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THE EUROPEAN COMMISSION’S ACTION PLAN TO MODERNIZE EUROPEAN COMPANY LAW: HOW FAR SHOULD THE SEC GO IN EXEMPTING EUROPEAN ISSUERS FROM COMPLYING WITH THE SARBANES-OXLEY ACT?

Kristina A. Sadlak*

I. INTRODUCTION

On July 30, 2002, in response to a series of corporate and accounting scandals,1 Congress passed the most comprehensive securities legislation since the 1930s,2 commonly known as the Sarbanes-Oxley Act (Act).3 President George W. Bush referred to the Act as the “most far-reaching overhaul of the nation’s business practices since the Great Depression.”4 The Act affects virtually every

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1 Most notably the 2002 Enron and WorldCom collapses. See Matthew M. Benov, The Equivalence Test and Sarbanes-Oxley: Accommodating Foreign Private Issuers and Maintaining the Vitality of U.S. Markets, 16 TRANSNAT’L LAW 439, 440. “The collapse of WorldCom illustrated that Enron was not simply an anomaly and that America needed corporate reform. The sudden and immediate collapse of two corporate giants forced the U.S. Congress and the President to respond,” id. at 441.


4 See Mike Allen, Bush Signs Corporate Reforms Into Law; President Says Era of “False Profits” is Over, WASH. POST, July 31, 2002, at A4.
facet of the United States’ capital markets.\(^5\) Enacted for the express purpose of protecting investors by “improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws,”\(^6\) the Act’s principle objectives are to restore investor confidence and to assure the integrity of U.S. markets.\(^7\) By passing the Act, Congress intended to address the systematic and structural weaknesses recently plaguing capital markets, which weaknesses are due mostly to ineffective audits and the lack of corporate responsibility.\(^8\)

The Act’s provisions require the Securities and Exchange Commission (SEC or Agency) to promulgate rules implementing the legislation.\(^9\) To date, the SEC has made substantial progress toward this end.\(^10\) The Act’s extensive rules and accompanying regulations apply to both domestic and foreign securities issuers that list in the United States or file reports with the SEC.\(^11\) As a result, the rules promulgated by the SEC in accordance with the Act initially subjected about 1300 foreign companies to the Act’s new requirements.\(^12\) For example, the New York Stock Exchange lists 460 non-U.S. companies with a global market value of roughly $7.1 trillion.\(^13\)

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\(^5\) See Testimony Concerning Implementation, supra note 2, at § III.

\(^6\) Sarbanes-Oxley Act, supra note 3; Bush, supra note 2, at 543.

\(^7\) See Testimony Concerning Implementation, supra note 2, at § III. The major objectives of the Act “can be grouped into the following themes: to strengthen and restore confidence in the accounting profession; to strengthen enforcement of the federal securities laws; to improve the ‘tone at the top’ and executive responsibility; to improve disclosure and financial reporting; and to improve the performance of ‘gatekeepers.’” Id.


\(^10\) See Testimony Concerning Implementation, supra note 2, at § I (stating “we have met all of the mandates and challenges set out by the Act, and in record time”).

\(^11\) See id. at § III(F)(1).


However, the SEC must face the reality that the development of multinational corporations,\(^\text{14}\) changing technology, and the removal of capital controls worldwide have brought about a truly global securities market that may require some exemptions for foreign issuers.\(^\text{15}\)

At the outset, the SEC did not provide any exemptions for foreign issuers.\(^\text{16}\) Not surprisingly, the Agency received countless objections and complaints from foreign securities issuers regarding the application of its rules.\(^\text{17}\) European companies chiefly complain that many of the Act’s provisions infringe upon other nations’ sovereignty, and as a result, the United States is acting “as a global corporate regulator.”\(^\text{18}\) Foreign issuers also claim that the Act’s stringent requirements fail to respect corporate structure norms in their home states.\(^\text{19}\) Strict compliance with the Act will cause European issuers to incur significant costs and time commitments. For example, European issuers must conform their financial statements to the Generally Accepted Accounting Principles (GAAP), reorganize their Board of Directors and audit committees, and comply with potentially conflicting corporate governance requirements. In response to mounting criticism from European issuers and governments, the SEC has finally started to address foreign issuers’ concerns by granting

\(^{14}\) Multinational corporations play a key role in both the U.S. and in the world economy. Such corporations operate throughout the world, entities incorporate under the laws of the countries in which they operate and have multi-tiered structures with a plethora of subsidiaries, and are incorporated under the laws of the countries in which they operate. PHILLIP I. BLUMBERG ET AL., 5 BLUMBERG ON CORPORATE GROUPS § 1.01 (2005).

\(^{15}\) See, e.g., Beth A. Simmons, The Internationalization of Capital, in CONTINUITY AND CHANGE IN CONTEMPORARY CAPITALISM 36 (Herbert Kitschelt et al. eds., 1999) (noting that “the internationalization and integration of capital markets has been the most significant change in the political economy of the industrialized countries over the past three decades”). See also Ethiopis Tafara, Director Office of International Affairs, SEC, Testimony Concerning Global Markets, National Regulation, and Cooperation Before the House Financial Services Committee (May 13, 2004), http://www.sec.gov/news/testimony/ts051304et.htm.

\(^{16}\) See discussion, infra Part I (discussing the President and the SEC’s intent to apply the Act in the same manner to domestic and foreign issuers).

\(^{17}\) See discussion, infra Part I.

\(^{18}\) See Falenczi, supra note 12, at 1218.

them exemptions to several of the Act’s provisions, which this paper discusses in later sections.\textsuperscript{20}

Just nine months after Congress’ enactment of the Sarbanes-Oxley Act, on May 21, 2003, the European Commission of the European Union (EC) presented a plan entitled “Modernizing Company Law and Enhancing Corporate Governance in the European Union—A Plan to Move Forward” (Plan).\textsuperscript{21} The Plan seeks to enhance investor confidence “in the wake of recent corporate governance scandals”\textsuperscript{22} and to foster the worldwide efficiency and competitiveness of businesses in the E.U.\textsuperscript{23} The Plan affects all E.U.-member countries and contains a set of legislative\textsuperscript{24} proposals and recommendations to be enacted over three phases through the year 2009.\textsuperscript{25} The Plan addresses many of the same reforms as the Act, but leaves significant room for flexibility in order to respect the differences in corporate norms and the diverging practices of E.U. Member States.\textsuperscript{26}

This paper proposes that the SEC should take further steps to exempt European issuers from certain of the Act’s provisions because they fail to consider the different E.U. corporate practice norms and because they infringe on the sovereignty of other nations. Additionally, European issuers should be exempt because the EC Plan

\begin{itemize}
\item \textsuperscript{20} See Testimony Concerning Implementation, supra note 2, at III(F)(I).
\item \textsuperscript{21} Communication From the Commission to the Council and the European Parliament, Modernizing Company Law and Enhancing Corporate Governance in the European Union—A Plan to Move Forward, EUR. PARL. DOC. (COM 284 final) 3 (2003) [hereinafter Modernizing Company Law].
\item \textsuperscript{22} Modernizing Company Law, supra note 21. The Parmalat scandal is the latest in a series of corporate scandals, in which, despite annual losses of 350 to 450 million euros from the 1990s through 2001, the company accountings showed positive earnings for the years in question. Id. Billions of euro-bonds were issued, despite the group’s weak real financial situation of the group. It is speculated that the scandal resulted from improperly functioning internal controls within Parmalat’s extensive subsidiaries web of subsidiaries, a lack of corporate leadership and governance, and audit failures. See Communication From the Commission to the Council and the European Parliament on Preventing and Combating Corporate and Financial Malpractice, EUR. PARL. DOC. (COM 611 final) 3 (2004).
\item \textsuperscript{23} See id.
\item \textsuperscript{24} Legislative instruments are defined as requiring “either the adoption of a new legislative proposal or the modification of one or several existing legislative instruments.” See Modernizing Company Law, supra note 21, at n5.
\item \textsuperscript{26} See generally Modernizing Company Law, supra note 21.
\end{itemize}
will likely accomplish the desired goals of the Act. The SEC could create additional limited exemptions without compromising the purposes of the Act—to restore investor confidence in the markets and to assure the integrity of the U.S. market. These exemptions include:

1) permitting European issuers to file financial statements with the SEC using only International Financial Reporting Standards (IFRS),
2) exempting European issuers from audit committee independence requirements when the issuer’s home country independence standards are the same as the SEC’s,
3) exempting European issuers from CEO and CFO certification requirements when the issuer’s home country or the EC imposes collective liability on board members, and
4) exempting European issuers from Public Company Accounting Oversight Board (PCAOB or Board) registration and inspection if the EC’s Committee of European Securities Regulators (CESR) and Committee on Auditing oversight capabilities parallel those of the PCAOB.

In Part I, this paper will briefly discuss the Sarbanes-Oxley Act’s initial impact on foreign issuers. Part II introduces the EC’s Plan, contrasting it with the Act. Part III analyzes the provisions of the Act and the accompanying SEC rules affecting European companies, contrasting them with equivalent provisions of the EC’s Plan. Part III also examines measures that the SEC has already taken to exempt European issuers from compliance with the Act, including a discussion of what further steps could be taken. Part IV summarizes the proposed exemptions.

II. THE SARBANES-OXLEY ACT

The Act’s provisions are far-reaching, making no explicit distinction between domestic and foreign issuers. The provisions and accompanying rules apply to any issuer who registers securities on an American exchange and, more broadly, to any issuer who is required to file reports with the SEC. Many provisions, such as the executive-officer-certification requirement, also apply to specific foreign corporations not issuing securities on a U.S. exchange. Today, the SEC requires foreign issuers with assets greater than $10 million, more than 300 U.S. shareholders, and more than 500 total worldwide

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shareholders to register and file reports with the SEC.\textsuperscript{28} Previously, the SEC exempted companies falling within this category from certain registration requirements, provided they submit reports containing information that the issuer’s home country required to be made public.\textsuperscript{29}

Apparently, the SEC intends to apply all provisions of the Act to foreign issuers registering in the United States and filing reports with the SEC.\textsuperscript{30} Yet, the Agency has also stated that it is “prepared to consider how [it] can fulfill the mandate of the Act through . . . rulemaking and interpretive authority in ways that accommodate the

\textsuperscript{28} Securities Exchange Act of 1934 § 12(g); Commission Notice: List of Foreign Issuers Which Have Submitted Information Under the Exemption Relating to Certain Foreign Securities, Release No. 34-39681 (Feb. 19, 1998). See \textsc{Louis Loss \\
and Joel Seligman, 5 Fundamentals of Securities Regulation} 211 (2000). See generally Stahr \\
& Palenberg, supra note 23.

\textsuperscript{29} The Securities Exchange Act of 1934 § 12g3-2(b) provides an exemption from registration under Section 12(g) with respect to a foreign private issuer that submits to the Commission, on a current basis, the material required by the Rule. The informational requirements are designed to give investors access to certain information so they have the opportunity to inform themselves about the issuer. The Rule requires the issuer to provide the Commission with information that it has: 1) made or is required to make public pursuant to the law of the country of its domicile or the country in which it is incorporated or organized; 2) filed or is required to file with a stock exchange on which its securities are traded and that was made public by such exchange; and/or, 3) distributed or is required to distribute to its securities holders. Commission Notice: List of Foreign Issuers Which Have Submitted Information Under the Exemption Relating to Certain Foreign Securities, Securities Act Release No. 34-39681 (Feb. 19, 1998), http://www.sec.gov/rules/other/34-39681.htm (last visited Nov. 16, 2006). In December 2005, the SEC announced that it will propose new reporting requirements, for example, that a foreign issuer may end its reporting requirements if ten percent or less of total shares are held by U.S. investors. Andrew Parker, \textit{SEC Reform to Ease U.S. Reporting Obligations}, FT.COM, Dec. 4, 2005; Press Release, SEC Votes to Propose Rules on Tender Offers, Foreign Issuer, Deregistration; See also Votes to Adopt Filing Acceleration Changes (Dec. 14, 2005), http://www.sec.gov/news/press/2005-176.htm.

home country requirements and regulatory approaches of the home jurisdiction of our foreign registrants and potential registrants.\footnote{Id.}

The Act not only imposes significant costs on foreign issuers, but many of its provisions conflict with European norms relating to the structure and practices of corporations as discussed in Part III(C)(1) and (D)(1). At the outset, numerous European issuers, interest groups, and governments widely opposed the Act.\footnote{See A.M. Best Company, Inc., Sarbanes-Oxley Adds Uncertainty to European View of U.S. Markets, BESTWIRE, Mar. 10, 2003 (stating “there’s a concern in the European Union about a lack of deference to the European regulatory environment” and “the idea that the U.S. approach to corporate governance and financial reporting is too rigid and complex is fairly common in Europe”).} For example, the Union of Industrial and Employers’ Confederation of Europe (UNICE) voiced concern over the application of the Act to European issuers.\footnote{See Maria Camilla Cardilli, LLM Perspectives: Regulation Without Borders: The Impact of Sarbanes-Oxley on European Companies, 27 FORDHAM INT’L L.J. 785, 791 (2004).} Specifically, UNICE complained that because European issuers already face tough audit standards, the extra burdens imposed by the Act are unnecessary.\footnote{See id.} UNICE also complained that although European countries and businesses support standardized corporate governance standards, these standards are nevertheless a product of the legal and economic cultures prevailing in each country.\footnote{See id.}

Likewise, European issuers object to the Act because compliance with the Act’s provisions imposes burdensome costs. In some instances requires issuers to comply with conflicting regulations.\footnote{See id.} German entities decried the incompatibility of the Act’s corporate governance provisions with German corporate governance laws.\footnote{See id. at 791-92.} The European Commission’s Director General, Alexander Schaub, even requested that the SEC exempt all E.U. companies and auditors from the Act’s corporate governance reform provisions.\footnote{Letter from Alexander Schaub, Director General of the European Commission, to Jonathan Katz, Secretary of the SEC (Feb. 18, 2003), http://www.sec.gov/rules/proposed/s70203/aschaub1.htm. Alexander Schaub stated in full: We request full recognition of equivalence of EU corporate governance system …. The SEC should be aware that EU
Prior to the Act, the SEC respected the different laws under which foreign issuers were incorporated. Consequently, the SEC did not require that foreign issuers in the U.S. capital markets comply with provisions relating to registration and disclosure. Instead, the SEC allowed foreign companies to prepare their financial statements according to U.S. GAAP, or some other adequate alternative accounting standard. As with the Act, companies preparing financial statements according to standards other than U.S. GAAP were required to include a reconciliation of material variations between the two standards. Before the Act, however, the SEC only required a signature on behalf of the company. Now, the Act requires a specific corporate officer to verify such reconciliations. Furthermore, prior to the Act, the SEC did not subject foreign issuers to requirements regarding internal control procedures. It noted that doing so “may be inconsistent with the laws or practices of the foreign private issuers’ home jurisdiction and stock exchange requirements.”

Companies and auditors are already subject to longstanding, well-developed member state corporate governance requirements. These are tailored to their specific legal environments and are in their different ways as effective and efficient at providing investor protection as U.S. rules. Additional requirements of the Sarbanes-Oxley Act applied to EU companies and auditors would place on them an unnecessary additional layer of requirements—taken from a completely different (U.S.) corporate governance environment. We fail to see why EU companies and auditors should be overburdened with such duplicative requirements compared to their U.S. counterparts. . . .Bearing this in mind, the SEC should recognize the equivalence of EU corporate governance systems and thus fully exempt not only EU lawyers but also EU companies and auditors from the provisions of Sarbanes-Oxley, also with regard to audit committee requirements.

40 See id.
41 See id.
42 See id.
44 See id. See also Falencki, supra note 12, at 1216 (noting that “despite the longstanding adherence to the presumption against extraterritorial application of U.S. regulatory frameworks, the SEC felt unable to ignore the language of the Sarbanes-Oxley Act of 2002 which calls for application to all companies that list stock on the U.S. capital markets”).
In response to the criticism of foreign government entities and corporations, the SEC has created various narrow exemptions for foreign entities. The SEC also extended compliance deadlines for foreign issuers. However, the SEC continues to apply the Act’s provisions to European corporations issuing securities on the U.S. market or filing reports with the SEC.

III. THE EUROPEAN COMMISSION’S PLAN

On May 21, 2003, the European Commission (EC) published an action plan entitled, “Modernizing Company Law and Enhancing Corporate Governance in the EU” (the Plan). The Plan implements new measures that strengthen shareholders’ rights, protect third parties, and foster business efficiency and competitiveness. By implementing these reforms, the EC respects the diversity of each member state’s response to the problems addressed by the Act. Although the EC adopted the Plan only nine months after the adoption of the Act, the Commission emphasized that:

[The Plan] should help shape international regulatory developments. The EU must define its own European corporate governance approach, tailored to its own cultural and business traditions. Indeed, this is an opportunity for the Union to strengthen its influence in the world with good, sensible corporate governance rules. Corporate governance is indeed an area where standards are increasingly being set at international level, as evidenced by the recent developments observed in the United States. The Sarbanes-Oxley Act, adopted on 30 July 2002 in the wave of a series of scandals, delivered a rapid response. The Act unfortunately creates a series of problems due to its outreach efforts on European companies and auditors, and the Commission is engaged in an intense regulatory dialogue with a view to negotiating acceptable solutions with the U.S. authorities (in particular the Securities and Exchange Commission).

45 Latham & Watkins LLP, supra note 25.
46 Modernizing Company Law, supra note 21, at 5.
47 Id.
In many areas, the EU shares the same broad objectives and principles of the Sarbanes-Oxley Act and in some areas, robust, equivalent regulatory approaches already exist in the EU. In other areas, new initiatives are necessary. Earning the right to be recognized as at least “equivalent” alongside other national and international rules is a legitimate end in itself.48

The Plan set forth short, medium, and long-term objectives49 designed to affect reform in the areas of corporate governance, shareholders’ rights, and transparency.50 The EC intended to accomplish its short-term objectives between 2003–2006, its medium-term objectives between 2006–2009, and its long-term objectives after 2009.51 As of June 2005, the Commission had purportedly addressed all actions originally identified as short-term objectives in the Plan.52

The EC’s approach integrated several other prior initiatives as part of the Plan’s overall objective. The EC previously set forth “The Financial Reporting Strategy of 2002,” which aimed to improve financial reporting by adopting a common set of accounting standards.”53 Charlie McCreevy, the European Commissioner for Internal Market and Services, has stressed that the Plan “must be focused and based on a solid assessment of actual needs of market players and investors [and the Plan’s] potential impact . . . must also be subject to careful and thorough assessment.”54 To this end, the EC “will seek to support corporate development and foster growth in an

48 Id.
49 See id. at Appendix A.
50 See id. at 2. The Plan looks specifically at the areas of capital maintenance and alteration, groups and pyramids, corporate restructuring and mobility, the European private company, and enhancing the transparency of for national legal forms of enterprise.
51 See id. at Appendix A.
53 See Modernizing Company Law, supra note 21, at 3–4. See also “The Communication on the priorities for the statutory audit in the EU.” These initiatives are not explicitly part of the Plan, but they seek to solve the same problems as the U.S. Sarbanes-Oxley Act through an integrated approach. See id.
54 McCreevy, supra note 52.
environment of trust and confidence in corporations and markets [because] businesses and investors alike need appropriate and efficient regulation, not over-regulation, but better regulation.55

In several aspects of its Plan, particularly in its non-legislative proposals, the EC follows its Member States’ traditional “comply or explain” approach.56 Under this approach, companies may choose to disclose whether they comply with the applicable code,57 and then they must explain any material departures from it.58 The Plan also uses both legislative instruments and broad recommendations, focusing on flexibility by accommodating the different approaches of its member countries. In addition, the EC approach phases in requirements over several years. In contrast, the SEC approach implements the Act’s rigid set of rules and reforms rapidly and with universal application, only considering the difference in issuers’ home countries in a post-hoc fashion.59

IV. THE MAJOR REFORMS

This section examines the Act’s major reforms and the SEC’s rules, with an emphasis on their impacts on European companies. In addition, this section analyzes the pertinent provisions of the EC’s Plan and any exemptions the SEC has already implemented. Finally, each section discusses further steps the SEC should take towards exempting European issuers from complying with the Act. The major reforms of both the Act and the Plan relate to A) accounting standards and financial reporting disclosures, B) accounting oversight, C) auditor independence, and D) corporate governance. Each reform, its impact on European companies, its counterpart in the EC Plan, and any relevant SEC exemptions for European issuers are discussed in turn below.

55 Id.
56 See Commission Recommendation 2005/162/EC on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, 2005 O.J. (L 52) 4 [hereinafter 2005 O.J. (L 52)]. “This approach enables companies to reflect sector- and enterprise-specific requirements, and the markets to assess the explanations and justifications provided. Id.
57 See id.
58 See id.
59 See discussion, infra Part III(A)–(D).
A. Accounting Standards and Financial Reporting Disclosures

Some of the most important reforms affecting investor confidence in publicly traded companies are those relating to accounting standards and financial reporting disclosures. Both the Act and the EC’s Plan incorporate strict disclosure requirements. To ease tensions and help facilitate a more global economy, the United States should bring its accounting practices in line with European and international standards by adopting IFRS or a similar principles-based accounting standard.

1. The Act

The Act imposes various corporate disclosure requirements in the areas of accounting and financial reporting. Section 401 of the Act requires that an issuer disclose “all material correcting adjustments that have been identified by a registered public accounting firm” in accordance with GAAP and SEC rules. An issuer must also disclose:

- All material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenue or expenses.

The rules adopted by the SEC pursuant to Section 401 are equally applicable to both domestic and foreign issuers. Foreign issuers, whose primary financial statements are prepared in accordance with non-GAAP standards, must reconcile the non-GAAP standards to the U.S. GAAP, in addition to identifying any differences between the

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60 Testimony Concerning Implementation, supra note 2, at III(E).
62 Sarbanes-Oxley Act, supra note 3, at § 401.
63 See Release No. 33-8182, supra note 63.
foreign standard and U.S. GAAP “if it would be necessary for an understanding of the financial statements as a whole.”64

Regulation G, adopted in accordance with Section 341, applies when a company uses a non-GAAP standard.65 Regulation G requires a “presentation of the most directly comparable financial measure calculated and presented in accordance with Generally Accepted Accounting Principles.”66 Any issuer, including foreign issuers, disclosing non-GAAP financial measures must present such information in a true and accurate manner that does not omit material facts and must reconcile the non-GAAP financial standard with GAAP.67 Thus, requiring foreign issuers to comply with Regulation G imposes significant costs on issuers preparing financial statements using non-GAAP standards.

2. The EC’s Plan

In June 2000, the EC adopted the EC Financial Reporting Strategy, requiring all listed E.U. companies to prepare their consolidated accounts in accordance with IFRS, starting January 1, 2005.68 In light of the securities market globalization, the EC recognized the desire to develop a “single, efficient, and competitive EU securities market.”69 The EC’s objective in adopting IFRS is to “accelerate the completion of a single securities market” and “to enhance comparability of financial statements.”70 After carefully

64 Id. (noting that “We believe that the references to U.S. GAAP in the definition best achieve the appropriate scope of arrangements that require more transparent disclosure, regardless of any particular accounting treatment”).
67 See 17 C.F.R. 244.100(b). See also Release No. 33-8176, supra note 67; Testimony Concerning Implementation, supra note 2, at III(E)(3).
69 Id. at 2–3 (noting that “Member States’ securities markets are in a period of dramatic change and increasing consolidation, driven by new technologies, globalization and the effect of the Euro”).
70 Id. at 2.
considering the benefits of and differences between the IFRS and U.S. GAAP, the EC elected to adopt IFRS.\textsuperscript{71} Regarding the differences between U.S. GAAP and IFRS, the EC noted:

Already [IFRS] provides a comprehensive and conceptually robust set of standards for financial reporting that should serve the needs of the international business community. [IFRS] also has the distinct advantage of being drawn up with an international perspective, rather than being tailored to the U.S. environment. U.S. GAAP, on the other hand, is voluminous and is based on very detailed rules and interpretations. Considerable education and training is necessary in order to use its standards. In the U.S. its effective application stems largely from the strong regulatory and enforcement powers exercised by the U.S. Securities and Exchange Commission. The European Union does not, of course, have influence on the elaboration of U.S. GAAP.\textsuperscript{72}

The Committee of European Securities Regulators (CESR) enforces IFRS.\textsuperscript{73} Although the IFRS transition costs European companies significant outlay, Charlie McCreevy, the European Commissioner for Internal Market and Services, views this transition as a success, because “given the success of the Euro and the growing liquidity of E.U. capital markets, access to U.S. capital is no longer as essential for many SEC-registrants as it once was. Rather the question has become how to get out of the U.S. capital market!”\textsuperscript{74}

3. The SEC’s exemptions for European issuers

A foreign issuer is only exempt from complying with Regulation G reconciliation requirements if:

(1) the securities of the registrant are listed or quoted on a securities exchange or inter-dealer quotation

\textsuperscript{71} See id. at 5–6.
\textsuperscript{72} Id. at 6.
\textsuperscript{73} See discussion, infra Part III(B)(2).
\textsuperscript{74} Id.
system outside the United States; (2) the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with generally accepted accounting principles in the United States; and (3) the disclosure is made by or on behalf of the registrant outside the United States, or is included in a written communication that is released by or on behalf of the registrant outside the United States.\footnote{17 C.F.R. 244.100(c).}

Foreign issuers remain exempt under Regulation G even if the non-GAAP communications intended for a foreign market happen to reach the United States.\footnote{See William H. Donaldson, Chairman, Speech by SEC Chairman: U.S. Capital Markets in the Post-Sarbanes-Oxley World: Why Our Markets Should Matter to Foreign Issuers (Jan. 25, 2005), http://www.sec.gov/news/speech/spch012505whd.htm.} The SEC implemented Regulation G because it “did not want to interfere with the regular practices governing how foreign companies communicated with investors in non-U.S. markets.”\footnote{Id.}

In response to the European Union’s costly conversion to IFRS, the SEC recently adopted a rule permitting European issuers using IFRS for the first time\footnote{Before January 1, 2007. See Final Rule: First-Time Application of International Financial Reporting Standards, Release Nos. 33-8567, 34-51535 (May 20, 2005) [hereinafter Release No. 33-8567].} to reconcile their financial statements to U.S. GAAP standards over two years, as opposed to three years, as required by Regulation G.\footnote{See id.} This minor change to the U.S. GAAP reconciliation requirement still subjects European firms to costs beyond those necessary to achieve the Act’s goals. The EC, however, expects to reach an agreement with the SEC, which would commit the SEC to remove the U.S. GAAP reconciliation requirement as early as 2007, but no later than 2009.\footnote{See id.}

Furthermore, under the Act, the SEC undertook a project entitled “Study and Report on Adopting Principles-Based Accounting” to determine whether the United States should transition from GAAP to an international accounting standard, such as IFRS.\footnote{See Sarbanes-Oxley Act, supra note 3, at § 108(d)(1).} IFRS is a
principles-based accounting method, whereas GAAP is rules-based. The study, which the SEC completed in 2003, concluded that the United States should adopt an accounting standard similar to international accounting standards, such as IFRS, because “the adoption of objectives-oriented principles-based accounting standards in the United States would be consistent with the vision of reform that was the basis for the Sarbanes-Oxley Act.”

Nevertheless, the United States has not followed the E.U.’s example of using IFRS, which has created a roadblock for European issuers registering with the SEC. European issuers are already undergoing the difficult transition of adopting IFRS in place of their home-country accounting standards. The difficulty of this transition is only exacerbated by the fact that these same European issuers must also reconcile IFRS with U.S. GAAP; instead of imposing this reconciliation requirement on European issuers, the SEC should permit them to file financial statements with the SEC using only IFRS. Doing so would greatly reduce costs imposed upon the European issuers, while still accomplishing the investor protection objectives of the Act. Additionally, the SEC should consider adopting IFRS, or a similar principle-based accounting standard, in order to bring U.S. accounting practices in line with European and international standards. Such a transition may ultimately prove possible if, as discussed previously, the SEC removes the U.S. GAAP reconciliation requirement by 2009.

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84 For more information regarding the work of the FASB and IASB on the convergence of a global accounting standard see http://www.fasb.org/intl/convergence_iasb.shtml (last visited Nov. 16, 2006).

85 DAVID R. HERWITZ & MATTHEW J. BARRETT, 3 ACCOUNTING FOR LAWYERS, 2005 SUPPLEMENT 22 (2005). In determining how a particular transaction should be treated, the IFRS relies on broad principles, as opposed to U.S. GAAP’s specific rules and on professional judgment.

B. Accounting Oversight

In addition to the changes to accounting standards and financial reporting disclosures, the Act has also made significant changes to accounting oversight. The accounting industry has become a global business, and as a result, accounting firms have consolidated and expanded their worldwide audit services. Prior to the Act, the accounting profession more or less regulated itself, setting its own accounting standards and conducting private disciplinary measures. In the United States, the Federal Accounting Standards Board (FASB) made rules, set accounting standards, and conducted independent tribunals when complaints arose. The FASB’s decisions were incorporated into federal law and followed by the SEC.

As described below, the Act changed auditing practices significantly by tightening controls, federalizing the accounting industry, and creating a new oversight board. The EC’s system parallels the situation in the United States prior to the new modifications, but it too will change as the EC implements the Plan. If the EC strengthens the oversight capabilities of the CESR and the Committee on Auditing so that they are more in line with the United States new oversight board’s functions, then the SEC should consider exempting European issuers from registration and inspection by the U.S. oversight board.


See id. See, e.g., Williams, supra note 9, at 484–85.

See HAMILTON & TRAUTMANN, supra note 8, at 13–14.

Tracy N. Tucker, International Accounting Standards in the Wake of Enron Essay: It Really is Just Trying to Help: The History of FASB and its Role in Modern Accounting Practices, 28 N.C.J. INT’L L. & COM. REG. 1023 (2003). “The FASB was launched amid general optimism and enthusiasm. It was literally unique in almost every respect, most notably in the fact that it was a rule-making body financed and operated entirely in the private sector but whose decisions would be backed by federal law and a powerful federal regulatory agency. The authority of the FASB derives from Congress in the Securities Acts of the early 1930s and comes through the SEC and the trustees of the Financial Accounting Foundation.” Id. at 1026–27 (internal quotations omitted). See generally Facts About FASB, FASB, http://www.fasb.org/facts/ (last visited Nov. 7, 2006).

See id. The FASB still exists, and its accounting standards have been adopted by the PCAOB.
1. The Act

One of the Act’s major reforms was the federalization of the accounting industry and regulation by the Public Company Accounting Oversight Board (PCAOB or Board).\(^92\) The PCAOB oversees auditors of public companies,\(^93\) establishes ethics and quality control standards for auditors,\(^94\) and inspects public accounting firms.\(^95\) Although the PCAOB is responsible to regulate the accounting industry, it may adopt rules and standards established by professional private accounting organizations.\(^96\) The PCAOB also investigates and charges public consulting firms for violations of rules relating to audits, imposing sanctions for such violations.\(^97\) The SEC appoints PCAOB members, approves PCAOB rules and professional standards, approves the annual budget and support fees, acts as an appellate authority for PCAOB disputes relating to PCAOB inspection reports, and oversees PCAOB operations.\(^98\)

All audit firms, including foreign audit firms “providing significant audit services for issuers listed in the U.S.”,\(^99\) must register with, and be inspected by, the PCAOB.\(^100\) In fact, any foreign auditing firm that prepares or furnishes an audit report concerning an issuer is subject to the Act and SEC rules “in the same manner and to the same extent” as a domestic accounting firm.\(^101\) This requirement treats foreign accounting firms the same as domestic accounting firms, thus eliminating any incentive for either domestic or foreign companies to use foreign accounting firms to circumvent the Act.\(^102\) Exempting

\(^{92}\) Sarbanes-Oxley Act, supra note 3, at §§ 101–09.
\(^{93}\) Id. § 101(a).
\(^{94}\) Id. § 103.
\(^{95}\) Id. § 104.
\(^{96}\) Id. § 103(a)(3).
\(^{97}\) Id. §101(c).
\(^{98}\) Testimony Concerning Implementation, supra note 2, at III(A)(1).
\(^{99}\) Donaldson, supra note 76.
\(^{100}\) See id.
\(^{101}\) See Sarbanes-Oxley Act, supra note 3, at § 106(a)(1). However, registration with the board itself will not subject a foreign accounting firm to state or federal court jurisdiction other than with regard to controversies between those firms and the PCAOB. See id.
\(^{102}\) See HAMILTON & TRAUTMANN, supra note 8, at 26.
foreign accounting firms from complying with the Act would create “a significant loophole in the protection offered U.S. investors.”

2. The Plan

Established in 2001 by the EC, the Committee of European Securities Regulators (CESR) is charged with overseeing the European accounting industry and enforcing the IFRS. The CESR’s official role is to improve coordination among European Securities Regulators and to advise the EC, especially when it prepares draft measures for the securities field. CESR, however, does not function as a regulatory agency like the PCAOB.

The EC also established an additional oversight committee, the E.U. Committee on Auditing, in May 1998. The committee meets two or three times a year and is composed of statutory audit regulators from the fifteen Member States, members from the three countries of the European Economic Area, representatives of the audit profession, as well as the internal auditors and European representatives of the large audit firms. This committee’s overall objective is to develop a universal view on statutory audits at the E.U. level, especially for matters not covered by existing E.U. legislation.

The agenda priorities for the Committee on Auditing are to “review . . . the International Standards on Auditing (ISA) as a benchmark for E.U. audit requirements, examine the external quality assurance systems for statutory audit, develop minimum requirements to be applied throughout the single market, and examine a set of core principles on independence and audit objectivity developed by the

105 See Commission Decision establishing the Committee of European Securities Regulators, 2001 O.J. (L 191) 1.
108 See id. (noting that in the context of a single E.U. capital market audited financial information should have the same level of credibility throughout the E.U., thus facilitating and stimulating cross border investments).
Fédération des Experts Comptables Européens (FEE).” Through the Committee on Auditing, the EC plans to maintain a system of “monitored self-regulation” and to propose legislation only when necessary. The EC’s system closely parallels that of the United States prior to the creation of the PCAOB: the industry regulatory body functions independently from the government in developing minimum requirements and coordinating EC accounting and auditing practices, with only occasional governmental legislative intervention.

3. The SEC exemptions for European issuers

PCAOB may determine whether it will subject or exempt certain accounting firms from compliance with the Act. PCAOB may require the compliance of foreign firms if the Board determines that the firms play such significant roles in the preparation of audit reports that they should be treated the same as United States firms preparing audit reports. Conversely, the SEC and PCAOB—subject to SEC approval—may also exempt a foreign accounting firm from any provision of the Act, the SEC rules, or the PCAOB’s rules if it is necessary or appropriate in light of public interest.

In response to conflicts with foreign privacy laws and blocking statutes, the PCAOB has made changes in the information required from foreign accounting firms during the registration process. A foreign accounting firm may now withhold information from its application for registration when submitting such information if it would violate foreign law. When withholding information, applicants must submit a legal opinion stating that submitting the information would violate foreign laws. The justifications for withholding information under foreign laws generally relate to data

109 Id.
110 Id.
111 See Sarbanes-Oxley Act, supra note 3, at § 106(a)(2).
112 See id. at § 106(c).
114 Id.
115 Id.
protection, employee privacy, client confidentiality, bank secrecy, and national security.\textsuperscript{116}

Regardless of foreign privacy laws, however, if a foreign accounting firm issues an opinion or otherwise performs material services upon which a registered public accounting firm relies in issuing all or part of an audit report, the Act deems that foreign accounting firm to have consented to produce its audit work papers for the PCAOB or the SEC in connection with an investigation, and to be subject to United States judicial jurisdiction for enforcement of any request to produce such papers.\textsuperscript{117} Domestic accounting firms that rely on a foreign firm’s work receive the same treatment, and the SEC considers the domestic accounting firm to have received the foreign firm’s consent to such production as a condition of its reliance on the foreign firm’s opinion.\textsuperscript{118}

While the SEC could consider exempting European issuers from registration and inspection by the PCAOB, exemptions should not be necessary because it is unlikely the EC will strengthen the European accounting oversight capabilities. Instead, the EC has stated that it will maintain a system of self-regulation in the accounting industry. The EC’s system of “monitored self-regulation” parallels the United States’ situation prior to the creation of the PCAOB. Even without an equivalent European oversight body in place, the SEC’s current rule permitting foreign accounting firms to omit information conflicting with non-U.S. laws respects foreign laws. The PCAOB’s reach concerning registration requirements and information privacy is therefore adequately limited.

\textit{C. Auditor Independence}

Another of the Act’s important reforms increases enforcement of auditor independence. Since reliable information regarding a business’ financial health is central to investors’ decisions, third-party auditors are charged with independently examining a corporation’s financial statements\textsuperscript{119} and ultimately expressing an opinion about the accuracy

\textsuperscript{116} Letter from Ernst & Young, LLP, to Jonathan Katz, Secretary, SEC (July 2, 2003), http://www.sec.gov/rules/pcaob/pcaob 200303/ernstyoung070203.htm.
\textsuperscript{117} See Sarbanes-Oxley Act, \textit{supra} note 3, at § 106(b).
\textsuperscript{118} See \textit{id.} at § 106(b)(2).
\textsuperscript{119} See HERWITZ & BARRETT, \textit{supra} note 90, at 8–9.
of the financial statements. Requiring the auditor’s independence will “enhance the integrity of the audit process and the reliability of audit reports on issuers’ financial statements.”

1. The Act

Overall, the Act requires increased auditor independence by focusing on auditors and audit committees, as well as the executives and directors of public companies. The Act expands the list of non-audit services that an auditor is prohibited from providing to an issuer, requires an issuer’s audit committee to pre-approve all audit and non-audit services provided to the issuer by the auditor, and requires that partners on the audit team for a particular company rotate every five years. To avoid conflicts of interest:

It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated

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120 See id.
121 Testimony Concerning Implementation, supra note 2, at III(A). The Act “establishes a comprehensive framework to modernize and reform the oversight of public company auditing, improve quality and transparency in financial reporting by those companies, and strengthen the independence of auditors. It promotes competition among service providers, enhances accurate investor decision-making throughout the capital markets, and seeks to correct shortcomings that have threatened the reputation of those markets for integrity.” HAMILTON & TRAUTMANN, supra note 8, at 13.
122 Sarbanes-Oxley Act, supra note 3, at § 201–09.
123 Id. at § 201. The following services are listed as falling outside the scope of an auditor’s practice: “1) bookkeeping…; 2) financial information systems design and implementation; 3) appraisal or valuation services, fairness options, or contribution-in-kind reports; 4) actuarial services; 5) internal audit outsourcing services; 6) management functions or human resources; 7) broker or dealer, investment advisor, or investment banking services; 8) legal services and expert services unrelated to the audit; and 9) any other service that the PCAOB determines, by regulation, is impermissible.” Id.
124 Id. at § 202.
125 Id. at § 203.
in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.\textsuperscript{126}

Other provisions require the auditor to report certain matters to the issuer’s audit committee and require disclosing to investors certain information relating to audit and non-audit services the auditor provides as well as information on fees paid to the auditor.\textsuperscript{127}

Section 301 of the Act and the accompanying SEC rules set forth the independence requirements for members of an issuer’s audit committee.\textsuperscript{128} All audit committee members must be independent. The audit committee must be directly responsible for the appointment, compensation, retention, and oversight of a company’s outside auditors; and outside auditors must report directly to the audit committee.\textsuperscript{129} No member of an audit committee may accept a consulting, advisory, or other compensatory fee from the issuer other than in their capacity as a member of the audit committee, board of directors or other board committee.\textsuperscript{130} This requirement is known as the “compensation prong.”\textsuperscript{131}

Further, an audit committee member cannot be an “affiliate” of the issuer or of a subsidiary of the issuer, other than in that affiliate’s capacity as member of the audit committee or director.\textsuperscript{132} Specifically, the Act defines an “affiliate” as “a person that directly or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.”\textsuperscript{133} The SEC added

\textsuperscript{126} Id. at § 206.

\textsuperscript{127} Id. at §§ 201–09. See also Testimony Concerning Implementation, supra note 2, at § III(A)(2).

\textsuperscript{128} See Sarbanes-Oxley Act, supra note 3, at § 301; Standards Relating to Listed Companies Audit Committees, Release No. 33-8220, 79 SEC Docket 2876 (Apr. 9, 2003) [hereinafter Release No. 33-8220]. The rules direct the nation’s exchanges to prohibit any company that is not in compliance with the Section 301 audit committee requirements established by Section 301 from listing on such exchange. See Testimony Concerning Implementation, supra note 2, at § III(F)(1). These rules prevent auditors from controlling a company’s financial reporting system by first designing the internal audit system, and then purporting to offer an unbiased external audit. See HAMILTON & TRAUTMANN, supra note 8, at 15.

\textsuperscript{129} See Testimony Concerning Implementation, supra note 2, at § III(F)(1).

\textsuperscript{130} Release No. 33-8220; Sarbanes-Oxley Act, supra note 3, at § 301(3)(B)(i).

\textsuperscript{131} See Release No. 33-8220, supra note 128.

\textsuperscript{132} Sarbanes-Oxley Act, supra note 3, at § 301(3)(B)(ii).

a safe harbor to this provision, wherein “a person who is not an executive officer or a shareholder owning ten percent or more of any class of voting equity securities of a specified person will be deemed not to control such specified person.” Where an audit committee member is a significant shareholder, owning ten percent or more of the entity’s shares, such member’s decisions regarding appointment, retention, and oversight of the outside auditor may be tainted by financial interests in the entity. For example, the member would have a financial interest in portraying the corporation’s financial situation positively and would therefore likely seek to appoint an auditor who would provide a favorable opinion of the company’s financial statements.

In American corporations, compliance with such requirements is easy to ascertain, albeit costly, because American publicly traded corporations are typically owned by millions of shareholders. Most American publicly traded corporations have widely dispersed ownership, and no one group of shareholders exercises ultimate control over selecting directors. Thus, separation of ownership and control characterizes American corporations.

Applying the Act’s independence requirements to European corporations, however, is more than just costly. Although the

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134 Release No. 33-8220, supra note 128.

135 See Benjamin Mojuye, French Corporate Governance in the New Millennium: Who Watches the Board in Corporate France?, 6 COLUM. J. EUR. L. 73, 74 (2000) (discussing how U.S. public corporations typically divide shares among millions of individuals, who can sell their stocks quickly if and when they become dissatisfied with the corporation’s management).

136 See id. The directors manage the corporation and the control of the corporation is separated from its ownership. Shareholders own the corporation—by virtue of their stock ownership interest—and they elect a board of directors to exercise control over the corporation. The directors then choose the officers to run the business, subject to their supervision. See id.

137 ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 85 (1999) (describing how institutional investors also play a large role in American investing strategy, accounting for approximately seventy percent of all trading activity in the U.S.); see Ben McClure, Institutional Investors and Fundamentals: What’s the Link?, INVESTOPEDIA, Oct. 15, 2005, http://www.investopedia.com/articles/fundamental/03/101503.asp. Institutional investors consist of mutual funds, pension funds, banks and other large financial institutions. These institutional investors act as intermediaries for individuals investing their money in securities. These types of investment entities are often considered “smart money” because, as professional traders and stock market watchers, they have more knowledge and expertise than average investors. See id.
fundamental common law and civil law concepts of the corporation rest on the same medieval roots. European corporation ownership structures are fundamentally different from their U.S. counterparts. In Europe, a corporation’s shareholders often have a significant stake in the company’s equity. For example, in France the dominant shareholder is usually a family, company, or the State. In Germany, a “universal bank” typically owns a large share of the corporation, which makes it unlikely that board members and audit committee members in these corporations will meet the safe harbor’s ten percent maximum ownership requirement. Moreover, through shared ownership, European governments have historically exercised “special rights” to retain control of privatized corporations. Such special rights permit the government to veto or hinder changes in the enterprise’s ownership structure or its management. Such circumstances greatly limit an investor’s right to participate in the corporation’s management. Examining German and French board of director and audit committee practices reveals the difficulties posed by the Act’s independence requirement.

138 See HARRY G. HENN & JOHN R. ALEXANDER, 3 LAWS OF CORPORATIONS 14–16 (1983) (discussing how the concept of the corporate form in both civil law and common law societies developed out of ancient medieval and Roman law and how such concepts developed into canon law in the early thirteenth century, followed by merchant law, which served as the model for the modern civil and common law corporations); See also PHILIP I. BLUMBERG, THE MULTINATIONAL CHALLENGE TO CORPORATION LAW: THE SEARCH FOR A NEW CORPORATE PERSONALITY 3–4 (1993) (noting that despite disagreement over the extent that Roman law accepted concepts of corporations, modern corporate law has distinct direct or indirect roots in Roman law).

139 But, in both the U.S. and in European civil law countries, such as Germany and France, the corporation itself is a separate legal entity separate from its shareholders. See Franck Chantayan, An Examination of American and German Corporate Law Norms, 16 St. John’s J. Legal Comment 431, 435 (2002); Naidu, supra note 82, at 280.


141 Id.

142 See id.


144 Id.

145 Id.
a. German practice. While German and U.S. corporate practices share common traits, some differences between them make it difficult for German companies to comply with the Act’s independence requirement. The German corporation most similar to an American publicly traded corporation is the Aktiengesellschaft (AG).\textsuperscript{146} Unlike a U.S. corporation, however, the AG has a two-tiered board structure consisting of a managing board and a supervisory board.\textsuperscript{147} At least one-third of a corporation’s supervisory board members must be employee representatives.\textsuperscript{148}

Commercial banks typically own the majority of stock held in AG.\textsuperscript{149} This phenomenon results from the fact that historically, Germans are very risk averse and will not invest in corporations the same way Americans do.\textsuperscript{150} Consequently, German banks play an important role as intermediaries. Individuals purchase the majority of stocks in a German corporation through one of the large banks in a similar fashion to any other product available to depositors.\textsuperscript{151} As a result, in most corporations, the supervisory board generally consists of representatives of large German banks acting as executive officers of the company.\textsuperscript{152} This creates “an interlocking network among supervisory boards within Germany.”\textsuperscript{153} The EC delegates auditing responsibilities to the managing board, and many German companies must have employees or union representatives on their audit committees.\textsuperscript{154} These practices make it difficult to comply with the Act’s independence requirement. Individuals affiliated with the company, such as employees or union representatives often sit on the managing board, which violates the Act’s Section 301 independence requirement. Furthermore, since German banks often own the majority of shares in AG’s, any individual associated with such banks, who also

\textsuperscript{146} See Chantayan, supra note 139, at 434.
\textsuperscript{148} See Naidu, supra note 82, at 281.
\textsuperscript{149} See Chantayan, supra note 139, at 435, 448–49 (noting efforts to increase the number of shares owned by private investors).
\textsuperscript{150} See id.
\textsuperscript{151} See id. at 435.
\textsuperscript{152} See Butler, supra note 147, at 559.
\textsuperscript{153} Naidu, supra note 82, at 281.
\textsuperscript{154} See id.
sits on the audit committee, would violate the independence requirement if the bank owns ten percent or more of the AG’s shares. Because the inherent structure of many German corporations makes compliance with the Act so difficult, the SEC should consider granting exemptions for German corporations and other similarly structured European companies.

b. French practice. Similar to German corporations, French corporations face numerous challenges trying to comply with the Act because of inherent corporate structure. French corporations use one of two different management structures: a one-tiered board, consisting of a board of directors; or a two-tiered board, comprised of an executive board and a supervisory board and modeled after the German corporate structure.\(^{155}\) Although the single-board-of-directors approach is used most often, corporations may use a two-tiered board when one group of shareholders agrees that it will not play an active role in the corporation’s management, when the corporation is family owned, or when the corporation’s management requires more independence from the shareholders.\(^{156}\) In a traditional French corporation with a single board of directors, the board controls the corporation and participates in the corporation’s management.\(^{157}\) In the two-tiered system, there is a clear delegation of powers. The executive board manages the corporation and the supervisory board controls the actions of the executive board without taking part in the corporation’s management.\(^{158}\) Also, similar to Germany, France is characterized by a “bank-centered capital market and a singularly concentrated ownership structure.”\(^{159}\) In French public corporations, known as Societes Anonymes (SA), stockholdings have traditionally been relatively concentrated among specific families, financial institutions, corporations, or the State.\(^{160}\) As a result, directors of different corporations are often linked to one another, and members of one corporation’s board of directors often sit on other corporations’ boards.\(^{161}\)

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156 See id.
157 See id.
158 See id.
159 Mojuye, supra note 135, at 74.
160 See id. at 75.
161 See id. at 90.
Problems with compliance also result in French corporations because, except for state-owned corporations, families own or
dominate more than fifty percent of the largest public corporations in
France.162 These family-owned corporations combine ownership and
control, and the board does not play an independent role.163
Concentration of ownership by institutional investors such as banks,
insurance companies, and networking corporations comprise the
remaining group of large corporations.164 French banks, as dominant
shareholders in French corporations, have considerable power within
corporations through their membership on boards and through the
companies’ heavy reliance on debt financing.165 Since the State owns a
significant share in many public corporations, it traditionally utilizes
its shareholder vote to place government-related board members on the
board of directors.166 Consequently, members of the board of directors
day often be closely related to, or have substantial interest in, the
corporation. As a result, an individual affiliated with the corporation or
representing a substantial shareholder will likely sit on an audit
committee, thereby violating the Act’s Section 301 independence
requirements.

Consequently, French companies, as members of the Association
Francais des Enterprises Privées, Association des Grandes
Entreprises Francais (AFEP-AGREF) have complained about the
negative consequences of the compensation and affiliated-person
prongs of the independence requirement.167 These companies criticized
the Act as automatically disqualifying directors that may also be
executive officers of a bank that is a controlling shareholder, in the
event that the bank receives any fees in connection with transactions in
the ordinary course of business.168 As to the affiliated-person prong,
one company stated, “it is not clear to us why a director, otherwise
independent, should be disqualified from audit committee service if

162 See id. at 95.
163 See id.
164 See id.
165 See, e.g., Edward S. Adams, Corporate Governance after Enron and Global
Crossing: Comparative Lessons for Cross-National Improvement, 78 Ind. L.J. 723,
767 (2003).
166 See Mojuye, supra note 135, at 75.
167 See, e.g., Letter from AXA to Jonathan G. Katz, Secretary, SEC (Feb. 18,
2003), http://www.sec.gov/rules/proposed/s70203/butte1.htm (this letter was issued as a supplement to the letters of AFEP-AGREF).
168 See id.
that director also sits on the board of entity [sic] in which the issuer holds a substantial interest but less than a majority.  

As a result of this majority shareholder influence on the boards of directors of European corporations, it is difficult for these corporations to comply with the Act’s strict independence requirements. Without an exemption, such European corporations may have to undergo burdensome costs and forgo traditional European practices in restructuring their boards of directors and audit committees.

2. The EC’s Plan

In light of recent European accounting scandals, the Plan includes a specific proposal to adopt a short-term recommendation (Recommendation), placing special emphasis on audit committee standards. The EC expressed its intention to address the role of audit committees in supervising audits, both in selecting an external auditor for appointment by shareholders and monitoring the relationship with the external auditor. The EC also stated it would address such internal aspects as reviewing accounting policies as well as monitoring internal audit procedures and the company’s risk management system.

Acknowledging unique European practices, the EC’s Plan provides a flexible approach whereby corporations with varying structures may face fewer obstacles to achieve compliance. On February 15, 2005, addressing the role of audit committees and related board and audit committee independence standards, the EC recommended that Member States delegate responsibilities to the audit committee. Examples of these responsibilities include ensuring the accuracy of financial reports and other disseminated information, as well as monitoring procedures established for evaluation and management of risks. As a result, the EC established independence requirements because most audit committees are composed of members of the board of directors or supervisory board. In contrast

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169 Id.
170 See Modernizing Company Law, supra note 21.
171 See id.
172 See id.
173 See 2005 O.J. (L 52), supra note 56.
174 See id. at 14.
175 See id.
with the U.S. requirements, the EC’s approach integrates its traditional “comply or explain” principle, whereby companies are “invited to disclose whether they comply with the code and to explain any material departures from it.”176 The EC adopted this approach so that companies would be able to comply with sector- and enterprise-specific requirements that may depart from the EC or national independence standards.177

As to independent directors, the recommendation states that “the (supervisory) board should comprise a sufficient number of committed non-executive or supervisory directors, who play no role in the management of the company or its group and who are independent in that they are free of any material conflict of interest.”178 However, “in view of the different legal systems existing in Member States,” the EC declined to determine what proportion of board members should consist of independent directors.179 Nevertheless, the EC should organize boards in such a way “that a sufficient number of independent non-executive or supervisory directors play an effective role in key areas where the potential for conflict of interest is particularly high.”180 To this end, the EC should create audit committees within the supervisory board or the board of directors.181 Audit committees should be composed exclusively of non-executive or supervisory directors, and at least a majority of members should be independent.182 In contrast to the Act’s strict independence rules, the Plan defines independence as being “free of any material conflict of interest.”183 Furthermore, under the Plan, audit committees should assist the board in (1) monitoring the integrity of financial information provided by the company, particularly by reviewing the relevance and consistency of the accounting methods and the internal control and risk systems the company uses; (2) ensuring that major risks are

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176 See id. at 4.
177 See id.
178 See id. at 8.
179 Id.
180 See id. at 5.
181 Id.
182 Id. at Annex 1, art. 4.
183 Id. at 8.
properly identified, managed, and disclosed; and (3) ensuring the effectiveness of the internal-audit system.\textsuperscript{184}

In 2002, the EC adopted a recommendation requiring Member States to prohibit statutory auditors from carrying out statutory audits, either on their own, or on behalf of an audit firm, if they are not independent.\textsuperscript{185} The recommendation defines independence as not having any “financial, business, employment or other relationships between the statutory auditor and his client (including certain non-audit services provided to the audit client) that a reasonable and informed third party would conclude compromise the statutory auditor's independence.”\textsuperscript{186}

Member States must ensure that statutory auditors are liable for sanctions when they do not perform a statutory audit in an appropriate manner.\textsuperscript{187} Member States must also ensure that members and shareholders of an audit firm do not intervene in a statutory audit in a manner that jeopardizes the independence of the individuals performing the audit.\textsuperscript{188} Moreover, regarding non-audit services, the recommendation limits the type of non-audit services a Statutory

\textsuperscript{184} Id. at Annex 1, art. 4.2. With respect to the external auditor appointed by the company, the audit committee, at a minimum, should perform the following functions: 1) make recommendations to the supervisory board relating to the selection, appointment, reappointment and removal of the external auditor and to the terms of his appointment; 2) monitor the external auditor’s independence and objectivity, particularly by reviewing the audit firm’s compliance with applicable guidance relating to the rotation of audit partners, the fees paid by the company, and other related regulatory requirements; 3) ensure the nature and extent of non-audit services are under continuous review, based upon, inter alia, disclosure by the external auditor of all fees paid by the company or its group to the audit firm and network, with the purpose of preventing any material conflicts of interest from arising; 4) set forth and apply a formal policy specifying the types of non-audit services which are excluded, permissible after review by the committee, and permissible without referral to the committee; 5) review the effectiveness of the external audit process and management’s responsiveness to recommendations made in the external auditor’s management letter; and 6) investigate issues giving rise to an external auditor’s resignation and make appropriate recommendations. Id. at Annex 1, art. 4.2(2).


\textsuperscript{186} Id. at 4.

\textsuperscript{187} Id. at 26.

\textsuperscript{188} Id. at 27. This requirement also applies to those members of the administration, management and supervisory body of the audit firm who are not personally approved as statutory auditors. Id.
Auditor or Audit Firm may provide to an audit client. Much like the Act, the recommendation also sets forth examples of prohibited non-audit services.

The foregoing EC recommendations, if adopted by Member States, would help bring European auditor and audit committee independence provisions more in line with the Act’s independence requirements. However, the EC’s proposed independence requirement is not as strict as the requirement set forth in the Act. For instance, Member States have flexibility in applying these recommendations, and their individual independence requirements will likely reflect prevailing national corporate practices. The EC’s broad definition of independence and its “comply or explain” approach directly contrast with the Act’s stringent independence requirements. Therefore, the EC’s independence requirements will not likely transform European board structure enough to bring it entirely into compliance with the Act. A European issuer, which may easily comply with European independence requirements, will likely have to undergo significant restructuring costs when issuing securities in the U.S. market.

3. The SEC’s exemptions for European issuers

As a result of the differences in European corporate practices, the SEC has made limited accommodations to foreign issuers pertaining to auditor and audit committee independence. The final rules include several provisions applicable only to foreign issuers in order to “address potential conflicts with foreign legal requirements where consistent with fulfilling the investor protection mandate of the

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189 The company’s “overall safeguarding system” must ensure that those employed by the Audit Firm or its “Network . . . neither take any decision nor take part in any decision-making on behalf of the Audit Client or one of its affiliates, or its management while providing a non-audit service; and where an independence risk remains due to specific threats which may result from the nature of a non-audit service, this risk is reduced to an acceptable level.” Commission Recommendation 2002 O.J. (L 191), 7.1.

190 Examples of such non-audit services include preparing accounting records and financial statements, designing and implementing financial information technology systems, performing valuation services, participating in the audit client's internal audit, acting for the audit client in the resolution of litigation, and recruiting senior management. Id. at 7.

Act.192 In Final Rule 33-8220, the SEC makes appropriate exemptions to address potential conflicts that the independence requirement of Section 301 poses with foreign issuers’ corporate structures.193

Acknowledging that Germany’s requirement that employees sit on a corporation’s supervisory board would not meet the Act’s independence requirement,194 the SEC made a limited exemption from the independence requirement for such foreign issuers.195 The final rule permits non-executive employees196 to sit on the audit committee of a foreign private issuer if the employee is elected or named to that issuer’s board of directors in accordance with one of the following: the issuer’s governing law or documents, an employee collective bargaining agreement, or some other home country legal or listing requirement.197 Furthermore, with respect to a two-tiered board system, which is prevalent in both Germany and France, the SEC’s final rule clarifies that the supervisory board acts as the “board of directors” for purposes of implementing the Act.198 Either the supervisory board can form a separate audit committee, or the supervisory board can serve as the audit committee if the entire supervisory board is “independent” (within the meaning of Section 301 and the final rule).199 As applied to German issuers, employees may continue to sit on the supervisory board in accordance with German law, provided they are not executive officers.200

Because of criticism from European companies, the SEC recognized that many foreign issuers permit representatives of controlling shareholders or groups of shareholders to sit on their audit committees.201 In its final rule, the SEC decided that one member of an

192 Testimony Concerning Implementation, supra note 2, at III(F)(1).
193 See generally Release No. 33-8220, supra note 128.
194 See supra notes 128-131, and accompanying text.
195 See Release No. 33-8220, supra note 128.
196 See id. (acknowledging that “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”). This is consistent with the EC’s recommendation. See supra notes 190–91, and accompanying text.
197 See id.
198 See Release No. 33-8220, supra note 128.
199 See id.
200 See Naidu, supra note 82, at 298.
201 See Release No. 33-8220, supra note 128.
audit committee can be a representative of an affiliate of a foreign private issuer, provided they fulfill the “no compensation prong,” and they are not one of the issuer’s executive officers. Further, the representatives may only have observer status on the committee and may not participate as a voting member or as the chair of the audit committee. This exemption brings both French and German companies with more than one controlling shareholder represented on the board or audit committee into compliance with the Act.

Because many foreign governments hold significant shares of issuing companies, or special shares permitting the government to exercise certain rights over the issuer, such issuers would fail to satisfy the Act’s independence requirement. Therefore, the SEC also provided a limited exemption for foreign issuers with government representatives sitting on their audit committees. Under the final rule, an audit committee member can be a representative of a foreign government or foreign governmental entity, provided the member does not violate the “no compensation prong” and is not one of the issuer’s executive officers. Foreign governments that are also listed issuers are exempted entirely from the audit committee requirement of the Act.

In light of the EC’s recommendations regarding audit committee independence requirements, the SEC should consider granting additional exemptions on a country-by-country basis. The SEC should consider permitting European governments that have implemented the EC’s recommendations to provide comprehensive information on their own independence requirements in order to determine whether to exempt issuers in such countries. Thereafter the SEC should issue exemptions based on whether each individual nation’s requirements are equivalent to the Act’s independence standards. For example, a

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202 See supra notes 128-131, and accompanying text.
203 See id.
204 See id. (noting that “this limited exception is designed to address foreign practices, assure independent membership and an independent chair of the audit committee and still exclude management from the committee”).
205 See discussion, supra Part III(C)(1)(b).
206 See Release No. 33-8220, supra note 128.
207 See id.
208 See supra notes 128-131 and accompanying text.
209 See Release No. 33-8220, supra note 128.
210 See id.
nation’s standards would be equivalent if its laws (a) develop an independence standard so as to prevent significant shareholders (ten percent or more) or affiliated persons from sitting on a company’s audit committee, (b) have a similar compensation requirement as the United States, and (c) eliminate or restrict the application of a “comply or explain” approach. Exempting corporations on a country-by-country basis under an equivalence approach should adequately balance the need to respect differing European corporate norms while still protecting American investors and maintaining the integrity of U.S. markets.

D. Corporate Governance

Another major set of reforms affecting foreign securities issuers relates to corporate responsibility. Corporate governance involves protecting shareholders from self-dealing by those in control of a corporation.211 This is particularly important in both American and European corporations because the ownership of a publicly traded corporation is often separate from its control.212 In the Act, corporate governance reforms relate particularly to individual director and executive officer responsibility. The EC’s Plan, however, focuses on implementing rules providing for the collective responsibility of the board rather than making specific individuals responsible for a corporation’s control.

1. The Act

Provisions of the Act reflect Congress’ belief that individual managers should be held responsible for a company’s financial representations.213 Under the Act’s separate criminal and civil provisions, CFOs and CEOs are now required to personally certify the issuer’s annual and quarterly reports.214 Therefore, both the Act and accompanying rules require the CEO and CFO to individually certify that they have reviewed the reports and that based on their knowledge,

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211 See PINTO & BRANSON, supra note 137, at 84.
212 See supra notes 137-142, and accompanying text.
213 See HAMILTON & TRAUTMANN, supra note 8, at 57.
214 Sarbanes-Oxley Act, supra note 3, at §§ 302(a)1–3, 906(a).
the reports do not contain any material misstatements or omissions. The CEO and CFO are also responsible for certifying that (1) they established and maintained internal disclosure controls and procedures to ensure that material information relating to the company is made known to them, (2) they designed internal controls over financial reporting to provide reasonable assurance that financial reporting and the preparation of financial statements are reliable, (3) they disclosed any material change in the company’s internal control over financial reporting, and (4) they disclosed to the auditors or audit committee any significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting as well as any fraud.

In addition, if the SEC requires an issuer to prepare an accounting restatement due to a material non-compliance caused by misconduct, the CEO and CFO must reimburse the issuer for “(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period.”

Requiring CEO and CFO certification for annual and quarterly reports runs directly contrary to European practice, in which the board of directors or the supervisory board must collectively certify the accuracy of the company’s financial statements. Furthermore, the E.U. does not currently have an internal-control reporting requirement. Several European companies have complained about both the CEO- and CFO-certification provision and the internal-control reporting requirements. For example, Porsche, the German car company, cancelled plans to issue securities on the New York Stock Exchange.

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216 See Sarbanes-Oxley Act, supra note 3, at §§ 302(a)4–6; Release No. 8238, supra note 218. See also Testimony Concerning Implementation, supra note 2, at n7.

217 See Sarbanes-Oxley Act, supra note 3, at § 304(a).

218 See Code de Commerce L225-251 (Fr.); see also German Stock Corporation Act 93-II.

219 See Green, supra note 12.
Exchange, stating that it did not agree with the Act’s CEO-and-CFO-certification requirements. By increasing management responsibility, the Act may have deterred European companies from participating in the U.S. market.

2. The EC’s Plan

In formulating its Plan relating to corporate governance reforms, the EC considered each Member State’s unique practices and beliefs regarding the roles of corporations and how corporations should be financed. Consequently, the EC decided that adopting a full European corporate governance code would not “achieve full information” for investors about corporate governance rules affecting companies in various European countries, nor would a code improve corporate governance rules in Europe because harmonization would be difficult to achieve. As part of the EC’s ongoing process to review and implement corporate governance reforms, the EC created the European Corporate Governance Forum (the Forum) in October 2004. The Forum consists of fifteen senior experts from various professional backgrounds whose experience and high level of expertise is widely recognized across Europe. The Forum should

220 Id.
221 Id.
222 See Modernizing Company Law, supra note 21, at 10.
223 Id. at 11.
224 Press Release, European Commission, Corporate Governance: Commission Creates European Forum to Promote Convergence in Europe (Oct. 18, 2004), http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/04/1241&format=HTML. Upon announcing the creation of the Forum, Internal Market Commissioner Frits Bolkenstein stated, “The more national corporate governance codes converge towards best practice, the easier it will be to restore confidence in capital markets in the wake of the scandals that have shaken trust in some European companies, including traditional ‘blue chips.’ Broad convergence not only strengthens shareholders’ rights and the protection of third parties such as creditors and employees, it makes it easier for investors to compare investment opportunities. That leads to a more efficient allocation of capital, which matters to everyone because it is the basis for creating growth and jobs. The time is ripe for this initiative, as many Member States are reviewing their own corporate governance codes. The Forum with its distinguished membership, will be well placed to help build consensus on key issues. This work is not a precursor for a European governance code, but it is a drive to raise standards across the board. The Forum will help us achieve this without bulldozing national traditions or forcing anything down anyone’s throat.” Id.
225 See id.
meet two or three times a year and deliver an annual report to the EC. 226

A major corporate governance reform elaborated upon in the Plan relates to the composition, remuneration and responsibilities of the board of directors. 227 The EC’s proposal calls for giving E.U.-listed companies the option of having either a one-tiered board structure, with executive and non-executive directors, or a two-tiered board structure, with managing directors and supervisory directors. 228 The Commission may also permit additional organizational freedom, but first wishes to study the implications of doing so. 229 The Plan suggests that in certain areas where executive directors have clear conflicts of interest, such as in audits, these decisions should be made exclusively by non-executive or supervisory directors. 230

On February 15, 2005, the EC adopted a set of recommendations in which it confirmed the collective responsibility of either the board of directors or the supervisory board for a company’s financial statements. 231 This recommendation does not take the form of a legislative act. However, the EC requests that Member States take the “necessary measures to promote the application . . . of the principles set out in [its] Recommendation” by June 30, 2006, so that the EC may closely monitor the situation in Member States and take further action if necessary. 232

The Forum “advised unanimously against the imposition of an obligation for boards to certify the effectiveness of internal controls at the present time.” 233 The Forum instead decided that it would study the U.S. experience in relation to such certification requirements. 234 If it adopts an internal-control certification requirement, “it would be

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226 See id.
227 See Modernizing Company Law, supra note 21, at 15.
228 See id. at 15–16.
229 See id. at 15.
230 See id.
231 2005 O.J. (L 52), supra note 56, at 10.
232 Id. at § IV, 14 (stating that “[i]n principle, and without prejudice to the powers of the general meeting, only the (supervisory) board as a whole has statutory decision-making authority and, as a collegiate body, is collectively responsible for the performance of its duties”).
234 See id.
necessary to strike the balance between the benefits of additional requirements and the potential costs and burdens for companies.”  

In the medium term, the EC also intends to examine how it might enhance directors’ responsibilities.  

3. The SEC’s exemptions for European issuers  

The SEC granted foreign issuers a short-term exemption from complying with requirements relating to disclosures of internal control over financial reporting. Foreign issuers have until July 15, 2007, to become a compliant. The SEC explains that foreign issuers have “faced particular challenges in complying with the internal control over financial reporting and related requirements, which include language, culture, and organization structures that are far different from what is typical in the United States.”

CEO-and-CFO-certification requirements run directly contrary to European practice, wherein the entire board certifies financial statements. Imposing full board responsibility for financial statements may provide similar corporate governance protection as a CEO-and-CFO-certification requirement. This similar level of protection is only possible if the EC or Member States impose collective liability on board members. The Plan is uncertain on whether the EC intends to impose collective liability on board members for non-compliance. Therefore, the SEC should consider granting exemptions only to issuers located in EC Member States wherein the laws provide for full

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235 Id.

236 The EC will accomplish this through (a) introducing a “special investigation right,” which would enable stakeholders holding a certain percentage of shares to have the right to ask a court or administrative authority to authorize a special investigation into the company’s affairs; (b) developing a “wrongful trading rule,” wherein directors would be held personally accountable for the consequences of a company’s failure if it is foreseeable that a company cannot continue to pay its debts, but the directors do not take steps to “rescue” the company and ensure payment or to liquidate the company; and (c) imposing “director’s disqualification” rules as a sanction for misleading financial and non-financial statements and other types of misconduct by directors. See Modernizing Company Law, supra note 21, at 16.

board responsibility and liability. Doing so would achieve Congress’ objective of holding the management of a company fully responsible for the corporation’s representations. In such cases, collective responsibility may thus render individual CEO-and-CFO-certification unnecessary.

However, CEO-and-CFO-certification regarding the effectiveness of internal controls is still required under section 302 of the Act. If legislation in individual European countries or by the EC achieves board accountability for internal control efficiency, the SEC should consider granting exemptions on a case-by-case basis. On the other hand, this accountability is unlikely to occur in the near future, as the EC plans to study the effects of U.S. internal control certification requirements prior to implementing similar legislation. Therefore, until the EC imposes similar internal control certification, the SEC should not consider granting internal control exemptions to European issuers.

IV. CONCLUSION: WHERE SHOULD THE SEC GO FROM HERE?

While the SEC has made progress in creating limited exemptions for foreign corporations, in light of the EC Plan, and the existence of fundamental differences between European and American corporations, the SEC should consider granting further limited exemptions for European companies. The agency should (1) permit European issuers to file financial statements with the SEC using only IFRS, (2) exempt European issuers from audit committee independence requirements if the issuer’s home country independence standards are equivalent to those set forth by the SEC, and (3) exempt European issuers from CEO-and-CFO-certification requirements if the issuer’s home country or if the EC imposes collective liability on board members. Finally, the SEC should consider exempting European issuers from PCAOB registration and inspection only if the EC’s CESR and Committee on Auditing oversight capabilities are sufficiently strengthened so as to parallel those of the PCAOB.

If the EC’s Plan is successfully developed and adopted, the principles of the Act may eventually be realized throughout Europe. In the long term, the SEC may be able to exempt European companies from full compliance as to many of the Act’s provisions and accompanying rules. However, the EC’s “comply or explain” position directly contradicts the stringent rules imposed by the Act. Therefore, in order for the SEC to fully exempt European issuers, the EC would have to abolish its “comply or explain” rule.

As the EC’s Plan calls for three phases of implementation through 2009, it is yet to be determined whether the Plan will thoroughly
achieve the goals of the Act, or even whether individual European Member States will adopt the EC’s recommendations. It thus remains to be determined how far the SEC should go in the long term to exempt European companies from the stringent requirements of the Act. In the meantime, granting the foregoing narrow exemptions would appropriately take account of the EC’s developing Plan and respect the different European corporate practices, while still protecting American investors and preserving the integrity of the American securities market.