Revisiting the Impact of the Sarbanes-Oxley Act of 2002 on Foreign Private Issuers

Harry S. Pangas
J. Clay Douglas

December 2016
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Background of Sarbanes-Oxley Act of 2002 and Application to Foreign Private Issuers (“FPIs”)

Sarbanes-Oxley Act of 2002 (the “Act”)

- Enacted sweeping accounting, corporate disclosure and corporate governance legislation
- Response to accounting scandals at public companies and other corporate malfeasance (e.g., Enron, WorldCom, Adelphia, Tyco, Global Crossing, etc.)

Application of the Act to FPIs

- The Act does not distinguish between U.S. companies and FPIs and contains no explicit exemption for FPIs.
- The Act applies to any issuer that has registered securities under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), or is required to file reports under the Exchange Act.
  - The Act does not apply to issuers who merely submit information under Exchange Act Rule 12g3-2(b).
With regard to internal control over financial reporting, the Act requires:

- an assessment by management of the issuer’s internal control over financial reporting; and
- a report of the issuer’s independent auditors on the issuer’s internal control over financial reporting.

**Exception**: Form 20-F provides for a “transition period” pursuant to which management’s assessment and the auditor’s report is not required until the issuer “either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Exchange Act for the prior fiscal year or had filed an annual report with the [U.S. Securities and Exchange Commission (the “SEC”)] for the prior fiscal year.”
The Act requires that an FPI maintain and evaluate the effectiveness of its “disclosure controls and procedures.”

- **Disclosure Controls and Procedures** - Controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports (i.e., Forms 20-F and 6-K) it files or submits under the Exchange Act is (1) timely recorded, processed, summarized, and reported, and (2) accumulated and communicated to the issuer’s management, including its principal executive and principal financial officers, to allow for timely decisions about disclosure.

- The concept of disclosure controls and procedures overlaps substantially with the concept of internal control over financial reporting.

  - Disclosure controls and procedures will include those components of internal control over financial reporting that provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles (“GAAP”).

  - In contrast, disclosure controls and procedures would not necessarily include accurate recording of transactions and disposition of safeguarding of assets, which would remain components of internal control.
Impact on CEOs and CFOs

• Certifications by CEOs and CFOs under Sections 302 and 906 of the Act

• CEOs and CFOs must disgorge bonuses and profits in the event of a financial reporting restatement
The Act includes two overlapping certifications that an issuer’s CEO and CFO (or persons performing similar functions) must provide:

(1) **Section 302 Certification**
   - Section 302 of the Act amended the Exchange Act and requires certain certifications in periodic reports filed under Section 13(a) or 15(d) of the Exchange Act (e.g., Form 20-F).

(2) **Section 906 Certification**
   - Section 906 of the Act amended the U.S. federal criminal code and requires certain certifications in periodic reports containing financial statements filed by an issuer with the SEC (e.g., Form 20-F).

Both certifications must be included in an FPI’s annual report on Form 20-F; however, neither is required for reports on Form 6-K.
Under Section 302 of the Act, the CEO and CFO of an issuer must individually certify in connection with any filing of a periodic report with the SEC (e.g., Form 20-F) that:

- They reviewed the report.
- Based on their knowledge:
  - the report does not contain any untrue statement of a material fact or omit to state a material fact; and
  - the financial statements, and other financial information in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in the report.
- The CEO and CFO are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting* for the company;
- The CEO and CFO have designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under their supervision, to ensure that material information is made known to them;
- The CEO and CFO have designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;*  

* The underlined/italicized portions are not required until the FPI either (1) had been required to file an annual report pursuant to the Exchange Act for the prior fiscal year or (2) had filed an annual report with the SEC for the prior fiscal year.
Impact on CEOs and CFOs – Certification Requirements – Section 302 (continued)

- The CEO and CFO evaluated the effectiveness of the disclosure controls and procedures and presented in the applicable report their conclusions about such effectiveness, as of the end of the period covered by the report;

- The CEO and CFO have disclosed in the applicable report any change in the company’s internal control over financial reporting that occurred during the period covered by the report that has materially affected, or is reasonably likely to materially affect, the company’s internal control over financial reporting; and

- The CEO and CFO have disclosed, based on their most recent evaluation of internal control over financial reporting, to the company’s auditors and the company’s audit committee:
  - all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company’s ability to record, process, summarize and report financial information; and
  - any fraud, whether or not material, that involves management or other employees who have a significant role in the company’s internal control over financial reporting.
Section 906 of the Act establishes a separate certification requirement and provides for criminal penalties for knowingly or willfully filing false certifications.

Each “periodic report containing financial statements” (i.e., Form 20-F) must be accompanied by CEO and CFO certifications that:

- the periodic report “fully complies” with the Exchange Act requirements; and
- information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the company.
If an issuer is required to “prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct with any financial reporting requirements under federal securities laws” then the CEO and CFO must reimburse the issuer for:

- bonuses or other incentive- or equity-based compensation received from the issuer during the 12-month period following the earlier of the first public issuance or filing with the SEC of the document requiring such restatement; and
- any profits received in connection with the sale of the issuer’s securities during that 12-month period.

U.S. courts have consistently held that no private right of action exists under Section 304 of the Act; only the SEC can bring suit.
Under the Act, it is illegal for an issuer to “extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof)” of the issuer.

- This includes direct and indirect extensions of credit (e.g., through subsidiaries).
- Certain limited exemptions include:
  - any loan existing on or before July 30, 2002; however, material modification or renewal of such loans is prohibited;
  - consumer credit and extensions of credit under a charge card; and
  - certain bank loans.
Impact on Audit Committees – Audit Committee Member Independence

Under the Act, as implemented by Exchange Act Rule 10A-3 (“Rule 10A-3”), each member of an issuer’s audit committee must be a member of the issuer’s board of directors and must meet certain independence requirements.

• To be independent under Rule 10A-3, a member of an audit committee (1) may not, other than in his or her capacity as a member of the audit committee, the board of directors or any other board committee, accept any consulting, advisory or other compensatory fee from the issuer and (2) may not be an “affiliated person” of the issuer or any of its subsidiaries.

• An “affiliated person” includes any person who, directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with the specified person; however, there is a carve-out for certain non-executive officers and other persons that are 10% or less shareholders of the issuer.

FPIs, however, are entitled to certain exemptions from Rule 10A-3’s independence requirements.
The following members of an FPI’s audit committee may be exempted from Rule 10A-3’s independence requirements, though (2) and (3) below are exemptions only from the “affiliated person” prong:

- (1) a non-executive employee of the FPI if the employee is elected or named to the FPI’s board of directors or audit committee pursuant to the issuer’s governing law or documents, an employee collective-bargaining or similar agreement or other home country legal or listing requirements;

- (2) an affiliate, or a representative of an affiliate, of the FPI if such member has only observer status, and is not a voting member or chair of, the audit committee, and if neither the member nor the affiliate is an executive officer of the FPI; and

- (3) a representative or designee of a foreign government or foreign governmental entity that is an affiliate of the FPI, if such member is not an executive officer of the FPI.
Impact on Audit Committees – Audit Committee Responsibilities

**Under Rule 10A-3, an audit committee must:**

- be directly responsible for the appointment, compensation, retention and oversight of the work of any of the external auditors, who must report directly to the audit committee;
- establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, and for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters;
- have the authority to engage independent counsel and other advisers, as it deems necessary to carry out its duties; and
- be provided with appropriate funding by the issuer, as determined by the audit committee, for compensation of external auditors, advisers employed by the audit committee, and ordinary administrative expenses that are necessary for the audit committee to carry out its duties.

The above requirements are not intended to conflict with or affect the application of any requirement or ability under an FPI’s governing law or documents or other home country legal or listing provisions that require or permit shareholders to ultimately vote on, approve or ratify such requirements. However, if an FPI provides a recommendation or nomination regarding such responsibilities to shareholders, its audit committee (or similar body) must be responsible for making the recommendation or nomination.

Rule 10A-3 also includes a general exemption for FPIs that have a board of auditors, or statutory auditors, established and selected pursuant to home country legal or listing requirements, which in turn meet certain requirements under Rule 10A-3. An FPI relying on Rule 10A-3’s exemptions from independence or the general exemption, must disclose in its annual report such reliance and an assessment of whether, and if so, how, the reliance would materially adversely affect the ability of the audit committee to act independently and to satisfy any other requirement under Rule 10A-3.
Section 407(a) of the Act, as implemented by Item 16A of Form 20-F, requires an FPI to disclose that its board of directors has determined whether or not the issuer has at least one audit committee financial expert serving on its audit committee, or if not, to explain why. If an FPI has a two-tier board of directors, the supervisory or non-management board makes this determination.

In addition, an FPI must disclose in its Form 20-F the name of the audit committee financial expert (if applicable) and whether that person is “independent” from management.
“Audit committee financial expert” means a person who has the following attributes:

- an understanding of GAAP (or the body of GAAP used by the issuer in its primary financial statements) and financial statements;
- the ability to assess the general application of GAAP in connection with the accounting for estimates, accruals and reserves;
- experience preparing, auditing, analyzing or evaluating financial statements similar to those of the issuer, or actively supervising others engaged in these activities;
- an understanding of internal control over financial reporting; and
- an understanding of audit committee functions.

In addition, an audit committee financial expert must have acquired such attributes through:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or through experience in similar positions;
- experience actively supervising these functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- other relevant experience.
Safe Harbor - Item 16A of Form 20-F includes a safe harbor from liability for audit committee financial experts, under which:

- a person who is determined to be an audit committee financial expert will not be deemed to be an expert for any purpose, such as Section 11 of the Securities Act of 1933, as amended (the “Securities Act”); and

- the designation of a person as an audit committee financial expert does not impose greater duties, obligations or liabilities on the person than on other audit committee and board members, and does not affect the duties, obligations or liabilities of other audit committee and board members.
Non-GAAP/Non-IFRS Financial Measures – Application of Regulation G and Item 10(e) to FPIs

Regulation G
• Generally requires public companies that disclose or release non-GAAP/non-International Financial Reporting Standards (“IFRS”) financial measures to include, in that disclosure or release, a presentation of the most directly comparable GAAP/IFRS financial measure and a quantitative reconciliation of the disclosed non-GAAP/non-IFRS financial measure to the most directly comparable GAAP/IFRS financial measure.

Item 10(e) of Regulation S-K (“Item 10(e)”) 
• Governs SEC filings made under the Securities Act and the Exchange Act
• If an FPI includes a non-GAAP/non-IFRS financial measure in an SEC filing, it must also include: (1) a presentation, with equal or greater prominence, of the most directly comparable GAAP/IFRS financial measure; (2) a quantitative reconciliation of the difference between the non-GAAP/non-IFRS financial measure and the most directly comparable GAAP/IFRS financial measure; (3) a statement as to why management believes the non-GAAP/non-IFRS financial measure provides useful information for investors; and (4) to the extent material, a statement of the additional purposes for which management uses the non-GAAP/non-IFRS financial measure.
• In addition to other requirements, Item 10(e) prohibits the presentation of non-GAAP/non-IFRS financial measures on the face of financial statements or the accompanying notes and on the face of any pro forma financial information required to be disclosed pursuant to Regulation S-X.

Limited exemptions exist for FPIs under both Regulation G and Item 10(e).
Limited Exemption Under Regulation G

- Regulation G does not apply to public disclosure of a non-GAAP/non-IFRS financial measure by, or on behalf of, an FPI if:
  - the securities of the FPI are listed or quoted on a securities exchange or inter-dealer quotation system outside the U.S.;
  - the non-GAAP/non-IFRS financial measure is not derived from or based on a measure calculated and presented in accordance with U.S. GAAP; and
  - the disclosure is made by or on behalf of the FPI outside the U.S., or is included in a written communication that is released by or on behalf of the FPI outside the U.S.

- This exemption continues to apply to any disclosure of non-GAAP/non-IFRS financial measures even where any one or more of the following circumstances exist:
  - the FPI releases a written communication in the U.S. as well as outside the U.S., so long as the communication is released in the U.S. contemporaneously with or after the release outside the U.S. and is not otherwise targeted at persons located in the U.S.;
  - foreign journalists, U.S. journalists or other third parties have access to the information;
  - the information appears on one or more websites maintained by the FPI, so long as the websites, taken together, are not available exclusively to, or targeted at, persons located in the U.S.; or
  - following the disclosure or release of the information outside the U.S., the information is included in a submission to the SEC made under cover of a Form 6-K.
Limited Exemption under Item 10(e)

• FPIs are permitted to use a non-GAAP financial measure otherwise proscribed by Item 10(e) so long as the measure:
  - relates to home-country accounting standards that comprise a comprehensive basis of accounting or IFRS;
  - is required or “expressly permitted” by the standard-setter responsible for establishing the home-country accounting standards; and
  - is included in the annual report prepared by the FPI for use in its home-country jurisdiction for distribution to security-holders

• What is “expressly permitted”?
  - Any financial measure will be considered to be “expressly permitted” if either of the following is true:
    ▪ the applicable standard-setter clearly and specifically identifies the measure as acceptable; or
    ▪ the primary securities regulator in the FPI’s home-country jurisdiction or market explicitly accepts a presentation, including by publication of such views by the regulator or its staff or by letter to the FPI from the regulator or its staff indicating such acceptance.
Additional Impact on Disclosure

- FPIs must disclose in their annual report on Form 20-F whether or not, and if not, the reason why not, the issuer has adopted a written code of ethics applicable to the principal executive officer, principal financial officer and controller or principal accounting officer, or person performing similar functions.

- The Act subjects FPIs to rules that require enhanced disclosure regarding off-balance sheet arrangements and contractual obligations in annual reports on Form 20-F and registration statements on Forms F-1, F-3 and F-4. FPIs are required to disclose off-balance sheet arrangements in a separately captioned subsection in the relevant filing.

- Under New York Stock Exchange ("NYSE") corporate governance requirements, FPIs must disclose in their annual report on Form 20-F any significant ways in which their corporate governance practices differ from those followed by U.S. companies under NYSE listing standards.

- Under the Act, the SEC must review disclosures made by issuers in their annual reports, including financial statements, at least once every three years.
Regulation BTR

Section 306 of the Act, as implemented by Regulation Blackout Trading Restrictions ("Regulation BTR"), prohibits any director or executive officer of an issuer from purchasing, selling, or otherwise transferring the issuer’s equity securities during any “blackout period” applicable to the securities if the officer acquires or previously acquired the securities in connection with his or her service or employment as a director or officer, subject to certain exceptions.

A blackout period for an FPI generally means any period longer than three consecutive business days during which the ability to purchase or sell an interest in the issuer’s equity securities held in an “individual account plan” (e.g., a qualifying retirement plan under Section 401(k) of the U.S. Internal Revenue Code) is temporarily suspended by the issuer or by a fiduciary of the plan with respect to 50% or more of participants or beneficiaries located in the U.S. and either:

- the number of participants and beneficiaries located in the U.S. subject to the temporary suspension is greater than 15% of the total number of employees of the issuer and its consolidated subsidiaries; or
- more than 50,000 participants or beneficiaries located in the U.S. are subject to the temporary suspension.
Impact on Attorneys

Section 307 of the Act, as implemented by the SEC’s Part 205 standards, requires covered attorneys who become aware of a material violation of U.S. securities law or a breach of fiduciary duty or a similar material violation of any U.S. federal or state law to report evidence of the violation to an issuer’s chief legal officer (“CLO”) or to both the CLO and CEO.

If the reporting attorney does not reasonably believe that the CLO’s response was adequate, he or she is required to report the matter to the audit committee of the issuer, or another independent board committee if the issuer does not have an audit committee, or the full board of directors.

Covered Attorney - Generally, any attorney that is appearing and practicing before the SEC in the representation of an issuer (Note: this is a broad definition).
Impact on Auditing Firms

Foreign audit firms that include audit reports on the financial statements of issuers in SEC filings must be registered with the Public Company Accounting Oversight Board (the “PCAOB”).

The Act imposes a ban on the provision of certain non-audit services to audit clients, including the following:

- bookkeeping or other services related to the accounting records or financial statements;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker/dealer, investment advisor, or investment banking services; legal services and expert services unrelated to audit; and
- any other service that the PCAOB prohibits.
Impact on Auditing Firms (continued)

All audit and non-audit services (including tax services) must be pre-approved by the audit committee or board of auditors, as applicable.

De minimis exception for approval of non-prohibited non-audit services, provided that they:
- do not comprise more than 5% of the fees paid to the auditors for the year;
- were not recognized as non-audit services at the time of the engagement; and
- are approved by the audit committee.

FPIs must discuss the audit committee’s policies and procedures for pre-approval of audit and non-audit services in annual reports on Form 20-F and must disclose:
- the percentage of non-audit services approved by the audit committee under the “de minimis” test;
- the percentage of hours, if greater than 50%, expended on the principal accountant’s audit engagement for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant’s full-time, permanent employees; and
- the amount of fees paid during the two most recent fiscal years to their auditors for audit services and audit-related services, tax services and all other services; the issuer must also include a description of audit-related, tax and other services.
Impact on Auditing Firms (continued)

Rotation of Audit Partners

- **Lead and Concurring Partners**
  - The lead and concurring partners on the audit engagement team for a particular issuer must rotate off the team after five years, after which such individuals are subject to a five-year “time out” period before being permitted to return to such team.

  - Independence of a lead or concurring partner is considered impaired if a one-year cooling-off period is not maintained between his or her provision of more than 10 hours of audit, review or attest services or service on an issuer’s audit engagement team and his or her employment by such issuer in a “financial reporting oversight role.”

- **“Audit Partners”**
  - Other “audit partners” are also subject to rotation requirements and must rotate after no more than seven years on an engagement team for a particular issuer, after which such individuals are subject to a two-year “time out” period.

  - Independence of an “audit partner” is deemed impaired if he or she receives compensation for an engagement to provide any services to the issuer other than audit, review or attest services.
Enforcement, Penalties and Liability

SEC Enforcement

- The Act provides that any violation of the Act is considered a violation of the Exchange Act, availing the SEC of its full range of powers, remedies, and penalties under the Exchange Act.

- The Act gives the SEC authority to temporarily freeze “extraordinary” payments to directors, officers and employees of companies under investigation.

- The Act gives the SEC greater power to bar persons from serving as directors and officers of public companies due to violations of certain securities laws.

Under the Act, as implemented by SEC rules, it is also unlawful:

(1) to falsify, or cause to be falsified, books, records and accounts;

(2) for a director or officer to make, or cause to be made, a materially false or misleading statement, or to omit, or cause to be omitted, any material fact necessary to make statements made not misleading, in connection with an audit, review or examination of financial statements or the preparation or filing of any document/report required to be filed with the SEC; and

(3) for a director or officer, or persons acting under their direction, to improperly influence an auditor engaged in the performance of an audit of the issuer’s financial statements when the director, officer or other person knew or should have known that the action, if successful, could result in rendering the issuer’s financial statements filed with the SEC materially misleading.
To “improperly influence” includes any action “to coerce, manipulate, mislead, or fraudulently influence.”

The SEC has suggested that types of conduct that could be seen as “improperly influencing” include, but are not limited to, directly or indirectly:

- offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services;
- providing an auditor with inaccurate or misleading legal analysis;
- cancelling, or threatening to cancel, existing audit or non-audit engagements if the auditor objects to the issuer’s accounting;
- attempting to have a partner removed from an audit engagement due to the partner’s objection to the issuer’s accounting;
- blackmailing; and
- making physical threats.
Criminal Violations

Under the Act, the following acts are crimes:

- to knowingly alter, conceal, or destroy a document with the intent of impeding, obstructing, or influencing an ongoing or contemplated federal investigation or bankruptcy proceeding (maximum 20-year sentence)
- to knowingly execute a scheme to defraud shareholders of a publicly traded company (maximum 25-year sentence and substantial fines)
- to knowingly submit a false Section 906 certification (penalties range from up to 10 years and $1 million for a knowing violation and up to 20 years and $5 million for a willful violation)
Civil Liability

- Under the Act, the statute of limitations for a private right of action for a securities fraud claim can be brought not later than the earlier of (1) five years after the date of the violation and (2) two years after its discovery.

Bankruptcy Code

- Under the Act, bankruptcy judgments and settlement agreements resulting from a violation of U.S. federal or state securities laws, or common law, fraud pertaining to securities sales or purchases are non-dischargeable.
Sutherland’s Securities Practice

Sutherland’s securities practice serves a wide range of clients, from public companies large and small raising capital in the public capital markets to private corporations leveraging private placements to build their businesses. We work with management teams, boards of directors, and underwriters of small, medium, and Fortune 500 companies to complete initial public offerings, follow-on equity and debt offerings, rights offerings, and private placement transactions to fund corporate growth, strategic transactions, and refinancing activity. Our team includes a number of attorneys who previously served on the staff of the U.S. Securities and Exchange Commission, and we routinely interact with SEC staff members in connection with the filing of registration statements and other securities filings. We have the breadth, depth and experience to complete complex capital formation transactions efficiently. Our securities team is highly experienced in successfully completing offerings of all types including:

- Private placements of debt and equity
- Initial public offerings and follow-on equity offerings
- Secured and unsecured public debt
- Convertible debt
- Stock exchanges, tender offers, and stock repurchase programs
- Sales of stock by insiders and other selling stockholders
- Transferable and non-transferable rights offerings
- Ongoing financial reporting and disclosure
- Ownership reporting under Section 13 and Section 16
Contact Information

Harry S. Pangas, Partner
202.383.0805
harry.pangas@sutherland.com

J. Clay Douglas, Associate
202.383.0830
clay.douglas@sutherland.com