regarding the structure of audit committees, loans to executives and forfeiture of bonuses, publication of codes of ethics, definition of financial experts, audit committee composition, off-balance sheet transactions, auditor independence, registration of foreign auditors, and regulation of foreign attorneys—and there are many other contentious provisions as well.

Finally, take one specific example: the disclosure requirements relating to financial experts. The SEC has in some ways acknowledged certain problems by saying that the definition of "financial expert" for purposes of a foreign company's audit committee includes someone who is an expert in foreign GAAP, not necessarily in U.S. GAAP. But all companies are required to disclose whether or not they have financial experts. It will be unfortunate if companies that find this provision troublesome simply disclose that they do not have a financial expert on their audit committees. What help would that be to investors? This is just one example of the kinds of problems that the SEC and public companies will run into with the implementation of Sarbanes-Oxley.

The SEC has been walking along the road of international cooperation long enough that it should not just stop short and go back to the more hostile attitude it had in past days. In the future, hopefully there will come another era in which the SEC and foreign regulators work together to solve problems of investor confidence in global markets.

Remarks by Edward Kwalwasser*

The New York Stock Exchange, as a private corporation, has no direct ability to promulgate corporate governance standards for any corporation, but we do have listing standards. We can set forth who we believe it is appropriate to list and trade in our marketplace. As a result of the Enron and WorldCom failures, the Exchange formed a blue-ribbon panel to see if there was a way to enhance our listing standards so as to regain the confidence of the investing public, which was clearly shaken by what went on at Enron and WorldCom, and several other corporations along the way. The committee was headed by three of our non-securities industry directors, Carl McCall, then comptroller of the State of New York, Jerry Levin, then chairman of AOL, and Leon Panetta, White House chief of staff in the previous administration. The committee they put together included directors from private issuers who are on our board and the heads of our pension managers advisory committee, legal advisory committee, and institutional investors advisory committee. This committee met over four months, hearing witnesses from twenty-seven different groups, from corporations to the AFL-CIO. The witnesses all set forth what they believed was needed to upgrade corporate governance. We also had more than three hundred comment letters from sources around the world, including foreign private issuers, U.S. issuers, lots of institutional investors, and groups that represented institutional investors.

The outcome was that the exchange developed a whole group of new standards that will apply to any company seeking to list on the New York Stock Exchange. Previously, most of the standards had dealt with requirements on the financial side, related to earnings, capital, and number of investors. After taking all the testimony and reading all the comment letters, the committee decided that the most important thing was to substantially increase the influence of independent directors on the board of directors of any company. They did that by requiring that a majority of the directors of every company that lists on the New York Stock Exchange be independent directors as defined by the exchange. This was a major change in the corporate governance requirements, particularly for small corporations. We understand that it will be much more difficult for companies to get people to serve as independent directors; particularly, it will be much more difficult to get independent directors to serve on audit committees. But we said not only that the majority of the directors must be independent, but also that every corporation must have a compensation committee, a nominating committee and an audit committee made up entirely of independent directors (with one exemption: if a company has a majority owner, although it must still under Sarbanes-Oxley have an audit committee made up entirely of independent directors, the majority of the board and both the nominating committee and the compensation committee do not have to be made up totally of independent directors). We also said that before each board meeting, nonmanagement directors must meet without management.

Although the SEC has not yet approved these rules, many corporations that know the rules are going to be approved are implementing most of them before they have to. The stock exchange itself has implemented the board of directors rule, and before every meeting of the board there is a meeting of our nonmanagement directors.

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The exchange has also mandated that each company have a code of ethics and that the code be set forth in its annual report so that investors can determine whether they think the code is appropriate. Foreign private issuers are not subject to these rules but must disclose any material difference between the corporate governance structure under which they operate and the corporate governance structure that other private issuers trading on the exchange are bound to maintain.

We also said that all stock options plans must be voted on by shareholders. In the past, we had required only those shareholder plans dealing with officers and directors, not broad-based plans, to be voted on by shareholders.

Another issue that raised questions with the SEC staff was how to define director independence. We had set specific standards dealing with employment by the corporation: employees or officers of the corporation would have to wait five years after departure from the corporation before they could be considered independent. For an officer of an accounting firm, the waiting period would also be five years. But otherwise we said it was the duty of the board to determine whether any director had such a material conflict that the director could not be determined to be independent. NASDAQ resolved this question with some bright-line rules—for instance, if the company contributed more than $60,000 to a charity, a director associated with that charity could not be considered independent. We think we have reached an accommodation with the Commission whereby we will set some bright lines but still permit a company's board to have some say in the final determination.

With respect to foreign private issuers, about 12 percent of all the companies trading on the New York Stock Exchange are foreign private issuers; they represent about 10 percent of exchange volume. The New York Stock Exchange now does a total of about 1.5 billion shares a day, average daily volume. That means that foreign private issuers trade about 150 million shares a day—more than the total volume of the New York Stock Exchange fifteen years ago. Foreign private issuers are a very important part of our business. Certain companies have told us that Sarbanes-Oxley is a substantial impediment to them coming to the United States (though the global recession may also be a factor). The SEC staff has been extremely helpful in defining Sarbanes-Oxley for foreign private issuers in certain countries that by law could not comply with the specific wording of Sarbanes-Oxley. We at the Exchange have been going out on road shows to Europe, and soon to Asia, to explain what we and the SEC have done and how foreign companies can deal effectively with Sarbanes-Oxley. Although there are still some problems, the SEC staff is working hard to come to grips with them. We hope that, in the not too distant future, it will really be the economy that determines whether foreign private issuers come to the United States and list on the New York Stock Exchange.

One reason companies come to the United States has not yet been discussed, and it does not relate to trading markets. You will notice that foreign issuers represent 12 percent of listed companies but only 10 percent of the volume on the Stock Exchange. Many foreign private issuers come to the United States and list on the Stock Exchange, without making any public offering in the United States, because they have taken over a corporation in the United States and want to be able to reward their employees with either stock or options and offer a market in which those employees, at some point, can get out. That is another reason we need to have rules—not that the United States should lower its standards, because I do not think that's the case—that permit foreign private issuers that want to do the right thing to come to the market and be listed on the Stock Exchange.