Sarbanes Oxley and its Implications on Asian companies

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In July 2002 the US Congress passed the Sarbanes-Oxley Act, the most comprehensive corporate reform and financial market protection legislation in decades. The passage of 'SOX' or 'SarbOx,' as the Sarbanes-Oxley package of statutes is often known, was a political and public policy reaction to the string of US financial scandals, such as Enron and WorldCom that began in 2001 soon after the terrorist attacks in New York and Washington.

Since its enactment, the SOX Act has had the business lobby in the US up in arms, complaining about red tape and extra costs; European corporations are threatening to withdraw from American stock exchanges; and in Asia a number of companies have cancelled or delayed plans to list in the US, opting instead for other means of raising capital.

Probably the greatest impacts of the SOX Act listed companies will be in terms of personal risk exposure for CEOs and CFOs and better integration of internal and financial controls. Sections 302 and 404 of the Act requires a company's top management and its auditors to attest to the financial disclosures of the company and the reliability of their company's internal controls on the gathering and reporting of financial data.

The adjustments required by US and non-US listed corporations have not been easy. At the end of 2004, more than 100 large US companies disclosed 'material weaknesses' or 'significant deficiencies' in meeting the rules for new or strengthened internal controls (known as SOX Section 404) with more than 250 US companies having to 'restate' previously announced annual financial results, a quarter more than the 203 firms restating in 2003.

How Sarbanes-Oxley Act Affects Asian Companies Listed on/ Wanting To List On US Bourses

- Higher levels of financial disclosures
- Financial reports need to be personally certified by CEOs and CFOs
- US companies are now obliged to have an internal audit function, which will need to be certified by external auditors
- Criminal and civil penalties for securities violations
- Significantly longer jail sentences and larger fines for corporate executives who knowingly and willfully misstate financial statements
- Public disclosure of CEO and CFO compensation and profits
- Faster reporting of trades by insiders
- Prohibition on insider trades and company loans to executives
- Auditor independence required, including outright bans on certain types of work and pre-certification by the company's Audit Committee of all other non-audit work

What are the implications of the Sarbanes Oxley Act on Asian companies?

In Asia, the Sarbanes-Oxley Act has been routinely derided as a typically American over-the-top response to a crisis, and a very costly one. The price of SOX compliance is significant – estimates range from an extra US$1 million to US$5 million annually. Audit costs are inflated as internal controls need to be documented and senior executives are required to take personal responsibility for financial statements.

For chief executives in Asia, the obvious risk lies in the Sarbanes-Oxley requirement that they certify the accuracy of corporate financial reports. This is an especially pertinent consideration, especially in a region where most large corporations listed in the United States are either family owned or state owned, and where personal loans to directors and nepotism are a cultural norm. In addition, internal control and audit systems are not normally required to be certified in Asia. Other difficulties for some Asian companies in meeting the new standards is the requirement for audit committees to consist solely of independent directors – Asian companies usually only have two or three independent directors. All these present a cultural barrier, on top of the already massive and difficult task of complying with the many provisions of Sarbanes Oxley.

Another risk that Asian companies already listed or seeking to list in the US are increasingly taking note of is the extra-territorial reach of the SOX Act. American judges are increasingly willing to consider the claims of non-US plaintiffs who may not have bought American depositary receipts (ADRs), but rather ordinary shares trading in Hong Kong, London, or Paris. What the US courts have done in such cases have been to determine whether there was sufficient activity in the US related to the complaints, such as a roadshow marketing the foreign shares in the US. Even if the conduct entirely occurred outside the US, if the effects of that conduct were sufficiently severe in the US, that would constitute enough reason to apply the US law extraterritorially. This was clearly illustrated in the case of French conglomerate Vivendi Universal, which settled a civil fraud case for US$50 million last December on allegations of false press releases, improper adjustments to earnings, and failure to disclose future financial commitments represents

For the Asian companies listed in the US, the impact of SOX is direct and clear cut. For others, the impact is less clear. There are already US companies who are expecting their contractors and suppliers to follow SOX guidelines. What about the many US-Asian Joint ventures and investments? Under the spirit of SOX, it is a matter of time before these entities would have to adopt SOX-like corporate governance and internal control principles to align themselves with their parent US companies.

Sarbanes Oxley and its Implications on Asian capital markets

One of the most closely watched effects of Sarbanes Oxley was its effects on the capital markets in Asia. Were Asian IPOs in the United States destined to dry up in the wake of Sarbanes-Oxley? Would there be mass desertion of foreign firms to other exchanges? Will we see a race to the bottom in governance?

As a direct consequence of Sarbanes Oxley, some Asian firms are indeed rethinking their approach to the US market. A US listing is no longer a foregone conclusion for even the largest Asian company unless there is a strong business need for American visibility. The statistics to support the case have indeed been most compelling. For example, there has been no Japanese firm listed in the US since 2002. Air China, the Chinese national airline flag-carrier which launched an IPO in December 2004, chose London over New York to complement its Hong Kong listing due to SOX considerations. There is also an increasing number of Chinese corporations going to market in Hong Kong have opted for private placements instead with large US institutional investors which do not require them to be in compliance with the new regulations, the recent IPO of China Communications Bank being the most prominent.

However, even while there remains resentment and a quiet resignation among Asian companies, the SOX governance card are touching a chord even in emerging Asian markets, where transparency levels and governance standards are much lower and the interest level among Asian companies on a listing on US bourses remains very high.

The US capital market easily remains the choice listing destination among aspiring Asian companies with global ambitions. The strength of US funds on a global scale and the lure of Nasdaq and the New York Stock Exchange require Asian companies to embrace corporate governance if they are to continue to raise capital from external sources. Although some Asian firms have made noises about delisting from US exchanges, few have done so – not least because in practice it is extremely difficult.

As for better corporate governance as demanded by SOX, while some Asia companies have been put off from a US listing by the regulatory climate, others have decided that there is an advantage in testing themselves against the toughest regulatory regime in the world. The recent success of **Baidu's** IPO has also boosted the confidence of Chinese companies seeking a listing in the United States. Ultimately, Asian companies need access to the global capital markets for the next stage of their growth. There is a growing recognition among Asian companies that the ability to respond to tough international regulatory requirements in today's environment will translate into the greatest access to global capital markets at the lowest cost of capital.

The global branding aspect is an important consideration for Asian companies. Branding themselves as a NYSE/NASDAQ quoted company appeals to a company's customers, both domestically in Asia and internationally. Ultimately, to many Asian companies, it does make a difference to say, 'I'm listed on the NYSE or Nasdaq; I comply with SEC regulations." And if you're in the technology space, you want to go to NASDAQ regardless. For example, elong, an online travel company that is listed on the NASDAQ, have their television advertisements in China specifically mention that they are listed on NASDAQ. It is very much a branding issue for them.

At the end of the day, Asian companies would still prefer a US listing, even if they are a little bit apprehensive of all the Sarbanes-Oxley regulation and even more so of the potential for shareholder litigation.

Conclusion

The Sarbanes Oxley Act is but the beginning of a global wave of calls for better corporate governance. Like it or not, Sarbanes Oxley is here to stay in one form or another. In addition to the global regulatory climate, the crusading zeal of US investment in Asia will likely place pressure on local regulators and companies to adopt large swathes of the SOX Act, be it in form or substance.

The call for tighter corporate governance in Asia is also gaining currency in the light of local business crises such as the derivatives-triggered collapse of China Aviation Oil in Singapore and the recent Kelon scandal in China. Adding to the fluidity of the picture are a number of further regulatory changes in the pipeline or already completed all around the world: CLERP 9 in Australia, the new European Union prospectus directive, which comes into force in July 2005, the reorganization of the French stock exchanges, the prospect of stricter regulation in France, Germany and Japan, and ongoing uncertainty about long-term Europe-wide Risks and Rewards as well as Basel II for financial institutions.

In conclusion, I would like to leave Asian readers with these enlightened comments from Tim Pennington, CFO of Hutchison Telecommunications:

"At the end of the day, we consider ourselves to be an international company operating to the highest of standards and we felt that compliance should not be a decision driver for us. You need to operate by the rules of the market on which you list. Living under Sarbanes-Oxley regulations for the past 12 months has made us a better company, and there is a trophy at the end of it which is greater investor interest. Companies that say they don't want to list in the US because of Sarbanes-Oxley are short sighted. You should adhere to the highest standards, and it will only be a matter of time before Sarbanes-Oxley type controls are implemented in Europe."

About SOXGAP
The Sarbanes Oxley Group is the only global provider of SOX training and certification programs for Auditors and Practitioners involved or looking to get involved in SOX compliance projects.

About YONWA
YONWA is a compliance solutions provider.