

# News flash

## To list or not to list?

**J**uly 15, 2006 - The deadline for foreign companies listed in the US to comply with Sarbanes Oxley ("SOX") has finally come to pass, and international companies intending to do business in the US must now comply with its legal and governance requirements. The most controversial provision of SOX is what has been labelled the '*notorious section 404*', which requires directors of companies to certify the effectiveness of their internal controls and to **report any weaknesses or compliance deficiencies.**

Ahead of the SOX deadline, the debate that has stirred the boardroom of many foreign companies is the cost of doing business in the US. SOX, the SEC, extradition, registration of hedge funds, and now the regulatory investigation into Directors' stock options, (which includes companies with offices/listings in the UK), as well as the increasingly international nature of regulatory investigations and enforcement action, leaves companies weighing up the real cost of making a quick buck. **Nilam Sharma** and **Misha Nateghi** review the implications of SOX for UK and foreign companies, directors and their Insurers.

### Sarbanes Oxley Act 2002 ('SOX')

There are some 1,200 foreign companies listed on the US exchanges, including the New York Stock Exchange and NASDAQ. Of these, companies with a market capital of more than \$75million were required to comply with SOX by July 15, 2006 (following an extension of the deadline from July 15, 2005).

What does this mean? - Companies with a financial year end on or after July 15, must ensure that their next annual filings comply with the accounting and governance requirements set out in SOX, including the most controversial, section 404, which provides that issuers must disclose relevant internal control structures and procedure information in their annual reports.<sup>1</sup>

While it is not difficult to understand the reasons behind section 404, and the pressure from lobbyists that **there must be legal liability for financial reporting**, after the run of corporate scandals, ironically, one of the concerns raised by directors has been that by reporting insufficient internal controls and procedures, as required by section 404, this may impact shareholder confidence! The

SEC has, however, confirmed that it will not impose penalties on companies that do report material weaknesses in their controls, provided that companies have disclosed how they intend to, and will remedy these deficiencies.

In reality, **the focus is on how the company intends to address its shortcomings**, and it is possible that this transparency and open-ness can start to rebuild trust and confidence where shareholders can see what steps the directors are taking to remedy any deficiency in the internal controls and procedures to ensure the company has good standards of corporate governance.

### The cost of US business?

Aside from the criticism that SOX goes too far, recent surveys of directors and heads of industry outside the US, report that more than half of the companies with US listings are considering whether to delist (albeit not a simple process), and they are sceptical of the benefits of trading with the US. For those companies not listed in the US, there is also less temptation to venture across the pond.

For some time, the SEC has had extensive powers of investigation and enforcement, reaching beyond the US. Its compulsory powers are set out in the Securities Exchange Act 1934 ('SEA 1934')<sup>2</sup> and provide that the **SEC may conduct investigations, compel the production of documents and testimony from persons or entities, even if not regulated by the SEC**, and provide such information to other foreign governments and regulatory authorities.

However, whilst SOX arguably goes further than previous legislation, the SEA 1934 Section 10b and Rule 10b-5 make the



- ▶ use of manipulative and deceptive devices unlawful ie. schemes to defraud, untrue statements of a material fact, misleading statements and any practice/act or course of business that constitutes fraud or deceit.

Using its powers of investigation, the SEC has undertaken a number of international enforcement cases, where the entity or persons were not domiciled in the US eg. Sonja Anticevic<sup>3</sup> - the defendants traded at an Austrian broker and were charged with insider trading domestically and abroad, and violation of Section 10b and Rule 10b-5. Similarly, in the case of Lohmus Haavel & Viisemann,<sup>4</sup> the traders were an Estonian financial services firm that used an electronic trading scheme to steal non public issuer information to conduct a fraud.

Even more recently, the 1952 US Wire Fraud Statute has come to the fore, highlighting how criminal fraudulent activity involving electronic communications of any sort, which *do not have* to be initiated in the US, can be actionable.

All that is required under this statute for liability, is a knowing and wilful or an intended scheme to defraud. The penalty is a fine or 20 years imprisonment, or both. **If the violation affects a financial institution, the penalty is a fine of not more than \$1 million, or imprisonment, of not more than 30 years, or both!**<sup>5</sup>

For companies that undertake international activities and transactions, entities and individuals can find themselves exposed to serious liability, heavy fines and custodial sentences, where the violation occurs in the US or affects US persons. However, the US has traditionally been far more litigious, and **the potential for US exposure has always existed – it is not new and it is not simply a product of SOX.**

#### Conclusions

While the legal requirements to trade in the US, and the potential exposures faced by companies, and their directors and officers can be daunting, an alternative view is that this is simply the price of doing business in today's commercial world.

<sup>1</sup> Sarbanes Oxley Act 2002 SEC.404 Management Assessment of Internal Controls

<sup>2</sup> Securities Exchange Act 1934 (adopted 1988) section 21(a)(2) and 24(c)

<sup>3</sup> Securities and Exchange Commission v Sonja Anticevic et al., 05 civ. 6991 (KMM) (S.D.N.Y) (August 18, 2005)

<sup>4</sup> Securities and Exchange Commission v Lohmus Haavel & Viisemann, et al., Civil Action No. 05-9259 (S.D.N.Y)

<sup>5</sup> Wire Fraud Statute 1952 Title 18, Part 1, chapter 63, 1343: Fraud by wire, radio or television

Corporate governance has long been on the agenda of many UK boardrooms, and the forthcoming UK Companies Bill has posed similar questions, as to whether it goes too far, by imposing an obligation on directors to promote the interests of the company and its members, which extends beyond shareholders, to include consumers, the community, the environment, and to consider the long term implications of any decision.

Companies, directors and their Insurers, are adapting to a global corporate governance and regulatory regime, which is part and parcel of undertaking business on an international scale.

Working in partnership with underwriters, brokers and insureds, it is possible to better understand the risks companies face during the course of their usual business activities, and to find ways to address the potential exposures within their insurance program:

- Where are the insured's operations, communications, personnel and trading activities?
- What are the regulatory and governance requirements in those jurisdictions?
- What is the insured's knowledge and attitude to its legal and governance obligations? How does it intend to meet them?
- Is there any relationship/contact/client base/trading that occurs in the US, Asia, Latin America or Emerging Markets?
- How can underwriters rate varying levels of exposure faced by different segments of a business? eg. separate limits and retentions for US/European/Asian exposure?
- What about similar or related claims in multiple jurisdictions?
- Crisis management, reputation and publicity?

SOX is here to stay, the Companies Bill is expected to come into force in April 2007, and the global reach of the SEC and FSA are likely to continue to grow. The question may not be whether or not companies can afford to have business interests in the US, but assessing the costs of running a business generally, for companies, their directors and shareholders, and how they can protect themselves, if the worst does happen.

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**We can put together a seminar/talk or panel discussion on the issue above, or any of the issues featured in Inversions to be held at any of our offices, or yours. If you are interested, please contact any one of our lawyers or David Simon at david.simon@robinsimonllp.com.**

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