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# SOX: a case study in extra-territoriality

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*With New York losing financial business to London, many have pointed to the Sarbanes-Oxley Act as a leading culprit of over-regulation. But as Tod Ackerly II writes, its consequences may be even further reaching.*

Future historians, when describing global financial markets in the late 20th and early 21st centuries, will surely cite the passage of the Sarbanes-Oxley Act of 2002 (SOX)<sup>1</sup> as a watershed event. Its ultimate legacy, however, remains unclear. Will it be described as a prime example of overbearing regulation by the United States?<sup>2</sup> Will it be seen as the event that knocked New York off its pedestal as the “financial capital of the world,”<sup>3</sup> or will it have exactly the opposite effect?

## Genesis of the act

Sarbanes-Oxley was enacted in the heat of the Washington summer of 2002 in an atmosphere of near political panic.<sup>4</sup> Major US corporations had been discovered committing fraud on a massive scale. Hundreds of thousands, if not millions, of investors had lost large sums of money, and many people had lost their entire retirement nest-eggs. The pressure on Congress to “do something” was enormous. If some of the provisions of SOX appear out of place in the US federal system of securities regulation, it is because they were proposed in response to some abuse or perceived abuse that had received attention in the press, and opposing them would have been tantamount to political suicide in the atmosphere that prevailed that summer.

The application of SOX to non-US companies (“foreign private issuers” or FPIs) is a good example. The SEC had a long history of making accommodations for FPIs to ease their ability to access US capital markets, and as recently as June 14 2002, the commission had proposed that post-Enron anti-abuse measures not be applicable to FPIs.<sup>5</sup> However, the press carried stories of several well-known US companies that had re-incorporated offshore in order to save taxes. The argument was made that if SOX were not applied to all companies publicly traded in the US – regardless of place of incorporation – there would be an exodus of US companies reincorporating offshore simply to avoid it.<sup>6</sup>



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The adequacy of foreign corporate governance structures and their relationship to the new rules was simply not addressed.<sup>7</sup>

The question of applying the legislation to FPIs was still open as the conference committee set to work to resolve the differences between the bill passed by the House and the version passed by the Senate. In the conference, some argued that the foreign companies had chosen to come to the US markets; that they should play by our rules; and that, if they didn't like it, they could leave. That argument carried the day, and the legislative language was drafted broadly enough to include FPIs.<sup>8</sup>

## **Over-reaction**

Ironically, those who made this argument must have forgotten, or had never heard about, Section 12(g) of the Securities Exchange Act of 1934. Perhaps they can be forgiven. They were, after all, working almost around the clock to get the legislation completed. What they apparently failed to realise was that this section and its implementing regulations require any SEC reporting company, domestic or foreign, to continue to be subject to the SEC rules, unless it has fewer than 300 US shareholders.<sup>9</sup> Since virtually any publicly traded company has many more US shareholders than that, they were stuck in "Hotel California"<sup>10</sup> or a "roach motel."<sup>11</sup>

At a conference in Dublin later that fall, a

European authority on corporate governance asked me: "How do you explain Sarbanes-Oxley from a philosophical point of view?"

It was an interesting question. I thought for a moment and replied, "You can't. It violates the Kantian categorical imperative.<sup>12</sup> You can explain it only from a political point of view. Given the atmosphere at the time, political imperatives overwhelmed all others."

The fall-out from SOX, of course, was virtually instantaneous. A major European corporation almost immediately announced that it was suspending its planned stock offering in the US. Others followed suit. Numerous studies since then have addressed the attractiveness, or lack thereof, of the New York market.<sup>13</sup>

The events of the past five years raise two interesting questions.

First, to what extent can the shrinkage of New York's share of the global securities market<sup>14</sup> be attributed to SOX? Second, is SOX a good example of the US attitude toward extra-territoriality in the field of securities law?

I should emphasise that I write from my personal perspective only. I am a private lawyer who has represented both issuers seeking to raise capital and foreign markets seeking to attract the business of those issuers. I have no experience as a regulator, and I have not conducted any learned broad-based statistical analyses these issues. My views are based solely on my personal experience.

## Impact of SOX on US markets

As to the first question, my view is that SOX is a factor, but that it is only one of many.

The costs of SOX are very real. For example, the costs of complying with section 404 have turned out to be substantially higher than initially estimated.<sup>15</sup> However, there are many other factors, and the relative importance of SOX among the entire mix of considerations varies depending on each issuer's particular circumstances. For example, features of the US securities regulatory regime totally unrelated to SOX can play a significant role. Offerings can be accomplished much more rapidly in markets other than in the US.<sup>16</sup> Thus, if a company believes that the timing is right and that the market may fall away from it, it will conduct its offering where it can get to market most rapidly.

Other regulatory factors include the more extensive disclosure that US regulations require on various subjects, executive compensation being only one example. Also, the recent SEC interpretation of rule 415 has caused PIPE issuers and investors to look outside the US for sources of liquidity.<sup>17</sup>

Factors totally unrelated to regulatory regimes also play a substantial role. Litigation risk is one factor. Market trends are another factor: at any given point in time, the New York market may not be as receptive as the London market to companies with a particular profile. Moreover, if an issuer has

important connections with another country, such as significant investors or a large customer base there, that country may make more sense than the US. The issuer's industry can also make a difference. For example, companies in the minerals exploration and development industry consider other markets as being more receptive to their particular "story" than the US.

The list goes on. My point simply is that Congress could repeal Sarbanes-Oxley tomorrow and New York would not automatically regain a position of pre-eminence.

## Foreign consequences

The second issue is the apparent disinclination of the US to pay sufficient attention to the problems caused beyond its borders by the extraterritorial application of its domestic laws and regulations. On the surface, of course, SOX appears to be an obvious case of over-reaching, but there is more to the story.

Over the past five years, there has been a startling, almost miraculous, sea-change in the attitude of US regulators toward the rest of the world. The US has traditionally followed a "national treatment" approach to securities regulation, ie, with only limited exceptions, it applies a uniform standard to all market participants regardless of nationality. The concept of "mutual recognition," with which Europeans are so well acquainted, was simply not in the SEC's vocabulary five years ago.

Let me mention just one example. During the fall of 2002 and the early months of 2003, as the SEC was proposing and then adopting its regulations under Sarbanes-Oxley, numerous delegations from other countries came to the SEC and made the following plea: “Our country has a good corporate governance system. It is not broken. SOX was passed to fix the corporate governance system in the US, which was broken. There is no reason to force our companies to adopt the corporate governance ‘fixes’ that the US has now imposed. Please recognise our system as being worthy of your respect and exempt us.”

The SEC took a hard-line position: “We will give you an exemption only if you can demonstrate a direct conflict between your local law or market practice and the SOX requirements. If you are actually prohibited from adopting the SOX rules, then we will consider an exemption. We will not consider an exemption otherwise.”<sup>18</sup>

## **Humble pie**

Today, the attitude at the SEC is markedly different. At least two commissioners,<sup>19</sup> the director of the division of market regulation<sup>20</sup> and the director of the office of international affairs,<sup>21</sup> have each made strong statements supporting “mutual recognition” (or “substituted compliance”) with respect to at least some issues.

How can this change be explained? There are a number of factors, including pressure from Wall Street and an increasing flow of US investors going directly to offshore markets. From my perspective, however, SOX has had a lot to do with it. In effect, the act has been a poster child, a whipping boy, “Exhibit A” (use whatever analogy you like). It has been the catalyst for a broad realisation that US securities regulation has gone too far in the direction of extra-territoriality and that the pendulum should swing back. In substantial part because of SOX, it is becoming more and more widely accepted that the US needs to reach out if it is to avoid being isolated as the rest of the world moves on.

I should emphasise that this change has occurred primarily at a very high, conceptual, level and that it is not yet clear to what extent it will be implemented on a subject-by-subject basis. Thus, the new attitude is largely untested and, as always, the devil is in the details. One concrete example is the recent adoption of rule 12h-6, which establishes a mechanism for FPIs to gain freedom from their SEC reporting obligations even though they may have substantially more than 300 US shareholders. This is an important step in the right direction.

However it is too soon to claim this is representative of a broad willingness by the SEC to modify existing regulations to “mutually recognise” non-US practices.

## **SEC: resistant to change**

In fact, in at least one instance the trend has moved in the opposite direction.

SEC Regulation S establishes the basic principle that “offshore” offerings do not have to be registered under the Securities Act of ’34. What does “offshore” mean? Reg. S establishes two safe harbours with rather detailed rules, and these rules vary depending upon the identity of the issuer and the circumstances of the offering. Foreign issuers typically fall into “category one,” and the rules are quite simple. US issuers, however, fall into “category three,” and the rules are much stricter and more complex.

The category three rules, which were designed to keep unregistered shares from “flowing back” into the US market, were adopted in 1990 as a codification of practices that had been developed over the previous 25 years. They do not work very well in the context of markets that are modern, electronic and highly automated.

In 1999 and 2000, the SEC staff granted no-action letters to three non-US markets, approving “alternative procedures” that were compatible with electronic trading systems and still provided reasonable protection against “flow back.” The SEC staff has now said that they will not issue any more no-action letters of this kind. Whatever the justification, this position is hardly consistent with a philosophical change in favour of mutual recognition.

As a result of the SEC position, for example, trades in shares of US companies on the AIM market in London are typically settled the old-fashioned way, using paper certificates. As one of the main drafters of Reg. S, who is now in private practice, was quoted as saying not so long ago, settling trades with paper certificates is “silly”.<sup>22</sup> Yes, it is silly, and it hurts the liquidity of the stock and therefore hurts the shareholders of these US companies. However, that is what a many London lawyers are requiring in order to assure that their clients remain in compliance with Regulation S.

## **A new vocabulary**

To return to my opening question, I believe that, in spite of being an obvious case of regulatory over-reach, SOX will leave a positive legacy relative to extra-territoriality and the development of the global marketplace.

Precisely because it went too far and has had dire consequences, or at least consequences that many view as being dire, SOX almost surely will be seen by future historians as a turning point, as marking the beginning of a period in which US securities regulation became more agile and less muscle-bound. As compared with the situation that would have pertained if SOX had not been passed, mutual recognition will inform more decisions, and progress will be made

more rapidly toward a smoothly functioning global market unimpeded by regulation-based inefficiencies, a global market from which all players will benefit.

There will be hurdles. Progress will be slow. However, the vocabulary of the debate has changed, and for that we owe a vote of thanks to Sarbanes-Oxley.

## Notes

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- 1 Pub. L. 107-204, 116 Stat. 745 (2002).
- 2 Extraterritoriality — the operation of laws upon persons existing beyond the limits of the enacting state — is a topic with a proud history. See generally, Restatement of the Law Third, The Foreign Relations Law of the United States (1986) Part IV; Jessup, *Transnational Law* (New Haven 1956) 72-113; Haight, “International Law and Extraterritorial Application of the Antitrust Laws,” 63 *Yale LJ* 639 (1954). A discussion of the extent to which SOX is justifiable under traditional principles of extraterritoriality is beyond the scope of this article.
- 3 Europe’s Commissioner McCreevy stated recently that the US share of global IPOs has fallen from 57% in 2001 to 16% in 2006, while Europe’s has increased from 33% to 63% during the same years. *Wall Street Journal* (March 5, 2007) at A17. (Text at [http://online.wsj.com/article\\_print/SB117304935844426392.html](http://online.wsj.com/article_print/SB117304935844426392.html)).
- 4 Eg, 148 Cong. Rec. H4480 (daily ed. July 10, 2002) (statement of Rep. Baldwin) (“Mr Speaker, there is a crisis in America. People are out of work and are worried about losing their jobs. ... Without action to shore up the confidence of the American public, our faith in the stock market will be shattered and, along with it, the backbone of our country’s financial system.”)
- 5 SEC Release No. 34-46079 (Proposed Rule re Certification of Disclosure in Companies’ Quarterly and Annual Reports) (June 14 2002) (“... mandatory requirements regarding internal procedures raise several issues, since those requirements may be inconsistent with the laws or practices of the foreign private issuers’ home jurisdiction and stock exchange requirements. For these reasons, applying the proposed rules to foreign

private issuers would raise additional issues that do not exist for domestic companies. Therefore, we do not propose to apply the certification and procedural requirements to foreign private issuers at this time.”)

- 6 Eg, 148 Cong. Rec. S6688 (daily ed. July 12 2002) (statement of Sen. Dorgan) (quoting a *Wall Street Journal* article of July 8, 2002, which described the effect of companies such as Tyco International Ltd. and Global Crossing Ltd. being incorporated in Bermuda); 148 Cong. Rec. H4479, H4484 (daily ed. July 10 2002) (statements of Rep. Lee and Rep. Sanchez).
- 7 The failure to address the issues relating to FPIs is highlighted by the fact that the staff of the Senate Banking Committee took a day-and-a-half to decide whether the Senate bill applied to offshore corporations. 148 Cong. Rec. S6689 (daily ed. July 12 2002) (statement by Sen. Dorgan) (“I have discussed my concern with the staff of the Banking Committee. They believe that their bill implicitly addressed the reincorporation problem. But Senator Graham of Florida and I said we are not satisfied with ‘implicitly’ being covered. We want the issue addressed explicitly. Let me also say, the technical people smile when I talk about this, but, frankly, it took a day and a half for us to evaluate whether it was implicitly covered in the bill. So because of that, I think it is important to have an explicit provision in this bill that says those companies involved in inversions that renounce their citizenship, they, too, will be required to certify their results.”)
- 8 Some conferees argued that Congress had not intended to include foreign private issuers. For example, Senator Enzi stated, “... I believe we need to be clear with respect to the area of foreign issuers and their coverage under the bill’s broad definitions. While foreign issuers can be listed and traded in the US if they agree to conform to GAAP and New York Stock Exchange rules, the SEC historically has permitted the home country of the issuer to implement corporate governance standards. Foreign issuers are not part of the current problems being seen in the US capital markets, and I do not believe it was the intent of the conferees to export US standards disregarding the sovereignty of other countries as well as their regulators.” 148 Cong. rec. S7356 (daily ed. July 25 2002) (emphasis supplied). The senator continued, “[The bill] gives the SEC wide authority to enact implementing regulations that are ‘necessary or appropriate in the public interest.’ I believe it is the intent of the conferees

- to permit the commission wide latitude in using their rulemaking authority to deal with technical matters such as the scope of the definitions and their applicability to foreign issuers. I would encourage the SEC to use its authority to make the act as workable as possible consistent with longstanding SEC interpretations.”
- 9 See 17 C.F.R. 240.12g-4 (a non-US issuer can terminate its US registration only if fewer than 300 holders of the issuer’s equity securities are US residents).
  - 10 “Hotel California” is the title of a popular song by the Eagles from the 1970s. It describes an establishment where “you can check out anytime you like, but you can never leave.”
  - 11 It took five years, but this situation has now been remedied. The SEC has adopted Rule 12h-6, which permits FPI’s to de-register with the SEC if certain conditions are met. See SEC Release No. 34-55540 (March 27 2007).
  - 12 The Kantian imperative is a more formal expression of the principle that many of us know as the “Golden Rule”: “Act only according to that maxim whereby you can at the same time will that it should become a universal law.” Immanuel Kant, *Metaphysics of Morals*.
  - 13 Eg, Commission on the Regulation of US Capital Markets in the 21st Century, Report and Recommendations (US Chamber of Commerce, March 2007).
  - 14 It should be noted that New York’s alleged loss of market share is not accepted by everyone. Eg, remarks by Commissioner Raul C. Campos, London, England, March 8, 2007 (text at <http://www.sec.gov/news/speech/2007/spch030807rcc.htm>) (“... a recent report by Thomson Financial points to the strength of the US IPO market. The study found that foreign IPOs accounted for 16% of the 208 IPOs in the US last year, the highest proportion of foreign IPOs in Thomson’s 20-year review. Also, foreign IPOs in the US last year raised \$10.6 billion of the \$45.3 billion in IPO offerings priced in the US, which equals 23% of IPO money raised year, the highest level since 1994. Further, and this is a quote: ‘since the adoption of Sarbanes-Oxley ... in July 2002, there has been little evidence that foreign issuer IPOs have been shying away from the US market.’ The 34 foreign IPOs in 2006 equaled the total in 2005 and represented the highest level since SOX was enacted.”)
  - 15 According to the Senate committee report issued on July 3, 2002, high quality audits already “incorporate extensive internal control testing” and, as a result, the committee did not expect the internal control provision to be the basis for any increased fees or charges by outside auditors. S. Rep. No. 107–205, Public Company Accounting Reform and Investor Protection Act of 2002 (July 3 2002) at 31. Reasonably soon thereafter, the SEC estimated that implementation of Section 404 would cost an average of \$91,000 per company, for a total of one and a quarter billion dollars. Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC Release No. 33-8238 (June 5, 2003) at Section V(B). Recent estimates have put actual average costs at more than 20 times that amount. Remarks by Commissioner Paul S. Atkins at Finance Dublin, March 26 2007 (text at <http://www.sec.gov/news/speech/2007/spch032607psa.htm>).
  - 16 Our firm has listed companies on AIM in 3 months, start to finish. The SEC registration process typically takes at least twice as long.
  - 17 Eg, “Gazing Abroad — US Regulations and Overseas Opportunities Creating Global PIPE Investors,” The PIPEs Report (March 20 2007) at 1.
  - 18 Eg, Speech by SEC chairman, Harvey L. Pitt, at the *Financial Times*’ Conference on Regulation & Integration of the International Capital Markets (London, October 8 2002) (“[SOX] generally makes no distinction between US issuers and foreign private issuers listed in the United States. It applies equally to all who seek to access US capital markets. And we are committed to implementation of the Act that is fully consistent with its purpose and intent. ... [However] ... I urge foreign companies ... to comment on our rule proposals and to let us know when our proposals conflict with local law of local stock exchange requirements ...”). In fact, a few exemptions were granted on this basis. Eg, SEC Release No. 33-8220 (April 16 2003) text at footnotes 146–156 (“Section 10A(m) of the Exchange Act makes no distinction between domestic and foreign issuers. ... However, as discussed in the Proposing Release, we are aware that the requirements may conflict with legal requirements, corporate governance standards and the methods for providing auditor oversight in the home jurisdictions of some foreign issuers. ... We understand that some countries, such as Germany, require that non-management employees, who would not be viewed as “independent” under the requirements, serve on the supervisory board or audit committee. Having such

employees serve on the board or audit committee can provide an independent check on management, which itself is one of the purposes of the independence requirements under the Sarbanes-Oxley Act. Accordingly, we are adopting as proposed a limited exemption from the independence requirements to address this concern, so long as the employees are not executive officers, ...).

- 19 Eg, Remarks by Commissioner Paul S. Atkins at Finance Dublin, March 26 2007 (text at <http://www.sec.gov/news/speech/2007/spch032607psa.htm>) (“I believe that the territorial approach should continue to be the Commission’s guiding principle as we deal with what appears to be an unprecedented series of major international developments in the markets.”); remarks by Commissioner Raul C. Campos, London, England, March 8 2007 (text at <http://www.sec.gov/news/speech/2007/spch030807rcc.htm>) (“Instead of mentioning what the SEC has done to ease the regulatory burden on foreign issuers, I’ll now turn to what the SEC might do. Specifically, I’m referring to ideas that have been termed ‘mutual recognition’ and a ‘cooperative approach.’”)
- 20 Erik R. Sirri, “Trading Foreign Shares” (Boston, MA, March 1 2007) (text at <http://www.sec.gov/news/speech/2007/spch030107ers.htm>).
- 21 Tafara and Peterson, “A Blueprint for Cross-Border Access to US Investors: A New International Framework,” 48 Harv. Int’l L.J. 31, 51 (winter 2007). A respected former SEC official has even suggested that “mutual recognition” be extended from market-regulation issues to area of securities offerings. Greene, “Beyond Borders II: A New Approach to the Regulation of Global Securities Offerings” (June 2007) (text at [http://www.sechistorical.org/collection/papers/2000/2007\\_0501\\_GreeneBeyondT.pdf](http://www.sechistorical.org/collection/papers/2000/2007_0501_GreeneBeyondT.pdf).)
- 22 Burns, “LSE Offers Plan To Speed Settlement Of Restricted Shares” (Dow Jones Newswires, May 26 2006).

*This article is adapted from remarks made at a conference sponsored by the Royal Institute of International Affairs, June 15 2007.*

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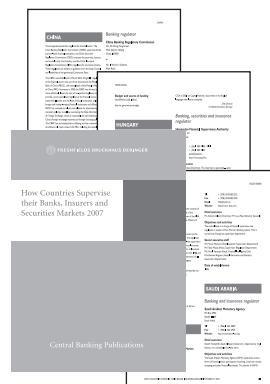
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