

New York International Chapter News

A publication of the International Law and Practice Section
of the New York State Bar Association

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Europe

Corporate Governance Reform—The Status of Sarbanes-Oxley in the European Union¹

The American chief executive officer, chief financial officer, and board of directors can find no greener pastures by taking up new corporate residence in Europe. The European Union (EU) and its individual member states² are following America's lead to closely scrutinize the corporate decision-making process and make it more accountable. The Sarbanes-Oxley Act (2002) (SOA) offers swift U.S. measures to remedy the economic perfect storm set in motion by the crises at Enron, Global Crossing, Adelphia, Tyco, and others. However, as has been the case historically in just about everything else imaginable, Europe walks a slower, more cautious and studied pace.

The international business community should be mindful that corporations with European origination, which have either a U.S. listing, U.S.-registered securities, or are subsidiaries of such companies, will likely be impacted by SOA. Conversely, American corporations operating in European jurisdictions, listing shares on foreign exchanges, or owning subsidiaries that do so, need to carefully track the progress of the EU and each particular jurisdiction in terms of their respective legislative and administrative agendas.

Key Elements of SOA

SOA established unprecedented standards for ethics in corporate governance, auditing and financial reporting. The act affects all publicly traded companies that qualify as "issuers" under the Securities and Exchange Act of 1934 whose securities are registered under section 12 of the 1934 Act. SOA contains far-reaching rules on accounting oversight, auditor independence, corporate responsibility, enhanced financial disclosure, analyst conflict of interest, and corporate and criminal fraud accountability. The new law directly impacts certified public accounting firms auditing public companies, by making them

accountable to the newly created Public Company Accounting Oversight Board (PCAOB). Oversight will be accomplished through registration, annual inspections, annual fee requirements and specific ad hoc investigation of alleged misconduct. SOA also bans CPA firms from auditing clients for whom they do consulting work, and provides for enhanced fines or up to 20 years imprisonment for offenses such as destroying, altering, hiding or falsifying documents or records—obstruction of a federal investigation.

SOA makes it unlawful for an officer, director or agent of the corporation to fraudulently influence, coerce, manipulate, or mislead the auditing CPA firm. The SEC is required to issue rules requiring a publicly traded company's audit committee to be comprised of at least one member who is a *financial expert*. The act vests such audit committees with responsibility for the appointment, compensation and oversight of any *registered* public accounting firm employed to perform audit services.

Perhaps the most significant attribute of SOA is the duty it imposes on chief executive officers (CEOs) and chief financial officers (CFOs) to certify annual reports. Certification is a sworn statement by the CEO and CFO of a public company stating that such officer has reviewed the financial reporting documents, and that the documents are devoid of material misstatements and omissions of fact. In addition, CEOs and CFOs are now responsible for establishing and maintaining internal controls to ensure they are notified of any significant financial developments (corporate officers' ignorance is no excuse).

SOA gives these provisions teeth by admonishing that if there is such a material misstatement or omission that causes the company to restate its financial reports, the CEO and CFO forfeit any bonuses and other incentives received during the 12-month period following the first filing of the erroneous financials. The corporation also risks an outright *ban* on the sale of its securities through the various national exchanges.

SOA has also intensified civil and criminal penalties for fraudulent acts by corporate insiders and expands the statute of limitations for securities fraud. Finally, the act provides for other miscellaneous remedial measures designed to address specific abuses prevalent in the highly publicized corporate scandals mentioned above. Such remedial measures include enhanced financial disclosure of off-balance sheet transactions, and eradication of personal loans and extensions of credit to company executives.

Developments in the European Union Since SOA: Financial Services Action Plan (FSAP)

The careful progress of corporate reform in the European Union results in part from the history and purpose of its creation. The EU, for example, does not purport to be a replacement nation-state for existing governments. To the contrary, the individual member states delegate limited sovereignty to create specific common institutions representing the interests of the Union as a whole. Enabling legislation essentially derives from basic treaties between the member states.

The principal objectives of the Union are:

- to establish “European citizenship,” minimum *fundamental* civil rights and free mobility throughout the EU;
- to ensure “freedom, security and justice” (akin to the concept of equal protection in the United States);
- to promote the general economic and social welfare of the EU through development of a market, common currency (the Euro), mutual economic development, and common social policy such as environmental protection;
- to advance the notion of a “united Europe” for stronger assertion of its interests throughout the world.

In light of the history and purpose of the EU, its goal is transparent: to foster consensus and address issues clearly common to the individual member states. Change follows consensus; the EU as an institution is not designed to be idealistic and overly proactive absent a clearly discernible mandate communicated from the governments of the individual member states.

Presently, there is enough common concern about the proliferation of the United States’ current economic crisis that some level of preventive action is favored. The EU is developing a paradigm for reform under the Financial Services Action Plan (FSAP), already having been established in 1999 to review existing codes of corporate governance in terms of identifying legal and administrative barriers to a single unified European capital market.

The EU has also made slow but steady progress by providing for the implementation of international

accounting standards for all listed EU companies by 2005. European companies which list their shares both in their home country and in the U.S. must prepare their financial disclosure documents twice under different and sometimes conflicting rules. To address this problem, the EU and the U.S. (through the Securities Exchange Commission) are exploring the proposed convergence/mutual acceptance of the International Accounting Standards (IAS) and the U.S. standard, which is the Generally Accepted Accounting Principles (GAAP). There is current debate over which is more appropriate. On the one hand, GAAP is heavily “rules based,” whereas, on the other hand, the IAS permits a more subjective “true and fair” override principle. The U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have announced a joint project to reach consensus on the differing standards.

European officials have generally taken a softer and less intrusive approach than the U.S. by issuing “guidelines” and modifying existing corporate practices rather than passing tough new laws like Sarbanes-Oxley. However, certain member states such as France, Germany, and Italy have enacted or proposed at least somewhat aggressive reform.

High Level Group of Company Law Experts

As to the EU, the European Commission has mandated the High Level Group of Company Law Experts (“Group”) to develop a policy on corporate governance and European company law. The Group recently published its report in November 2002.

Because the EU requires the board of directors to be responsible for financial and key non-financial statements of the company (in contrast to the U.S., where these functions are delegated to the corporations’ officers), the Group’s recommended reforms are focused at the director level. For example, the Group recommends that a strong and effective role for independent nonexecutive or supervisory directors, and an appropriate regime for director remuneration should be achieved in the shorter term. Furthermore, it is recommended that where the companies are listed, shareholders should have a choice between a unitary board structure (to include both executive and non-executive, non-supervisory independent directors combined), and a two-tiered board structure (separate boards for independent and managing/supervisory directors). This, it is hoped, would achieve a greater level of accountability at the highest corporate policy making levels.

The Group also recommends greater financial disclosure through enactment of an integrated cross-border legal framework to facilitate efficient shareholder information and communication. This

would require listed companies in the EU to provide shareholders with electronic facilities to access relevant information and to vote in *absentia* through the corporate Web site.

Finally, the Group admonishes against an aggressive campaign to create a single European Code of corporate governance, as the underlying company laws in the member states are not harmonized in various key areas. Rather, the EU should actively coordinate the corporate governance efforts of member states through their company laws, securities laws, listing rules, codes or otherwise, in order to facilitate mutual sharing of information. In short, the Group favors less rash enactment of uniform EU law to ensure a continuous debate on corporate governance standards, compliance, and enforcement.

European Commission—Company Law Action Plan

The European Commission was expected to publish a *Communication on Company Law* by the end of the first quarter of 2003. According to the Internal Market Commissioner, Frits Bolkenstein, the Commission will present its *Company Law Action Plan* which will identify necessary actions, define priorities, and most importantly determine whether the necessary initiatives should be enacted in binding or non-binding fashion. The Commissioner stated in a speech on January 30, 2003, that the analysis of recent developments in the U.S. and the SOA will be an important element in the preparation of the Company Law Action Plan. He stated that the EU strongly supports the objectives of the SOA to enhance corporate governance, audit, and accounting standards in the U.S. However, he expresses the EU's concern about the potential impact of the SEC implementing rules giving the SOA extraterritorial effect.

In May 2002, the EU proposed a code of conduct on the independence of auditors, including five-year auditor rotation, and member states endorsed the *Market Abuse Directive* to harmonize and toughen rules against insider trading.³

Reform Enacted in the Individual Member States

The individual member states have passed various resolutions which respectively mandate somewhat diluted reforms as compared with Sarbanes-Oxley. In the United Kingdom, corporate governance reforms are gradual and do not promote a dramatic break with current corporate governance practices. The *Higgs Report*⁴ recommends that a majority of the company's board members should be independent, outside members. In contrast, existing guidelines recommend that one-third of board members be non-executives, and the majority of those should be independent. Furthermore, greater communication between shareholders is recommended, as is a limitation that

insider directors and chairpersons of one listed company not be permitted to chair a second listed company.

In Spain, the Aldama Report emphasizes greater corporate transparency and self-regulation. It also recommends more independent board members but doesn't recommend a minimum percentage. In addition, companies should explain how directors and executives are appointed and disclose compensation packages.

In France, proposals for a new financial markets law were presented on February 5th to the French cabinet, which called for an annual report on corporate governance by a new financial markets regulator, the *Autorite des Marchés Financiers*. This report also calls for the formation of a separate body to regulate France's system of independent company auditors and require company directors to disclose purchases and sales of shares in their company.

In June 2002, the German government passed into law the Transparency and Disclosure Act, which instituted the Cromme Code, a new voluntary code of corporate conduct aimed at making supervisory boards more active by requiring that they be given more information and crack down on poor attendance at board meetings. Germany has a dual-board system, consisting of a managing board and a supervisory board of outside directors. The new code also requires companies to disclose executive pay, and recommends that independent directors sit on supervisory boards.

Austria does not have a formal corporate governance code, but in April 2002, a working group on corporate governance presented a first draft of its code of conduct. The code, which applies to all listed firms, consists of legal requirements (such as the presence of independent directors on both supervisory and management boards), "comply or explain" rules (such as adoption of the "one share, one vote" principle), and additional recommendations of best practice. Austria has also introduced mandatory audit firm rotation rules or banks and listed companies.

Belgium has made numerous corporate governance developments in recent years, culminating in five codes. Nonetheless, last year the government proposed detailed modifications of the Companies Code, which were approved in August. The new rules increase the importance of independent directors.

European corporate governance reform, both in terms of the Commission and in terms of the individual member states, has clearly not risen to the emergency level that it has in the U.S. under SOA. Nevertheless, the EU has made significant progress at its own carefully navigated pace. Perhaps the EU approach will further advance the cause of ethics in corporate

conduct from the groundwork laid by the U.S. under SOA, and mutual benefit will result.

To stay informed regarding the progress of the EU and its individual member states, one Web site to visit is <http://cfoeurope.com> (there are many good sources of information, but this one we found to be up-to-date and user-friendly).

Scott D. Brenner, Esq. and Arete H. Koutras, Esq.
Barton Barton & Plotkin LLP
New York, N.Y.

Scott D. Brenner, a senior attorney with Barton Barton & Plotkin LLP, concentrates his practice in corporate and banking law. Arete H. Koutras, associated with Barton Barton & Plotkin LLP, concentrates her practice in the area of international trade law.

Endnotes

1. Information was drawn for this article from the following sources:

PricewaterhouseCoopers, "The Sarbanes-Oxley Act of 2002: Strategies for Meeting New Internal Control Reporting Challenges: A White Paper," *available at* <http://www.cfodirect.com>.

"Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States," Jan. 2002, *available at* http://europa.eu.int/comm/internal_market/en/company/news/corp-gov-codes-rpt-part1_en.pdf.

"Report of the High Level Group of Company Law Experts on A Modern Regulatory Framework for Company Law in Europe," Brussels, Nov. 4, 2002, *available at* http://www.ecgi.org/publications/documents/report_en.pdf.

Frits Bolkenstein (Internal Market Commissioner), Corporate Governance in Europe, speech delivered Jan. 30, 2003. *See* http://europa.eu.int/comm/internal_market/en/speeches/index.htm.

Where to Now?, Corporate Governance Review: CFO Europe, Oct. 2002, *available at* <http://www.cfoeurope.com/200210e.html>;
Katz, *The Insider*, CFO Europe, *available at* <http://www.cfoeurope.com/200212ego.html>; Karaian, *Woe is us*, CFO Europe, *available at* <http://www.cfoeurope.com/200212dgo.html>

"Institute of European Affairs, EU-US Project Group – Special Supplement on Corporate Governance," *available at* http://www.iiea.com/files/euus/corporate_governance.pdf
2. The European Union member states include Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, The Netherlands, Austria, Portugal, Finland, Sweden, and the United Kingdom. Currently, the several candidates for membership include Bulgaria, Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Romania, Slovenia, Slovakia, and Turkey.
3. The Market Abuse Directive aims to address definitions of insider trading including requiring investment analysts to disclose share ownership, comprehensive public disclosure by issuers, and fair representation of investment research.
4. The Higgs Report is entitled, "Review of the Role and Effectiveness of Non-Executive Directors." The report is aptly named for Derek Higgs. Higgs is Chairman of Partnerships UK plc and a non-executive director of Egg plc, The British Land Company plc, Allied Irish Banks, plc and Jones Lang La Salle Inc. He is also a senior adviser in the UK to UBS Warburg and a

Director of London Regional Transport and Coventry City Football Club. He was a director of Prudential plc between February 1996 and December 2000, and Chairman of its fund management subsidiary, M&G Investment Management Ltd. Prior to joining Prudential, he spent 24 years as a corporate adviser with the SG Warburg Group. He is Chairman of Business in the Environment, a member of the Financial Reporting Council and a qualified chartered accountant.