U.S. Regulation of the International Securities and Derivatives Markets, § 5.01, INTRODUCTION

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 5.01 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Chapter 4 discusses the continuing disclosure obligations of a foreign private issuer that is a reporting company, meaning that it is required to file reports with the SEC under either § 13(a) or § 15(d) of the Exchange Act. This Chapter 5 discusses other kinds of requirements that apply to a reporting foreign private issuer—those mainly relating to corporate governance. Specifically, it addresses audit committees (§ 5.02), independent auditors (§ 5.03), internal controls and management certifications (§ 5.04) and other governance-related requirements (§ 5.05).

Most of these requirements apply to all reporting foreign private issuers, but one of the most important applies only to a foreign private issuer that has securities listed on a U.S. securities exchange: the audit committee requirements discussed in § 5.02[1]. Similarly, only a foreign private issuer with U.S. listed securities is subject to the requirements arising from other governance rules of the securities exchanges, which are discussed in § 5.05[8]. A reporting foreign private issuer that does not have securities listed on a U.S. exchange is not subject to the audit committee requirements or to these exchange rules.

The requirements discussed in this Chapter 5 also apply to U.S. domestic issuers— *i.e.*, reporting issuers that are not foreign private issuers. Those issuers, however, are also subject to extensive further governance-related requirements that arise principally from three sources: (a) exchange rules, which are an important source of governance requirements but which largely exempt a foreign private issuer if it follows home country practice; [1] (b) the SEC's requirements governing proxy statements and proxy solicitation, which impose extensive disclosure requirements relating to governance and extensive procedural requirements relating to the conduct of shareholder meetings, but which exempt foreign private issuers; [2] and (c) the corporate law of the state of incorporation. Because these requirements do not apply to foreign private issuers, the governance regime for foreign private issuers under U.S. law is less demanding than the rules applicable to a foreign issuer that lists securities in the local market in many jurisdictions outside the United States, and notably on the main listing venues in London and Hong Kong.

Footnotes

1 NYSE Listed Company Manual 303A.00 (exemption from most NYSE governance rules for foreign private issuers following home country practice); NASDAQ Listing Rules 5615(a)(3) (exemption from most Nasdaq governance rules for foreign private issuers following home country practice) and IM-5615-3 (requiring a foreign private issuer to provide an opinion of counsel concerning home country practice).

2 Rule 3a12-3(b) under the Exchange Act.

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U.S. Regulation of the International Securities and Derivatives Markets, § 5.02, AUDIT COMMITTEES

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[1] Listed Company Audit Committees

[a] General Requirements

A foreign private issuer with securities listed on a U.S. securities exchange is required to meet the audit committee requirements of Rule 10A-3 under the Exchange Act. Rule 10A-3 was adopted in 2003 to implement § 301 of the Sarbanes-Oxley Act, which is codified in § 10A(m) of the Exchange Act. The Rule operates through listing rules: rather than impose requirements directly on issuers, it requires the exchanges to adopt listing rules that impose requirements on listed issuers. The NYSE and Nasdaq, in turn, have adopted listing rules that, in the briefest of terms, require a listed issuer to have an audit committee that complies with Rule 10A-3. [3]

Rule 10A-3 requires that the audit committee have the following attributes:

- Each member of the audit committee must be a member of the board of directors. The rule does not specify the number of members of the audit committee.
- Each member of the audit committee must be independent, as defined in Rule 10A-3. Section 5.02[1][b] below describes the independence requirements and certain exceptions, including exceptions specifically for foreign private issuers. Disclosures relating to whether the audit committee includes an audit committee financial expert are discussed in § 5.02[2] below.
- The audit committee must be directly responsible for supervising the independent auditor. This includes "appointment, compensation, retention and oversight," and it includes resolving disagreements between management and the auditor regarding financial reporting. The auditor must report directly to the audit committee. These provisions of Rule 10A-3 may conflict with provisions of foreign law, as discussed in § 5.02[1][c] below.

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Separately, the SEC's auditor independence rules also impose requirements for audit committee administration of auditor engagements. These are discussed in § 5.03[1][e] below.

- The audit committee must establish procedures to receive and treat "complaints regarding accounting, internal accounting controls, or auditing matters" and to allow employees to submit confidentially "concerns regarding questionable accounting or auditing matters." The rule does not provide any guidance on the nature of the required procedures.
- The audit committee must have appropriate funding and the authority to engage independent counsel and other advisers.

A foreign private issuer may be exempt from these requirements if it has a similar body established under requirements of its home country law, and that body meets the requirements of paragraph (c)(3) of Rule 10A-3. This exemption is described in § 5.02[1][c] below. [4]

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If an issuer relies on one of the exemptions from the independence requirements, or if it relies on the exemption for a foreign private issuer with a similar body under home-country law, it must disclose its reliance on the exemption and disclose an assessment as to whether, and if so how, such reliance would adversely affect the ability of the audit committee to act independently and to comply with other audit committee requirements. This disclosure is required in the annual report on Form 20-F. [5]

The listing rules of NYSE and Nasdaq contain extensive additional requirements for audit committees. [6] These requirements do not apply to a foreign private issuer, but they are a useful reference point for best practices. For example, the applicable NYSE rule requires that an audit committee have at least three members; that each member must be "financially literate"; that the board consider and disclose any instance of an audit committee member who is simultaneously on the audit committees of three or more companies; and that the company have an internal audit function. It also requires that the audit committee have a written charter that includes specific responsibilities listed in detail in the rule.

[b] Independence

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Rule 10A-3 requires that each audit committee member be independent under the standards set forth in the rule. The standards for independence address two issues: receipt of compensation from the issuer and affiliation with the issuer. There is no requirement, for either element, to "look back" to relationships in existence before the member was appointed to the audit committee. [7]

As to the compensation element, an audit committee member may not accept any consulting, advisory or other compensatory fee from the issuer or any subsidiary of the issuer, other than in his or her capacity as a member of the audit committee, the board of directors or another committee of the board. [8] This prohibition applies to indirect acceptance of fees, which includes compensation to certain family members. Indirect acceptance of fees also includes payments to a law firm, consulting firm, investment bank or financial advisor that provides services to the issuer or any subsidiary, if the audit committee member is a partner, member or officer of the service provider or occupies a similar position. [9]

As to the affiliation element, an audit committee member may not be an affiliated person of the issuer or any of its subsidiaries. [10] For this purpose, affiliation is defined in terms of control: an affiliate is a person that controls the issuer, is controlled by the issuer, or is under common control with the issuer. Under an express provision of the definition, beneficial ownership of 10% or less of an issuer's voting shares is deemed not to be control, as long as the beneficial owner is not an executive officer of the issuer.

Where an entity is an affiliate of the issuer, an individual is also deemed to be an affiliated person of the issuer if the individual is an executive officer, an inside director ("a director who also is an employee"), a general partner or a managing member of that entity. Under this definition, an outside director of an affiliate could be independent, and so could an employee of an affiliate who is not a director or executive officer of the affiliate. However, the SEC cautioned in adopting Rule 10A-3 that "an affiliate could not evade the prohibitions in the rule simply by designating a third party representative or agent that it directs to act in its place." [11]

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There is an exemption from the independence requirements for a newly-public company, providing for a transition period to achieve a fully independent audit committee. [12] All but one member of the audit committee may be exempt for the first 90 days from effectiveness, and a minority may be exempt for the first year from effectiveness. There is also an exemption that permits a person to be independent with respect to two or more affiliated issuers at the same time. [13]

Rule 10A-3 also provides three exemptions under the independence requirement specifically for foreign private issuers. The first is meant to accommodate the practice of requiring employee or union representation on the board of directors or the audit committee. It exempts a member of the audit committee who is an employee from

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the independence requirement, if the employee is not an executive officer and is elected or named to the board or audit committee pursuant to the company's governing documents or foreign law, an employee collective bargaining or similar agreement or home country legal or listing requirements. [14] The second exempts a member of the audit committee from the non-affiliation element of the independence requirement if the member has only observer status on the audit committee and is not a voting member or chair of the audit committee. [15] The third exempts a member from the non-affiliation element of the independence requirement if the member (who cannot be an executive officer) is a representative or designee of a foreign government or foreign governmental entity. [16]

[c] Exemption for an Alternative Mechanism

In implementing the audit committee requirement under § 301 of the Sarbanes-Oxley Act, the SEC acknowledged that many jurisdictions outside the United States have legal or listing requirements that contemplate a different mechanism for auditor oversight, separate from the board of directors. It established an exemption from the audit committee requirements for a foreign private issuer that has a board of auditors (or similar body), or that has statutory auditors, if that board or body, or the statutory auditors, meet the requirements listed below. [17] This is a significant example of the SEC accepting compliance with

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foreign law to meet a U.S. statutory mandate, and it has been relied on by issuers in several jurisdictions, notably in Brazil.

In order to qualify for the exemption, the body or the statutory auditors must:

- be established and selected pursuant to home-country legal or listing requirements that expressly require or permit such a body;
- be required under home-country legal or listing requirements to be either separate from the board of directors or mixed (composed of one or more board members and one or more non-board members); [18]
- not be elected by management, and not include any executive officers;
- be subject to independence standards under home-country law or listing provisions;
- be responsible for the appointment, retention and oversight of the work of any registered public accounting firm engaged to prepare and issue audit reports or perform an audit, review or attest services for the foreign company, including, to the extent permitted by local law, the resolution of disagreements between management and the auditor regarding financial reporting; and
- to the extent permitted by law, establish complaint procedures, have authority to engage advisers, and have appropriate funding, in each case as an audit committee must do under the general audit committee requirements.

[d] Conflicts Between Audit Committee Attributes and Foreign Law

The general audit committee regime under Rule 10A-3 requires that the audit committee have certain powers with respect to the auditor and accounting matters. Similarly, the exemption for an alternative mechanism requires that the body or the statutory auditors have certain powers. In many jurisdictions, however, those powers may be reserved to the shareholders, or they may be powers of the board of directors that it is not permitted to delegate. In some jurisdictions, those powers may be vested, for some issuers, with a governmental entity or tribunal.

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To minimize these conflicts, Rule 10A-3 includes three instructions stating that the requirements that the audit committee have these powers "do not conflict" with requirements under the issuer's home-country law or listing

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requirements. If the home-country requirement gives power to the shareholders, the applicable instruction states that the requirements of Rule 10A-3 relate to the division of responsibility between the audit committee and management, and any recommendation or nomination to the shareholders should be provided by the audit committee. [19] If the home-country requirement prohibits the full board from delegating, or it recognizes a government entity or tribunal, the instruction states that the audit committee must have such responsibilities, including advisory powers, as are permitted by law. [20]

[2] Audit Committee Financial Expert Disclosure

[a] Disclosure Requirement

A reporting foreign private issuer is required to disclose in its annual report on Form 20-F whether its audit committee includes at least one person who meets the definition of "audit committee financial expert." [21]

The disclosure requirement has led most issuers to identify an audit committee financial expert, but there is no requirement to do so. If there is no audit committee financial expert on the audit committee, the issuer must disclose why not. Such disclosure is not common, but while it can be delicate to prepare it does comply with the rule.

The disclosure requirement applies even if the issuer is not subject to the requirement to have an audit committee—for example, because it has no U.S.-listed securities. If the issuer has a two-tier board of directors, the disclosure requirement applies to the supervisory, or non-management, board. [22] If the issuer is exempt from the requirement to have an audit committee because it has an alternative body that qualifies under Rule 10A-3 under the Exchange Act, then it must disclose whether the alternative body has an audit committee financial expert. [23]

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If there is an audit committee financial expert, the issuer must disclose that person's name and whether that person is independent, as defined for this purpose. If the issuer has more than one audit committee member who meets the definition, it is only required to identify one, but if it identifies more than one it must disclose whether each is independent. [24] Independence, for the purpose of this disclosure requirement, is as defined in the U.S. listing rules applicable to the issuer. If the issuer is not listed, it must use the independence definition of a U.S. exchange and disclose what definition it uses. [25]

[b] Definition of Audit Committee Financial Expert

The audit committee financial expert is defined in Item 16A based on attributes the person must have and the experience by which such attributes are required. The attributes include: (i) an understanding of generally accepted accounting principles and financial statements; (ii) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; (iii) experience in preparing, auditing, analyzing or evaluating financial statements with a breadth and level of complexity in accounting issues that are reasonably expected to be comparable to the company's financial statements (or experience actively supervising a person engaged in the same); (iv) an understanding of internal control over financial reporting; and (v) an understanding of audit committee functions. When the definition refers to "generally accepted accounting principles," it means the accounting principles the issuer uses in its primary financial statements filed with the SEC. [26]

The experience may come from education or experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or in similar functions; experience actively supervising any of those positions; or experience overseeing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements. The experience may also derive from "other relevant experience," but if so the disclosure must describe that experience. The experience may not come solely from previous audit committee experience. [27]

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Item 16A includes several additional instructions, collectively designated "Safe Harbor," which are intended to ensure that the designation of an audit committee financial expert does not affect other legal liabilities or responsibilities. They provide that the designation does not make the designee an "expert" for liability purposes under the Securities Act, or increase the duties of the designee, or affect the duties of the other members of the audit committee or the board of directors. [28]

Footnotes

3 NYSE LISTED COMPANY MANUAL 303A.06; NASDAQ LISTING RULES 5605(c). The SEC stated in adopting Rule 10A-3 that it did not intend to consider requests for exemptions, waivers or no-action letters. SEC Release No. 33-8220 (Apr. 9, 2003). Rule 10A-3(b)(1)(iv)(F) provides that in addition to the enumerated exemptions, the SEC may exempt a particular relationship from the independence requirements, discussed below, as the SEC determines appropriate in light of the circumstances. This provision implements the exemptive authority granted to the SEC in § 301 of the Sarbanes-Oxley Act.

4 Rule 10A-3 also provides other exemptions, including: an exemption for listing securities of a foreign government (paragraph (c)(6)(iii)); an exemption for a subsequent listing by an issuer that is already subject to Rule 10A-3 (paragraph (c)(1)); and an exemption for the listing of debt securities by a subsidiary of an issuer that is already subject to Rule 10A-3 (paragraph (c)(2)).

5 Item 16D of Form 20-F; Rule 10A-3(d)(2) under the Exchange Act. For a domestic issuer, this disclosure would also be required in any proxy or information statement.

6 NYSE LISTED COMPANY MANUAL 303A-07; NASDAQ LISTING RULES 5605(c).

7 By contrast, the independence standards for domestic issuers impose a three-year "look-back." NYSE LISTED COMPANY MANUAL 303A.02; NASDAQ LISTING RULES 5605.

8 Rule 10A-3(b)(1)(ii)(a) under the Exchange Act. There is an exception for fixed, non-contingent compensation under a retirement plan.

9 Rule 10A-3(b)(1)(ii)(A) under the Exchange Act. "Indirect acceptance" is defined in Rule 10A-3(e)(8).

10 Rule 10A-3(b)(1)(ii)(B) under the Exchange Act. "Affiliated person" is defined in Rule 10A-3(e)(1).

11 SEC Release No. 33-8220 (Apr. 25, 2003). The SEC had originally proposed that a "designee" of an affiliate would be deemed to be an affiliate, and it deleted that word in the final rule but included the quoted language in the release.

12 Rule 10A-3(b)(1)(iv)(A) under the Exchange Act.

13 Rule 10A-3(b)(1)(iv)(B) under the Exchange Act.

14 Rule 10A-3(b)(1)(iv)(D) under the Exchange Act.

15 Rule 10A-3(b)(1)(iv)(D) under the Exchange Act.

16 Rule 10A-3(b)(1)(iv)(E) under the Exchange Act. In the adopting release, the SEC acknowledged the practice of foreign governmental representatives sitting on audit committees of foreign private issuers, and it sought to balance independence concerns and foreign practices by permitting the practice so long as the "no compensation" prong of the independence requirement is met and the person in question is not a member of management.

17 Rule 10A-3(c)(3) under the Exchange Act.

18 A body composed entirely of board members, or permitted to be composed entirely of board members, would not meet this requirement. We understand, however, that some issuers have received informal comfort from the SEC staff that they may rely on the exemption where the body is mixed, even though home-country law would permit it to be composed entirely of board members.

19 Rule 10A-3, Instruction 1.

20 Rule 10A-3, Instruction 2.

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21 Form 20-F, Item 16A. This disclosure requirement, which implements § 407 of the Sarbanes-Oxley Act, is essentially identical to the requirement for proxy statements of domestic issuers, which appears in Item 407(d)(5) of Regulation S-K. The requirement does not apply to a registration statement under the Securities Act or the Exchange Act.

22 Form 20-F, Item 16A, Instruction 3.

23 Form 20-F, Item 16A, Instruction 3.

24 Form 20-F, Item 16A, Instruction to paragraph (a).

25 Form 20-F, Item 16A, paragraph (a)(2).

26 Form 20-F, Item 16A, Instruction 3.

27 SEC Release No. 33-8177 (Jan. 23, 2003). The release also notes that "the fact that a person has experience as a public accountant or auditor, or a principal financial officer, controller or principal accounting officer or experience in a similar position does not, by itself, justify the board of directors in deeming the person to be an audit committee financial expert." Form 20-F, Item 16A, Instruction 3.

28 Form 20-F, Item 16A, Safe Harbor.

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U.S. Regulation of the International Securities and Derivatives Markets, § 5.03, AUDITS AND AUDITORS

U.S. Regulation of the International Securities and Derivatives Markets
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[1] Auditor Independence

[a] Overview

In general, maintaining independence from the audit client is a regulatory requirement applicable to auditors, and auditors are responsible for monitoring compliance and may be subject to penalties for failing to do so. [29] A full discussion of U.S. regulation of the auditing profession is beyond the scope of this chapter.

However, independence rules affect a reporting company in important ways. First, the SEC's rules require an issuer to file audited financial statements in annual reports and in registration statements, and the auditor must be independent. [30] If the auditor was not independent, the issuer that filed the audited financial statements violated its obligations under the securities laws. [31] In rare cases,

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the issuer may need to replace its auditor, if the condition that impairs independence is continuing, or to obtain a new audit of a past period by a different auditor. Second, the independence rules require that the issuer have certain governance measures in place; these are separate from the audit committee requirements discussed in § 5.02, but they are closely related in practice. Third, the independence rules affect how the auditor interacts with the company. This § 5.03[1] discusses the independence matters that most regularly affect a reporting foreign private issuer.

Auditor independence is sometimes a major issue in the initial public offering of a foreign private issuer, because SEC standards concerning the independence of auditors are more stringent than those in many other jurisdictions. A foreign issuer, together with its counsel, may need to discuss these standards with the SEC staff in order to confirm that its practices comply or understand what needs to be done to ensure that its practices will comply prior to registering any securities in the United States. If the SEC is not satisfied that auditors are independent, it may request that a second audit be conducted by a different auditing firm covering all periods subsequent to the date on which it deems the auditors to have lost independence. In special circumstances, however, the SEC may permit an issuer to proceed using financial statements for the most recent fiscal year audited either by a different auditor (or the same auditor if it is independent throughout the audit of that fiscal year), even though financial statements for prior years remain "tainted" by the non-independence of the auditors. This may be the case if, for example, the previous auditors lost independence inadvertently and such non-independence for U.S. purposes was permitted by home-country law, or if the issuer had not contemplated a U.S. listing or offering during the period in question.

An audit client already subject to the Exchange Act's ongoing reporting obligations faces potentially serious consequences if its auditor is determined not to be independent. The practical difficulties in resolving such a problem are substantial, and there is also the risk of SEC enforcement action. In the past, in independence cases the SEC has generally pursued remedies against the auditor and not against the issuer, but issuers (and particularly audit committees) would be prudent to exercise reasonable care to ensure that relationships with auditors comply with the independence rules.

Rule 2-01 of Regulation S-X governs independence for SEC purposes. It reflects two major rulemaking

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exercises in the early 2000s. The first was the Commission's reaction to the growth and diversification of auditing firms, which

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led to the adoption of a comprehensive new rule in November 2000. [32] The second was the enactment in 2002 of Title II of the Sarbanes-Oxley Act, [33] which led the SEC to adopt amendments in January 2003. [34] The rule has not been significantly amended since 2003. The rule generally applies to foreign private issuers in the same way as to domestic issuers. Within the SEC, the Office of Chief Accountant has primary responsibility for applying and interpreting the rules on auditor independence, and it has published on the SEC's website a detailed set of answers to Frequently Asked Questions on the subject. [35]

The independence requirements in Rule 2-01 apply not only to the principal firm that signs the audit report, but also to any other accounting firm or accountant performing services in connection with an engagement for which independence is required. Many of its provisions also refer to "covered persons," which includes auditor personnel who play specified roles related to the audit. In addition to the SEC's rule, the PCAOB has independence rules that apply to the auditor of any reporting company. [36]

Rule 2-01 sets forth a general standard of independence: an auditor is not independent if it is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that it is not, capable of exercising objective and impartial judgment on all issues encompassed within its engagement. [37] A preliminary note to Rule 2-01 identifies four factors to be considered in determining whether a relationship between the auditor and the audit client, or the provision of a service by the auditor, is consistent with independence: (i) whether there is a mutual or conflicting interest between the auditor and the audit client; (ii) whether the auditor will be in the position of auditing its own work; (iii) whether the auditor will be acting as management or an employee of the audit client; and (iv) whether the auditor is in a position of being an advocate

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for the audit client. [38] The "audit client" for purposes of Rule 2-01 is defined to include the issuer and its affiliates.

In addition to the general standard, Rule 2-01 also provides that in order to maintain independence:

- the auditor may not provide certain specified non-audit services to the audit client, as discussed in §§ 5.03[1][b] and 5.03[1][c] below; [39]
- the audit client may not employ former auditor personnel in certain positions unless certain conditions are met, as discussed in § 5.03[1][d] below;
- the issuer's audit committee must administer the engagement of the auditor to provide audit and non-audit services, as discussed in § 5.03[1][e] below;
- partners involved in the audit must rotate every five or seven years, depending on the partner's role in the audit; [40]
- an audit partner may not be compensated based on non-audit services provided to the audit client; [41]
- the auditor, and covered persons and their family members, may not have various forms of investment or other financial interest in the audit client; [42]
- the auditor, and covered persons and their family members, may not have various forms of business relationships with the audit client; [43] and

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- the auditor may not receive contingent fees from the audit client for any services. [44]

The specific requirements of the independence rules are not exclusive, and the general standard and the PCAOB rules must also be taken into account in evaluating independence. [45] For example:

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- The SEC takes the position that an audit client's agreement to indemnify the auditor is inconsistent with auditor independence. [46]
- PCAOB rules prohibit an independent auditor from advising on confidential or aggressive tax transactions, and from providing tax reporting services to an individual in a financial reporting oversight role at the audit client. [47]

[b] Prohibited Non-Audit Services

Rule 2-01(c)(4) lists ten categories of non-audit services that are inconsistent with independence. [48] The rule (i) governs the provision of non-audit services by an accountant to an audit client during the audit and professional engagement period and (ii) defines "audit client" broadly to include subsidiaries

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and affiliates. Section 201(b) of the Sarbanes-Oxley Act provides that the PCAOB may, on a case-by-case basis, exempt any person, issuer, public accounting firm or transaction from the prohibition of a given service to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors. Such exemptions are subject to review by the SEC.

Bookkeeping. Under the rules, an auditor's independence is impaired if the auditor provides the audit client with bookkeeping or other services related to accounting records or financial statements, including:

- maintaining or preparing the audit client's accounting records;
- preparing the audit client's financial statements that are filed with the SEC or form the basis of financial statements filed with the SEC; or
- preparing or originating source data underlying the audit client's financial statements;

unless, in each case, it is reasonable to conclude that the results of such service will not be subject to audit procedures during an audit of the audit client's financial statements. [49] The SEC has stated that the preparation of statutory financial statements by the auditor of a foreign private issuer on behalf of its audit client is prohibited if the statutory financial statements later form the basis of financial statements filed with the SEC. [50]

Information Technology. An independent auditor may not provide its audit client with design or implementation of financial information systems, including:

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- directly or indirectly operating or supervising the operation of the audit client's information system or managing the audit client's local area network; or
- designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements or other financial information systems taken as a whole;

unless, in each case, it is reasonable to conclude that the results of such service will not be subject to audit procedures during an audit of the audit client's financial statements. [51] The rules do not preclude an accounting firm from working on hardware or software systems that are unrelated to the audit client's financial statements or accounting records, so long as those services are pre-approved by the audit committee.

The SEC has stated that information will be considered significant to an audit client's financial statements as a whole if such information is reasonably likely to be "material" to the financial statements. The SEC has further stated that since materiality determinations may not be complete before financial statements are generated, the audit client and accounting firm will need to evaluate the general nature of the information rather than only system output during the period of the audit engagement. The SEC noted, for example, that an accounting firm will not be deemed independent of an audit client for which it designs an integrated Enterprise Resource

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Planning system. [52]

Appraisals, Valuations, Fairness Opinions, Contribution Reports. An independent auditor may not provide any appraisal service, valuation service or service involving a fairness opinion or contribution-in-kind report for its audit client, in each case unless it is reasonable to conclude that the results of such service will not be subject to audit procedures during an audit of the audit client's financial statements. [53] Appraisal and valuation services include any process of valuing assets (tangible or intangible) or liabilities. This includes valuing, among other things, in-process research and development, financial instruments, assets and liabilities acquired in a merger and real estate, and would include due diligence services to the extent valuation, or the development of assumptions relating to valuation, are involved. [54] Fairness opinions and contribution-in-kind

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reports include any opinion or report in which an accounting firm provides its opinion on the adequacy of consideration in a transaction.

The SEC has stated that the rule does not prohibit an accounting firm from providing services for nonfinancial reporting purposes, such as preparing transfer pricing studies or cost segregation studies. The SEC has further stated that the rule does not prohibit an accounting firm from using its own valuation specialist to review the work done by an audit client itself or an independent, third-party specialist employed by the audit client, if the audit client or the third-party specialist provides the technical expertise used in determining the required amounts recorded in the financial statements. [55]

The SEC has noted that a strict application of the rule related to contribution-in-kind reports might create conflicts in certain foreign jurisdictions, where laws or regulations require the auditor to provide contribution-in-kind reports in connection with designated transactions of its audit client. Although the SEC has declined to provide a categorical exception for such conflicts, it indicated that it is sensitive to the issue and will work with other regulatory agencies to resolve such conflicts. [56]

Actuarial Services. An auditor's independence is impaired if the auditor provides any actuarially-oriented advisory service involving the determination of amounts recorded in an audit client's financial statements and related accounts, other than assisting a client in understanding the methods, models, assumptions and inputs used in computing an amount, unless it is reasonable to conclude that the results of such service will not be subject to audit procedures during an audit of the audit client's financial statements. [57] The SEC has clarified that the rules permit an accounting firm to use its own actuaries to assist in conducting an audit, provided that the audit client uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities. [58]

Internal Audit. An independent auditor may not provide any internal audit service relating to the internal accounting controls, financial systems or financial statements of the audit client, unless it is reasonable to conclude that

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the results of such service will not be subject to audit procedures during an audit of the audit client's financial statements. [59] The SEC has clarified that the rule does not apply to nonrecurring evaluations of discrete items or programs that are not in substance the outsourcing of the internal audit function, nor does it include operational internal audits unrelated to internal accounting controls, financial systems or financial statements. The SEC has further noted that during the conduct of an audit in accordance with generally accepted auditing standards or when providing audit services related to internal controls, the auditor is expected to evaluate and make recommendations with respect to an audit client's internal controls, and has indicated that such services would not constitute an internal audit outsourcing engagement. [60]

Management Functions. An auditor's independence is impaired if he or she acts, temporarily or permanently, as a director, officer or employee of an audit client or performs any decision-making, supervisory or ongoing monitoring function for the audit client. [61] With respect to management of internal controls, the SEC has noted

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that its rule on management functions continues to permit an independent auditor to assess the effectiveness of an audit client's internal controls and to recommend improvements in the design and implementation of internal controls and risk management controls. However, the actual design and implementation of internal controls and risk management controls are prohibited. [62]

Human Resources. An auditor's independence is impaired if the auditor provides any of the following services to an audit client:

- searching for or seeking out prospective candidates for managerial, executive or director positions;
- engaging in psychological testing or other formal testing or evaluation programs;
- undertaking reference checks of prospective candidates for an executive or director position;

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- acting as a negotiator on the audit client's behalf, such as determining positions, status or title, compensation, fringe benefits or other conditions of employment; or
- recommending or advising a client to hire a specific candidate for a specific job (except that an accounting firm may, upon request by an audit client, interview candidates and advise the audit client on a candidate's competence for financial accounting, administrative or control positions). [63]

Broker-Dealer, Investment Adviser or Investment Banking Services. An independent auditor may not provide any of the following services to an audit client:

- acting as a broker-dealer (registered or unregistered), promoter or underwriter on behalf of an audit client;
- making investment decisions on behalf of an audit client or otherwise having discretionary authority over an audit client's investments;
- executing a transaction to buy or sell an audit client's investment; or
- having custody of assets of an audit client, such as taking temporary possession of securities purchased by the audit client. [64]

Legal Services. An independent auditor may not provide a service to an audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted or otherwise qualified to practice law in the jurisdiction in which the service is provided. [65] The rule may create conflicts where an auditor provides a service in a foreign jurisdiction, and the service must be performed by a licensed legal practitioner, even though it could be provided by a non-lawyer in the United States. The SEC has stated that, as a general matter, the rule is not intended to prohibit foreign auditing firms from providing services that an auditing firm in the United States may provide. Thus, in determining whether a service would impair the auditor's independence solely because the service is labeled a legal service in a foreign jurisdiction, the SEC will consider whether the provision of the service would be prohibited in the United States, as well as in the foreign jurisdiction. [66]

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Expert Services. An independent auditor may not provide an expert opinion or other expert service for an audit client or an audit client's legal representative for the purpose of advocating an audit client's interests in litigation or in a regulatory or administrative proceeding or investigation. [67] The prohibition covers any service that is intended to result in an accounting firm's specialized knowledge, experience or expertise being used to support the contentions of an audit client in adversarial proceedings. Thus, for example, an auditor cannot be engaged by an audit client's legal counsel to provide expert witness or other services, including forensic accounting services, in connection with the client's participation in a legal, administrative or regulatory proceeding. [68]

The independence rule does not, however, prohibit an auditor from testifying as a fact witness with respect to its audit work for a particular audit client. It expressly provides that in any litigation or regulatory or administrative

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proceeding or investigation, an auditor's independence will not be impaired if the auditor provides factual accounts, including in testimony, of work performed or explains the positions taken or conclusions reached during the performance of any service for the audit client. [69]

The SEC has stated that the rule does not prohibit an auditor from assisting a company's audit committee or its legal counsel by performing internal investigations or fact finding engagements that may result in the issuance of a report to the audit client. [70] If, subsequent to the completion of such an engagement, a proceeding or investigation is initiated, the accountant may allow its work product to be used by the audit client and its legal counsel without impairing the accountant's independence. The accountant, however, may not then provide additional services, with the exception of providing factual accounts or testimony about the work performed.

An auditor would not be considered independent if, at any time during the audit and professional engagement period, the auditor provided translation services in connection with SEC filings to its audit clients based in foreign jurisdictions or U.S. clients with foreign operations. The SEC staff explained that translation services require decisions and judgments on behalf of management on the selection and application of words, phrases, and specific accounting, business and industry terms. In conveying the meanings as expressed by management in the original language, it could create a mutual or conflicting interest between the auditor and the audit client and may put the auditor in the position of auditing its own work. [71]

[c] Tax Services

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Section 10A(h) of the Exchange Act specifies that tax services are among the non-audit services that an independent auditor may provide. The SEC's independence rule itself, consequently, is silent on tax services, but the SEC has stated that under its rule an accounting firm may provide tax services to its audit clients, such as tax compliance, tax planning and tax advice. [72] The SEC has, however, emphasized that classifying a service as a "tax service" does not necessarily mean that the service is permitted; for example, providing representation before a tax court, district court or federal court of claims, although it is tax-related, is inconsistent with independence.

With respect to the formulation of tax strategies designed to minimize an audit client's tax obligations, the SEC warned in 2003 that an issuer's audit committee should "scrutinize carefully the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may not be supported in the Internal Revenue Code and related regulations." [73] Subsequently the PCAOB adopted a rule providing that an audit firm is not independent if it provides services to its audit client on specified classes of tax-motivated transactions. To define the suspect categories of transactions, the PCAOB relies in part on existing regulations of the Department of Treasury, but it also includes any transaction initially recommended by an auditor or tax advisor "a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws." [74]

PCAOB rules also provide that an audit firm is not independent if it provides any tax service to an officer in a financial reporting oversight role at the audit client. It does not matter who pays for the service. The rule does not apply to tax services provided to directors who are in a financial reporting oversight role solely by virtue of their role as directors, or to other employees that do not have a financial reporting oversight role. [75]

[d] Conflicts of Interest Resulting from Employment Relationships

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Movement of personnel between an auditing firm and its audit client is not unusual, but it must be monitored so it does not compromise the auditor's continuing independence. The issue that arises most often is employment at the audit client of people who have some current or former connection with the auditor. [76]

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In particular, it is inconsistent with independence for the audit client to employ someone who is currently a partner, principal, shareholder or professional employee of the auditor. Such a person also may not serve on the board of directors of the audit client. [77] Even a former partner, principal, shareholder or professional employee of the auditor may not be employed in any accounting role or a "financial reporting oversight role" [78] at the audit client if he or she has a continuing financial interest in the auditor or is in a position to influence its operations or financial policies. [79] These prohibitions apply even if the person has had no involvement in the auditor's work for the issuer.

Employment of former auditor engagement team members in a financial reporting oversight role is subject to a more specific prohibition. The independence rule prohibits employment in such a role of a former partner, principal, shareholder or professional employee of the auditor, if he or she was a member of the audit engagement team of the issuer during the one-year period preceding the date that audit procedures commenced for the fiscal period that included his or her date of initial employment by the issuer. [80] Audit procedures are deemed to commence for a given fiscal period on the day following the filing with the SEC

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of the issuer's annual report on Form 10-K, Form 20-F or Form 40-F, as applicable, covering the previous fiscal period. [81]

Accordingly, an auditing firm is not independent if a member of the audit engagement team moves into a financial oversight role at the issuer, unless a cooling-off period has passed between the person's last participation in the audit engagement team and his or her first employment with the issuer. Although the formulation of the cooling-off period is complex, in most cases [82] it will last from the time the person ceases to be part of the audit engagement team through the filing of the next annual report, and then until the next fiscal year-end. [83]

These rules on conflicts of interest do not apply to:

- a person, other than the lead partner and the concurring partner, who provides ten or fewer hours of audit, review or attest services during the relevant one-year period preceding the date that audit procedures commenced;
- an individual employed by the issuer as a result of a business combination between an audit client and the employing entity, provided employment was not in contemplation of the business combination and the audit committee of the successor issuer is aware of the prior employment relationship; and
- an individual employed by the issuer due to an emergency or other unusual situation, provided the audit committee determines that the relationship is in the interest of investors. [84]

[e] Audit Committee Administration of the Engagement

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An auditor is not independent unless the audit committee administers the auditor's engagement. [85] The audit committee has other duties relating to the supervision of auditors, which are not directly related to independence but are set forth in the audit committee requirements of Rule 10A-3, discussed in § 5.02 above. If the issuer does not have an audit committee because it is not subject to Rule 10A-3, the requirement for audit committee administration of the engagement must be met by the board of directors as a whole. [86] If instead of an audit committee the issuer relies on an alternative body such as a board of statutory auditors to meet the requirements of Rule 10A-3, then the requirement for audit committee administration of the engagement must be met by that body. [87]

Under this requirement, each engagement of the auditor to provide any service to the audit client or any subsidiary must be either (i) specifically approved in advance by the audit committee or (ii) entered into pursuant to pre-approval policies and procedures established by the audit committee. [88] This requirement applies to audit

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services and to non-audit services, and it includes the engagement of statutory auditors for non-U.S. subsidiaries.

If the audit committee establishes pre-approval policies and procedures, they must be detailed as to the specific services that may be engaged, and they may not delegate audit committee responsibilities to management. [89] Any engagement pursuant to the pre-approval policies and procedures must be reported to the audit committee. An issuer must also disclose the audit committee's pre-approval policies and procedures in the annual report on Form 20-F. [90]

There is a limited exception from the pre-approval requirement for small, inadvertent engagements for non-audit services. The pre-approval requirement is waived for non-audit services that meet three conditions: (i) the aggregate amount of all such non-audit services provided to the company is not more than

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five percent of the total amount of revenues paid by the company to its auditor in the year the services are rendered; (ii) the services were not recognized by the company at the time of the engagement to be non-audit services; and (iii) the services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the audit committee or by one or more members of the audit committee to whom authority to grant such approvals has been delegated by the audit committee. [91] Any engagements that fall within this provision must be disclosed in the annual report on Form 20-F. [92]

[2] Auditor Reports to the Audit Committee

Auditors are required to report to the audit committee, pursuant to a variety of separate requirements of the SEC and the PCAOB. As a practical matter, the most important of these is the PCAOB's Auditing Standard No. 1301, which requires the auditor to (i) communicate with the audit committee regarding certain matters related to the conduct of the audit, (ii) obtain certain information from the audit committee relative to the audit, (iii) establish an understanding with the audit committee of the terms of the audit engagement, and (iv) record that understanding in an engagement letter. [93] The communications specified in the standard must occur prior to the issuance of the audit report, and they must be documented in the auditor's work papers and, for some but not all matters, delivered in writing.

The SEC also has a separate rule requiring the auditor to report to the audit committee, prior to the filing of its audit report with the SEC:

- all critical accounting policies and practices used by the issuer;
- all alternative treatments relating to material items that have been discussed with the issuer's management, including the ramifications of using the alternative treatment and the treatment the auditor preferred; and
- other material written communications between the auditor and management, such as any management letter or schedule of unadjusted differences. [94]

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In addition, there are many PCAOB standards requiring auditors to communicate specific matters to the audit committee. [95] For example, the auditor is required to make certain specific annual communications to the audit committee concerning its independence. [96] These communication requirements can have an impact on how the auditor and management interact; examples include the requirement that the auditor communicate any disagreements with management, the requirement that the auditor provide the schedule of unadjusted differences and discuss their materiality, or the requirement that it communicate its views about any matter about which it is aware that management has consulted with other accountants.

[3] Change-of-Auditor Disclosure

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An issuer is required to provide specific disclosures if its auditor has resigned, or declined to stand for re-election, or been dismissed, and if it has engaged a new auditor. For a foreign private issuer, the disclosure requirement is set forth in Item 16F of Form 20-F, and it is required in any annual report and in any registration statement under the Securities Act or the Exchange Act. [97] The disclosure requirements are virtually identical to those that apply to a domestic issuer, except that a domestic issuer must disclose the information more promptly. [98]

Some of the information required by Item 16F is simple background, and for many changes of auditor no further information is required. [99] The purpose of the disclosures, however, is to elicit information about disagreements with the old auditor and about pre-engagement consultations with the new auditor that might represent "opinion shopping." To that end, Item 16F sets forth an extensive list of matters that must be reported if they have occurred, centering around

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whether there were disagreements with the former auditor and whether there were consultations with the new auditor before its engagement. It also requires that the old auditor provide a letter to the SEC stating whether it agrees with the disclosures, and this letter must be filed as an exhibit to the annual report or registration statement containing the disclosures.

The principal U.S. securities exchanges also require a listed issuer to notify the exchange about a change in its auditors, but neither has substantive disclosure requirements concerning a change of auditors similar to Form 20-F. [100]

[4] Auditor Response to Evidence of Illegality

Section 10A(b) of the Exchange Act requires an auditor, if it encounters evidence of illegal acts in the course of conducting an audit, to take certain specific steps that can culminate in reporting the evidence to the SEC. These are sometimes referred to as "up-the-ladder reporting." These obligations have an important impact on how an issuer and its auditor deal with certain kinds of information that may come up in connection with the audit of the financial statements.

Section 10A(b) is triggered if, in the course of conducting an audit, the auditor discovers or becomes aware of information indicating an illegal act has or may have occurred, whether or not the illegality is perceived to have a material effect on the financial statements. [101] In that event, the auditor must determine whether it is likely an illegal act occurred and if so, determine the possible effect on the financial statements, including the possibility of consequences such as fines, penalties and damages. As soon as practicable, the auditor must inform management and assure that the audit committee is adequately informed, unless the illegal act is "clearly inconsequential." If there is no audit committee, the auditor must assure that the board of directors is adequately informed.

Further consequences under § 10A(b) depend on whether the illegality is material to the financial statements and whether the issuer responds with appropriate remedial actions. The auditor has an obligation to report to the board of directors if it concludes that (i) the illegal act has a material effect on the financial statements, (ii) neither senior management nor the board of directors has taken "timely and appropriate remedial actions" and (iii) the failure to take remedial actions is reasonably expected to warrant departure from the standard report of the auditor, or warrant resignation from the audit engagement. [102] If the board of directors receives such a report from its auditors, it is obligated to notify the

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Office of the Chief Accountant at the SEC within one business day of receipt and provide a copy of that notice to its auditors; if the auditor does not receive a copy of that notice within one business day, it must either resign from the engagement or furnish its report in writing to the SEC within one business day. [103]

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[5] Prohibited Conduct Involving Audits

Rule 13b2-2 under the Exchange Act specifically prohibits certain representations and conduct by issuer personnel in its dealings with auditors. In general terms, paragraph (a) of the Rule prohibits false or misleading statements or omissions by an officer or director to an accountant in connection with a required audit, review or examination or a required filing. [104]

Paragraph (b) of Rule 13b2-2 also specifically prohibits actions to coerce, manipulate, mislead or fraudulently influence an auditor. The directors and officers of a reporting issuer, and any person acting at their direction, may not take any direct or indirect action to coerce, manipulate, mislead or fraudulently influence an auditor in an audit or review of the issuer's financial statements required to be filed with the SEC, if such person knows or should know that such action could, if successful, result in rendering the financial statements materially misleading. [105] This prohibition would capture conduct whether or not it succeeds in affecting the audit or review. It is the act of coercing, manipulating, misleading or fraudulently influencing the auditor, for the purpose of rendering misleading financial statements, that is unlawful, and there is no requirement that the purpose be achieved. [106] Rule 13b2-2 is enforceable in civil proceedings exclusively by the SEC. [107]

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In addition to officers and directors, Rule 13b2-2(b) regulates the activities of persons acting "under the direction of" officers and directors. The SEC has stated that it interprets the term "direction" as encompassing a broader category of behavior than "supervision" and that persons acting "under the direction" of an officer or director could include persons outside the issuer's hierarchy who improperly influence the conduct of an audit. Such persons may include customers, vendors and creditors of the issuer, attorneys, securities professionals and other professional advisors and partners and other employees of the issuer's accounting firm. [108]

Rule 13b2-2(b) provides that actions that, if successful, could result in rendering an issuer's financial statements materially misleading, include but are not limited to, actions taken at any time, with respect to the professional engagement period, to coerce, manipulate, mislead or fraudulently influence an auditor:

- to issue or reissue a report on an issuer's financial statements that is not warranted in the circumstances (due to material violations of generally accepted accounting principles, generally accepted auditing standards or other professional or regulatory standards);
- not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;
- not to withdraw an issued report; or
- not to communicate matters to an issuer's audit committee.

Types of conduct that the SEC believes could constitute improper influence (whether engaged in directly or indirectly, but only if the person engaged in that conduct knows or should know that the conduct, if successful, could result in rendering the issuer's financial statements materially misleading) include, but are not limited to:

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- offering or paying bribes or other financial incentives, including offering future employment or contracts for nonaudit services;
- providing an auditor with an inaccurate or misleading legal analysis;
- signing misleading management representation letters addressed to the auditor;
- threatening to cancel or canceling existing nonaudit or audit engagements if the auditor objects to the issuer's accounting;
- seeking to have a partner removed from the audit engagement because the partner objects to the

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issuer's accounting;

- blackmailing; and
- making physical threats. [109]

With respect to the time frame of the prohibited conduct, the term "engaged in the performance of an audit" should be read broadly and should encompass both the professional engagement period and any other time the auditor is called upon to make decisions regarding an issuer's financial statements. [110] This would therefore include improperly influencing an auditor during negotiations for retention of the auditor, during a review of interim financial statements or in connection with the issuance of a consent to the use of the auditor's report. In limited circumstances, this time frame could also include conduct occurring before the professional engagement period begins—for example, if an officer offers to engage an accounting firm subject to a condition that could result in rendering the financial statements materially misleading, such as a condition that the firm issue an unqualified audit report on financial statements that do not conform with generally accepted accounting principles, or a condition that the firm limit the scope or performance of audit or review procedures in violation of generally accepted auditing standards. [111]

[6] Regulation of the Auditing Profession

Before the Sarbanes-Oxley Act, the auditing profession in the United States was largely self-regulated, and auditing standards were adopted by the AICPA. The PCAOB was established in 2002 pursuant to the Sarbanes-Oxley Act with a mandate to:

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- register public accounting firms that prepare audit reports for issuers;
- establish auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports; and
- conduct inspections, investigations and disciplinary proceedings of and take enforcement action against public accounting firms. [112]

The Sarbanes-Oxley Act prohibits the issuance of audit reports, or participation in the preparation of an audit report, with respect to any reporting issuer by any accounting firm that has not registered, as required, with the PCAOB. [113]

The PCAOB has five members, who serve full-time and are appointed to staggered five-year terms. They are appointed by the SEC, after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, and the SEC has continuing oversight of the PCAOB. [114]

Except for the information required to be provided in the initial registration and subsequent annual reports filed with the PCAOB (including information regarding fees paid to the public accounting firms by each issuer client for audit and nonaudit services), which will be publicly available, [115] other information received by the PCAOB is required to be maintained confidentially, although

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information with respect to an inspection or investigation may be shared with the SEC and, if deemed to be necessary by the PCAOB, with the U.S. Attorney General or other specified federal and state regulators. [116]

A foreign public accounting firm that prepares or furnishes audit reports with respect to any reporting issuer is required to register with the PCAOB just as a U.S. firm would be, and it is subject to the same inspection, investigation and disciplinary powers. [117] For most reporting foreign private issuers, the audit reports that the issuer files with the SEC are signed not by a U.S. auditing firm but by a local firm in the issuer's home jurisdiction, which must be independently registered with the PCAOB even if it is a member of a global network. In addition, even a foreign public accounting firm that does not furnish audit reports may be required to register if

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it plays a substantial role in the preparation of audit reports—for example, where a U.S. issuer has major French operations, and the French member of the global network does the audit work relating to those operations.

The PCAOB regularly conducts inspections of non-U.S. firms, and it has also conducted investigations and taken disciplinary actions against non-U.S. firms. [118] Furthermore, any foreign public accounting firm that performs material services relied on by a registered public accounting firm is required to produce its workpapers to the PCAOB. [119]

The conduct of inspections and investigations outside the United States, and the production of workpapers by non-U.S. auditing firms, have proven highly controversial. Some foreign accounting firms are organized in jurisdictions where by law the provision of workpapers requires the consent of the audit client. The PCAOB takes the position that an auditor must choose whether (i) to satisfy itself in advance that the non-U.S. client will provide any necessary consent if and when the PCAOB demands documents or information concerning the client, (ii) to proceed without such assurance and take a risk that it may later have to choose between providing information without the client's consent and facing a PCAOB sanction for failing to provide the information or (iii) to decline the audit engagement. Even if an accounting firm obtains advance assurance that the

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client will provide consent, it may still be subject to sanctions if the client ultimately refuses to provide the promised consent at the time the PCAOB requests documents from the auditor. [120]

In other jurisdictions, local law may be understood to prohibit the provision of workpapers or other aspects of cooperation by a local auditing firm with PCAOB inspections and investigations. This difficulty has led to protracted administrative proceedings and international negotiations involving the Chinese members of global auditing networks. [121]

The PCAOB has also faced objections from foreign auditor-oversight authorities in response to its attempts to carry out joint inspections of PCAOB-registered accounting firms located outside the United States, and it has sought to address these objections by entering into formal cooperative arrangements with foreign audit regulators. [122]

Footnotes

29 Rule 10A-2 under the Exchange Act provides that it is unlawful for an auditor not to be independent under the SEC's independence rules. Rule 10A-2 was adopted following the Sarbanes-Oxley Act to clarify that the auditor has a separate obligation to be independent. *See* § 208(b) of the Sarbanes-Oxley Act (providing that it is unlawful for an auditor to issue and audit report if it has violated specified independence requirements set forth in the Act or the SEC's rules thereunder). A failure of independence is a violation by the auditor, but an issuer might also be in violation of the rule to the extent it aided, abetted or caused the auditor to lose independence, and in any case failure of the auditor to be independent often results in failure of the issuer to comply with its Exchange Act reporting obligations, as discussed below.

30 *E.g.*, Item 8.A of Form 20-F (requiring financial statements audited by an independent auditor); Rule 1-02(a)(1)g of Regulation S-X (defining an "accountant's report" as a report of an independent public accountant).

31 SEC enforcement cases finding auditor independence violations have generally found that the issuer violated the Exchange Act but have not imposed sanctions on the issuer. *See*, *e.g.*, *In the Matter of Ernst & Young LLP and Gregory S. Bednar, CPA*, SEC Admin Proc. File No. 3-17552 (Sept. 19, 2016) and *In the Matter of Ernst & Young LLP, Robert Brehl, CPA Pamela J. Hartford, CPA and Michael T. Kamienski, CPA*, SEC Admin Proc. File No. 3-17553 (Sept. 19, 2016) (finding, in administrative proceedings against an auditor but not the audit client, that independence violations arising from improperly close personal relationships between auditor personnel and audit client personnel caused the audit client to violate § 13(a) of the Exchange Act and Rule 13a-1 thereunder); *In the Matter of KPMG LLP*, SEC Admin. Proc. File No. 3-15687 (Jan. 24, 2014) (finding, in administrative proceedings against an auditor but not the audit clients, that

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independence violations arising from prohibited non-audit services, employment relationships and investments cause three audit clients to violate § 13(a) of the Exchange Act and Rule 13a-1 thereunder).

32 SEC Release No. 33-7919 (Nov. 21, 2000).

33 §§ 201-204 and 206 of the Sarbanes-Oxley Act are codified as paragraphs (g)-(l) of § 10A of the Exchange Act. § 208(b) of the Sarbanes-Oxley Act separately provides that it is unlawful for an auditor to issue an audit report if it has engaged in conduct prohibited by paragraphs (g)-(l) or SEC rules adopted thereunder.

34 SEC Release No. 33-8183 (Jan. 28, 2003). Much of what § 201 required was already contained in the rule as adopted in 2000, so the 2003 amendments were fairly limited in scope.

35 *See* SEC, Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence Frequently Asked Questions (Dec. 13, 2004).

36 PCAOB Rules 3520–3526. These PCAOB rules notably prohibit an auditor from accepting contingent fees, from advising on confidential or aggressive tax transactions, and from providing tax reporting services to an individual in a financial reporting oversight role at the audit client. They also impose audit committee pre-approval requirements for certain services relating to tax and to internal controls, and they require auditors to communicate with audit committees concerning independence.

37 Rule 2-01(b) of Regulation S-X.

38 Preliminary Note 2 to Rule 2-01 of Regulation S-X.

39 *See*, *e.g.*, *In the Matter of KPMG*, *LLP*, SEC Release No. 71389 (Jan. 24, 2014) (finding that auditor violated independence rules by providing prohibited non-audit services such as bookkeeping and expert services to affiliates of audit clients).

40 Rule 2-01(c)(6) of Regulation S-X.

41 Rule 2-01(c)(8) of Regulation S-X.

42 Rule 2-01(c)(1). *See*, *e.g.*, *In the Matter of KPMG, LLP*, SEC Release No. 71389 (Jan. 24, 2014) (KPMG violated auditor independence rules because, among other things, KPMG personnel owned stock in companies or affiliates of companies that were KPMG audit clients). The prohibition on "other financial interests" can have far-reaching impact when the audit client provides financial services or is related to entities that do. *See*, *e.g.*, *Fidelity Management & Research Company*, *et al.* (avail. June 20, 2016) (no-action letter addressing whether lending relationships between auditor and an investment company complex are inconsistent with auditor independence). Paragraph (c)(1) also prohibits the audit client having an investment in the auditor.

43 Rule 2-01(c)(3) of Regulation S-X. *See*, *e.g.*, *In the Matter of Ernst & Young LLP*, SEC Release No. 34-49615 (Apr. 26, 2004) (suspending auditor from accepting audit engagements from new public audit clients for a period of six months as a result of auditor's joint business relationships with its audit client).

44 Rule 2-01(c)(5) of Regulation S-X. PCAOB Rule 3521 also provides that a registered public accounting firm is not independent if it enters into contingent fee arrangements, directly or indirectly, with the audit client. In 2002, the SEC settled an auditor independence case with PricewaterhouseCoopers related to violations spanning a five-year period from 1996 to 2001 arising from (i) PwC's use of prohibited contingent fee arrangements with 14 different audit clients for which PwC's broker-dealer affiliate provided investment banking services and (ii) PwC's participation with two other audit clients in an improper accounting of costs that included PwC's own consulting fees. *In the Matter of Avon Products, Inc.*, SEC Release No. 34-46215 (July 17, 2002); *In the Matter of PricewaterhouseCoopers LLP*, SEC Release No. 34-46216 (July 17, 2002).

45 For example, in 2014, an SEC investigation found that Ernst & Young violated auditor independence rules because an Ernst & Young subsidiary lobbied congressional staff on behalf of two audit clients. Ernst & Young agreed to pay more than $4 million to settle the charges. *In the Matter of Ernst & Young LLP*, SEC Release No. 72602 (July 14, 2014). *See In the Matter of Ernst & Young Accountants*, SEC Release No. 34-46130 (June 27, 2002).

46 SEC, Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence Frequently Asked Questions (Dec. 13, 2004). While the staff generally has not objected to the

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indemnification of a former auditor for costs incurred in the successful defense of claims (provided that the current auditor has opined on at least the most recent fiscal year and the indemnification arrangement is fully disclosed), the staff will not permit indemnification of a current auditor under any circumstances. *See also* SEC Codification of Financial Reporting Policies § 602.02.i.i., Fed. Sec. L. Rep. (CCH) ¶3874.

47 PCAOB Rules 3522 and 3523.

48 Section 10A(g) of the Exchange Act lists nine categories, which the SEC reworked into ten in Rule 2-01(c)(4). The 2000 version of the Rule established very similar categories (but it excluded expert services). In debating the Sarbanes-Oxley Act, Congress, like the SEC in the 2000 rulemaking, considered a range of approaches, ranging from the prohibition of any non-audit work (*see* S. Amdts. 4193, 4238, 4239, to S. 2673 (Senators Sarbanes, McCain, et al); "Auditor Independence Act of 2002," S. 1896, 107th Cong., Section 3 (2002) (Senator Boxer)) to permitting all non-audit work subject to audit committee pre-approval (*see* "Investor Confidence in Public Accounting Act of 2002," S.2004, 107th Cong., Section 201 (2002) (Senators Dodd, Corzine, *et al.*)).

49 Rule 2-01(c)(4)(i) of Regulation S-X. The qualification "unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements'" appears in the SEC's prohibitions on (i) bookkeeping, (ii) financial information systems design and implementation, (iii) appraisal or valuation services, fairness opinions or contribution-in-kind reports, (iv) actuarial services and (v) internal audit outsourcing. This language establishes a rebuttable presumption that the services in question are subject to audit procedures. *See* 2003 Auditor Independence Release, 68 Fed. Reg. 6006, 6030 (Feb. 5, 2003) ("2003 Auditor Independence Release"). The SEC has stated that an example of a situation where it would be reasonable to conclude that the results would not be subject to audit procedures would be where an accounting firm provides a prohibited service to an affiliate of the client, but the accounting firm is not the auditor of the entity that controls the accounting firm's client or its affiliate.

50 2003 Auditor Independence Release.

51 Rule 2-01(c)(4)(ii) of Regulation S-X.

52 2003 Auditor Independence Release.

53 Rule 2-01(c)(4)(iii) of Regulation S-X.

54 Due diligence services are generally regarded as permissible by the SEC if they do not involve valuation. *See* 2003 Auditor Independence Release (discussing "assurance and related services (*e.g.*, due diligence services) that traditionally are performed by the independent accountant" in terms of permissible services). Such services could include reviewing the reasonableness of assumptions and performing calculations based on those assumptions.

55 2003 Auditor Independence Release.

56 *See* SEC Release No. 33-8183 (Jan. 28, 2003) ("[W]e understand that laws and regulations in certain foreign countries require auditors to provide contribution-in-kind reports or valuation services. The Commission has historically addressed conflicts between U.S. and foreign requirements regarding non-audit services on an ad hoc basis. Commission staff has previously afforded relief from proscriptions against appraisal and valuation services where, among other things, the auditor and issuer were able to demonstrate that the auditor was not providing an opinion on the fairness of a given transaction. The Commission will continue to take this ad hoc approach, and will continue to consider requests for exemptive relief from foreign auditors.")

57 Rule 2-01(c)(4)(iv) of Regulation S-X.

58 2003 Auditor Independence Release.

59 Rule 2-01(c)(4)(v) of Regulation S-X. An engagement to provide services related to internal control over financial reporting is also subject to special pre-approval requirements under PCAOB Rule 3525.

60 2003 Auditor Independence Release. Existing auditing standards require an accountant to consider and evaluate an audit client's internal controls. *See* AICPA, CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards (AU) § 319, Consideration of Internal Control in a Financial

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Statement Audit and Statement on Auditing Standards (AU) § 325, Communication of Internal Control Related Matters Noted in an Audit. In addition, rules under § 404(b) of the Sarbanes-Oxley Act require an auditor to opine on the effectiveness of an issuer's internal control over financial reporting. *See* § 4.06[2].

61 Rule 2-01(c)(4)(vi) of Regulation S-X.

62 2003 Auditor Independence Release.

63 Rule 2-01(c)(4)(vii) of Regulation S-X.

64 Rule 2-01(c)(4)(viii) of Regulation S-X.

65 Rule 2-01(c)(4)(ix) of Regulation S-X.

66 2003 Auditor Independence Release.

67 Rule 2-01(c)(4)(x) of Regulation S-X.

68 2003 Auditor Independence Release.

69 Rule 2-01(c)(4)(x) of Regulation S-X.

70 2003 Auditor Independence Release.

71 *See* SEC, Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence—Frequently Asked Questions (Dec. 14, 2004).

72 2003 Auditor Independence Release. The SEC noted that reviewing the tax accrual included in an audit client's financial statements is part of audit services and is not, in and of itself, deemed to be a tax compliance service.

73 2003 Auditor Independence Release, *see also* Letter from Donald T. Nicolaisen, Chief Accountant, SEC, to Bruce P. Webb, Chair, AICPA Professional Ethics Executive Committee, (May 21, 2004) (confirming the SEC's view that, notwithstanding the AICPA's assertion to the contrary, the receipt by an auditor of contingent fees for tax services provided to an audit client would impair the auditor's independence with respect to that client). PCAOB rules also treat registered public accounting firms as not independent if they enter into contingent fee arrangements, directly or indirectly, with audit clients.

74 PCAOB Rule 3522.

75 PCAOB Rule 3523. *See infra* Note 78 and the definition of "financial reporting oversight role."

76 Employment at the auditor of former issuer personnel can also impair independence. In particular, a former officer, director or employee of the audit client may not participate in, or be in a position to influence, the audit of the audit client covering any period the individual was associated with the issuer. Rule 2-01(c)(2)(iv) of Regulation S-X.

77 Rule 2-01(c)(2)(i) of Regulation S-X. It is also inconsistent with independence for a "close family member" of a "covered person in the firm" to act in an accounting role or a financial reporting oversight role at the audit client. Rule 2-01(c)(2)(ii) of Regulation S-X. The terms in quotation marks are defined in Rule 2-01(f) of Regulation S-X.

78 A "financial reporting oversight role" is defined as a role in which a person is in a position to, or does, exercise influence over the contents of an issuer's financial statements, such as when a person is a member of the board of directors, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer or any equivalent position. Rule 2-01(f)(3)(ii) of Regulation S-X. The SEC has stated that a person who has direct responsibility for overseeing those who prepare a registrant's financial statements and related information, such as the MD&A, is in a financial reporting oversight role. 2003 Auditor Independence Release.

79 Rule 2-01(c)(2)(iii) of Regulation S-X.

80 Rules 2-01(c)(2)(iii)(A) and 2-01(c)(2)(iii)(B) of Regulation S-X. The Exchange Act also specifically provides that it is unlawful for an auditor to perform any audit service for a company if the company's chief executive officer, controller, chief financial officer or chief accounting officer, or any person serving in an equivalent position, was employed by the auditor and participated in any capacity in the audit of the company during

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the one-year period preceding the date of initiation of the audit. § 10A(1) of the Exchange Act, codifying § 206 of the Sarbanes-Oxley Act.

81 Rule 2-01(c)(2)(iii)(B)(3) of Regulation S-X.

82 The cooling-off period could differ from the paraphrase in the text above, where the filing date of the annual report changes from one year to the next (so that there is not exactly one year between annual reports), and the person leaves the audit engagement team during the period between the filing date and the date that is one year before the next filing date.

83 There are, however, some interpretive difficulties that could require clarification from the SEC staff. For example, on the face of the rule, the bar would appear to be permanent—if a person moves from the audit engagement team to a financial oversight position before the cooling-off period ends, the auditing firm can never be independent again. The SEC staff has informally indicated that the bar is only intended to last until the end of the cooling-off period, which is all the language of the Sarbanes-Oxley Act requires. The bar also seems to apply if a member of the audit engagement team moves to a nonfinancial-oversight position within the cooling-off period, and then moves into a financial oversight position after the end of the cooling-off period. This result is probably also unintended.

84 Rule 2-01(c)(2)(iii)(B)(2) of Regulation S-X. This particular exception was intended to address issues that may arise in foreign jurisdictions making it extremely difficult or costly to comply, but the SEC has noted that it expects the emergency exception to the rules to be invoked very rarely. 2003 Auditor Independence Release.

85 Rule 2-01(c)(7) of Regulation S-X. This requirement implements § 202 of the Sarbanes-Oxley Act, which is codified in § 10A(i) of the Exchange Act.

86 *See* § 3(a)(58) of the Exchange Act (defining "audit committee" to mean the full board where there is no separate audit committee).

87 SEC Release No. 33-8220 (Apr. 9, 2003).

88 In addition to SEC independence rules, PCAOB independence rules require audit committee pre-approval for certain tax services and for services related to internal control over financial reporting. PCAOB Rules 3524 and 3525.

89 Published guidance of the SEC's Office of Chief Accountant addresses the level of detail necessary, stating that monetary limits and broad, categorical approvals are not sufficient, and that while the level of detail will depend on the circumstances of the issuer, it must be sufficient so that there is no delegation to management and the audit committee can make a well-reasoned assessment of the impact of the services on independence. *See* SEC, Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence Frequently Asked Questions (Dec. 13, 2004).

90 Item 16C(e) of Form 20-F.

91 Rule 2-01(c)(7)(i)(C) of Regulation S-X, implementing § 10A(i)(1)(B) of the Exchange Act.

92 Item 16C(e) of Form 20-F, implementing § 10A(i)(2) of the Exchange Act.

93 Auditing Standard No. 1301, Communications with Audit Committees. Appendix C to Auditing Standard No. 1301 includes matters that are required to be included in the engagement letter.

94 Rule 2-07 of Regulation S-X ; § 10A(k) of the Exchange Act, codifying § 204 of the Sarbanes-Oxley Act. The communications required by Rule 2-07 are also required by Auditing Standard No. 1301.

95 These are listed in Appendix B to Auditing Standard No. 1301.

96 PCAOB Rule 3526.

97 Item 16F of Form 20-F. Item 16F was based on the disclosure requirements for domestic issuers in Item 4.01 of Form 8-K, Item 304(a) of Regulation S-K and Item 9 of Form 10-K. *See* SEC Release No. 33-8959 (Sept. 23, 2008). Disclosure must be provided in a registration statement at effectiveness, as well as in prospectuses used in connection with a shelf offering. *See* Item 5 of Form F-3.

98 A domestic issuer must file a current report on Form 8-K within four business days after the auditor resigns

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(or indicates it will not stand for re-election) or is dismissed and within four business days after the new auditor is appointed. The information required to be disclosed is set forth in Item 304 of Regulation S-K under the Securities Act, which is substantially identical to Item 16F of Form 20-F. *See also* Foreign Issuer Reporting Enhancement, 73 Fed. Reg. 58,300, 58,310 (Oct. 6, 2008) (discussing why the SEC chose not to impose a current reporting requirement on foreign issuers).

99 Such information includes the names of the old and new auditors, the date of the change and whether the change was recommended or approved by the audit committee or the board of directors. *See* Item 16F(a)(1)(i), (iii) and Item 16F(a)(2) of Form 20-F.

100 NYSE LISTED COMPANY MANUAL § 204.03; NASDAQ LISTING CENTER, FREQUENTLY ASKED QUESTIONS.

101 § 10A(b)(1) of the Exchange Act.

102 § 10A(b)(2) of the Exchange Act.

103 § 10A(b)(3) of the Exchange Act. Rule 10A-1 under the Exchange Act provides procedures for notices to the Office of Chief Accountant by either the issuer or the auditor. An auditor complying with its obligations under § 10A(b) will not be liable in a private action for any finding, conclusion or statement in its report to the board of directors or the SEC. § 10A(c) of the Exchange Act.

104 Rule 13b2-2(a) under the Exchange Act.

105 Rule 13b2-2(b) under the Exchange Act. The SEC adopted paragraph (b) of Rule 13b2-2 in 2003 to implement § 303 of the Sarbanes-Oxley Act. The SEC has stated that paragraph (b) establishes a negligence standard. SEC Release No. 34-47890 (May 20, 2003).

106 SEC Release No. 34-47890 (May 20, 2003).

107 § 303(b) of the Sarbanes-Oxley Act. A willful violation could also result in criminal penalties under § 32(a) of the Exchange Act. The SEC has brought a number of proceedings against individuals alleging violations of Rule 13b2-2, generally together with other violations. *See*, *e.g.*, *SEC v. Kipp and Viard*, SEC Litigation Release No. 23544 (May 24, 2016) (alleging the company's former CFO and former director of external reporting violated Rule 13b2-2 by manipulated acquisition-related reserves and expenses in order to increase earnings to predetermined targets tied to the expectations of lenders as the basis for future acquisition financing); *United States v. Lundstrom*, SEC Litigation Release No. 23499 (Mar. 25, 2016) (former chairman and CEO sentenced to 11 years in federal prison and ordered to pay a $1.2 million fine for orchestrating a scheme to defraud shareholders and mislead regulators by concealing more than $100 million in losses on loans and declining real estate); *SEC v. Neil*, SEC Litigation Release No. 23192 (Feb. 6, 2015) (alleging the former CEO directed an effort to fraudulently underreport money paid to walnut growers by delaying the recognition of related expenses into later fiscal periods); *In the Matter of Michael Mendes* and *SEC v. Neil*, SEC Litigation Release No. 22902 (Jan. 9, 2014) (alleging that a company's CEO and CFO violated Rule 13b2-2 by making false and misleading statements to external auditors in signed management representation letters); *SEC v. Forman,* SEC Litigation Release No. 21677 (Sept. 30, 2010) (alleging that a company's controller violated Rule 13b2-2 by providing independent auditors with false information and statements regarding prepaid transaction revenue); *SEC v. Gupta*, SEC Litigation Release No. 21451 (Mar. 15, 2010) (alleging that two of the company's CFOs knowingly signed management representation letters to its external auditors containing materially false or misleading statements or omissions); *SEC v. Stanard*, SEC Litigation Release No. 20875 (Jan. 30, 2009) (finding that the former CEO made false or misleading statements to external auditors in signed management representation letters and in providing them with false information about insurance claims).

108 SEC Release No. 34-47890 (May 20, 2003).

109 SEC Release No. 34-47890 (May 20, 2003).

110 SEC Release No. 34-47890 (May 20, 2003).

111 SEC Release No. 34-47890 (May 20, 2003).

112 § 101(c) of the Sarbanes-Oxley Act. The original authority of the PCAOB over audits of reporting "issuers" was extended by the Dodd-Frank Act, which amended the Sarbanes-Oxley Act to give the PCAOB

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oversight authority over audits of SEC-registered broker-dealers. The PCAOB adopted implementing amendments to its rules in December 2013. PCAOB Release No. 2013-010 (Dec. 4, 2013).

113 § 102(a) of the Sarbanes-Oxley Act; *see also* SEC Release No. 34-48180 (July 16, 2003). U.S. public accounting firms were required to register with the PCAOB by October 22, 2003; foreign firms were required to register by July 19, 2004. *See* SEC Release No. 34-48180 (July 16, 2003); SEC Release No. 34-49473 (Mar. 25, 2004). The prohibition in § 102(a) applies to audit reports with respect to an "issuer" as defined in § 2(a)(7) of the Sarbanes-Oxley Act, which includes a reporting company but not, for example, a company that is exempt from reporting under Rule 12g3-2(b) under the Exchange Act.

114 § 107 of the Sarbanes-Oxley Act. *See Free Enterprise Fund v. Public Company Accounting Oversight Board*, 130 S. Ct. 3138 (2010) (upholding the constitutionality of the PCAOB, but holding unconstitutional certain tenure provisions, or "removal restrictions," in the Sarbanes-Oxley Act allowing removal of the PCAOB's members only for "good cause" by the SEC).

115 The public availability of PCAOB registration applications and annual reports, or any portion thereof as may be designated by the PCAOB, is subject to the rules of the PCAOB or the SEC and to legal restrictions relating to confidentiality of proprietary or personal information. § 102(e) of the Sarbanes-Oxley Act. The PCAOB has accommodated foreign firms insofar as the scope of information required to be included in their registration applications is reduced and such firms may withhold certain information if they can demonstrate that providing the information would conflict with non-U.S. law (by providing an English copy or translation of the non-U.S. law, a legal opinion that submitting the information would violate the law and an explanation of the firm's efforts to seek consents or waivers to eliminate the conflict). *See* PCAOB Rules, Rules 2105, 2207; *see also* SEC Release No. 34-60497 (Aug. 13, 2009) (approving rules on annual and special reporting by registered public accounting firms proposed by the PCAOB).

116 § 105(b)(5) of the Sarbanes-Oxley Act.

117 § 106(a)(1) of the Sarbanes-Oxley Act.

118 For example, in December 2016, the PCAOB issued orders imposing sanctions on Deloitte Touche Tohmatsu Auditores Independentes, the Brazilian auditing firm in the Deloitte global network, and 12 individuals associated with that firm, arising from violations of U.S. securities laws and PCAOB rules in connection with audits of two reporting foreign private issuers. PCAOB Release No. 105-2016-031 (Dec. 5, 2016).

119 § 106(b) of the Sarbanes-Oxley Act, as amended by § 929J of the Dodd-Frank Act. Such foreign firms are subject to the jurisdiction of the U.S. courts for purposes of enforcing such production of workpapers.

120 PCAOB, Frequently Asked Questions Regarding Issues Relating to Non-U.S. Accounting Firms, Question 4 (Dec. 15, 2016).

121 The proceedings were settled in February 2015. *In the Matter of BDO China Dahua CPA Co.*, SEC Admin. Proc. File Nos. 3-14872, 3-15116 (Feb. 6, 2015) (finding that five auditing firms willfully violated § 106 of the Sarbanes-Oxley Act, and imposing among other things specified undertakings and other relief relating to the production of documents in response to future PCAOB requests).

122 In July 2010, the Dodd-Frank Act amended § 105 of the Sarbanes-Oxley Act to provide that the PCAOB may, in certain circumstances, share information with non-U.S. auditor oversight authorities. As of late 2016, the PCAOB reported that it had entered into cooperative arrangements with regulators in 23 countries, that it had conducted inspections in 45 non-U.S. jurisdictions on a cumulative basis, and that in 12 jurisdictions it was denied access to the information necessary to conduct inspections on the basis of asserted restrictions under local law or objections based on national sovereignty. PCAOB Cooperative Arrangements with Non-U.S. Regulators, Jurisdictions Where the PCAOB has Conducted Inspections of Registered non-U.S. Firms (June 30, 2015), and Registered Firms not yet Inspected even though Four or More Years have Passed since Issuance of an Audit Report while Registered (June 30, 2015), PUB. CO. ACCOUNTING OVERSIGHT BD. (Dec. 15, 2016).

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U.S. Regulation of the International Securities and Derivatives Markets, § 5.04, CONTROLS, OFFICERS CERTIFICATIONS AND RELATED DISCLOSURES

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 5.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Books and Records Requirement

The Foreign Corrupt Practices Act ("FCPA"), first adopted in 1977, has two parts: (i) the anti-bribery provisions, which prohibit the bribery of non-U.S. government officials, and (ii) the accounting provisions, which require issuers to keep accurate books and records and to maintain a system of internal accounting controls. The FCPA is codified in § 13(b) of the Exchange Act and enforced by the SEC and, in criminal cases, by the Department of Justice (the “DOJ”). The anti-bribery provisions are discussed in § 11.

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The accounting provisions apply only to "issuers," which are defined as companies that have shares registered under § 12 of the Exchange Act or file periodic reports under § 15(d) of the Exchange Act. [123] An issuer is responsible for compliance with the accounting provisions by its controlled subsidiaries. [124] An issuer that controls 50% or less of the "voting power" of an affiliate must use its influence, in good faith and to the extent reasonable under the circumstances, to cause the affiliate to maintain internal accounting controls that meet the FCPA standard. [125]

The accounting provisions of the FCPA require an issuer to keep books, records and accounts that, in reasonable detail, accurately reflect corporate payments and transactions. [126] An issuer must also maintain systems of internal accounting controls able to provide reasonable assurances that (i) transactions are executed in accordance with management's authorization; (ii) transactions are recorded as necessary both to permit the preparation of financial statements in conformity with generally accepted accounting principles and to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management's authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences. [127]

U.S. authorities frequently use the accounting provisions of the FCPA to impose liability on non-U.S. issuers, even where there might not be jurisdiction

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to apply the anti-bribery provisions. [128] A bribe payment by an issuer or its consolidated subsidiary, if falsely recorded, creates liability for the issuer, and no other tie with the United States is needed to establish accounting provision jurisdiction. [129] And bribe payments are almost invariably falsely recorded in the payor's accounting records as "sales expense," "commission," "agent fees," or similar terms. [130]

[2] Internal Control Over Financial Reporting

[a] Overview

One of the central innovations in the Sarbanes-Oxley Act was internal control reporting under § 404. Section 404 directed the SEC to adopt rules requiring that each annual report under the Exchange Act contain an internal

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control report stating that management is responsible for establishing internal controls, containing management's evaluation of their effectiveness, and providing the auditor's attestation as to that assessment. The SEC developed the expression "internal control over financial reporting"—sometimes shortened to "ICFR"—to describe the subject of this reporting requirement. The development of internal control reporting under § 404 involved, in addition to extensive rulemaking by the SEC, the adoption by the PCAOB of a new standard governing the related auditor attestation. [131] These reporting requirements were controversial, with many issuers and other commentators contending that they imposed excessive burdens; with respect to foreign issuers in particular, they were characterized as a significant deterrent to accessing the U.S. public markets. They have, however, come to be an accepted feature of reporting by public companies.

The principal elements of the framework for internal control reporting, as it applies to a reporting foreign private issuer, are listed below. A new reporting

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company is not subject to these requirements until it has filed at least one annual report. [132]

- The issuer must maintain internal control over financial reporting. [133]
- Management must evaluate the effectiveness of ICFR as of the end of each fiscal year. [134] This evaluation must be made with the participation of the principal executive officer and the principal financial officer, or persons performing similar functions. It must be based on "a suitable, recognized control framework," as defined in the applicable SEC rule. [135]
- Management must also evaluate any change in ICFR that occurred during the fiscal year and that has materially affected, or is reasonably likely to materially affect, the issuer's ICFR. [136] This evaluation must be made with the participation of the chief executive officer and the chief financial officer. Any change that is identified must be disclosed in the annual report on Form 20-F. [137]
- The officer certifications that accompany the annual report on Form 20-F must include specified information about ICFR, as discussed in § 5.04[4] below.
- The annual report on Form 20-F must include a management report on the issuer's ICFR. [138] The report must include a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting, and it must identify the framework management used to

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  evaluate effectiveness. It must also state whether or not ICFR was effective as of the end of the fiscal year, as discussed in § 5.04[2][c] below.
- The annual report on Form 20-F must also include an auditor's report on management's assessment of effectiveness. Smaller issuers—issuers that are not "accelerated filers" or "large accelerated filers" [139]—are exempt from this requirement. [140]

The SEC staff has published answers to frequently asked questions on ICFR reporting that address a number of recurring issues in the application of the rules. Among other things, the staff addresses how ICFR reporting applies to an equity method investment or a proportionally consolidated investment. [141] The SEC staff also acknowledges that, where an issuer has recently acquired a business, it may be unable to conduct an assessment of ICFR at the newly acquired business in time to include it in management's report on ICFR. In such a case, the staff will not object to the issuer excluding the acquired business from the scope of the report, for not more than one year from the date of acquisition, provided it makes specified disclosures. [142]

[b] Definition

Internal control over financial reporting is defined as a process designed by, or under the supervision of, an issuer's principal executive and principal financial officers, or persons performing similar functions, and effected

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by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. [143] Internal control over financial reporting includes those policies and procedures that:

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- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of an issuer;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and receipts and expenditures of the issuer are made only in accordance with authorizations of management and directors; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

[c] Effectiveness

A foreign private issuer must disclose under Item 15 of Form 20-F whether its internal control over financial reporting was effective as of the end of the fiscal year. When the conclusion is affirmative, the language used for this disclosure is highly standardized. The SEC staff has objected in comment letters when an issuer provides a partial summary of the definition of ICFR or qualifies management's conclusion about effectiveness.

The determination whether ICFR is effective relies on two concepts that were developed by the PCAOB to govern the auditor's attestation relating to internal control: "significant deficiency" and "material weakness." [144] A material weakness is "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis." If management identifies a material weakness, it must disclose the material weakness and may not conclude that internal control over financial reporting is effective. [145] A conclusion that ICFR is

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not effective does not affect the issuer's eligibility to use short-form registration. [146]

A significant deficiency is "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting." There is no requirement to disclose a significant deficiency. However, certain process implications are the same as for a material weakness: management is required to certify that it has communicated any significant deficiency to the board of directors, and the auditor is also required to communicate with the audit committee concerning any significant deficiency.

[3] Disclosure Controls and Procedures

The regulatory requirements concerning disclosure controls and procedures are parallel in some ways to the requirements concerning internal control over financial reporting, but there are important differences. [147] Disclosure controls and procedures are not limited to financial reporting, so they are broader in scope than internal control over financial reporting; but with respect to financial reporting, ICFR has a much more developed regulatory framework and an auditor attestation requirement. Auditors do not report on disclosure controls and procedures, and perhaps for that reason compliance has proven to be less burdensome than for internal control over financial reporting.

Disclosure controls and procedures are defined as those controls and other procedures of an issuer that are designed to ensure that information, both financial and nonfinancial, required to be disclosed in reports filed or

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submitted by such issuer under the Exchange Act is recorded, processed, summarized and reported within the required time periods. These controls and procedures include, without limitation, measures designed to ensure that information required to be

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disclosed in Exchange Act reports is accumulated or communicated to an issuer's management, including its principal executive and financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. [148] In discussing how the DC&P requirements are broader than the ICFR requirements, the SEC has stated that disclosure controls and procedures should be designed, in particular, to capture the following types of information:

- information potentially subject to disclosure under Regulation S-X, Regulation S-K and Form 20-F;
- information relevant to an assessment of the need to disclose developments and risks that pertain to an issuer's businesses (including, in some cases, an assessment and evaluation of operational and regulatory risks); and
- information that must be evaluated for disclosure pursuant to Rule 12b-20 under the Exchange Act, which requires that Exchange Act reports include any material information necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. [149]

The requirements for DC&P reporting, as they apply to a reporting foreign private issuer, are as follows:

- The issuer must maintain disclosure controls and procedures. [150]
- Management must evaluate the effectiveness of the issuer's disclosure controls and procedures as of the end of each fiscal year. [151] The evaluation must be conducted with the participation of the principal executive officer and the principal financial officer, or persons performing similar functions.
- The officer certifications that accompany the annual report on Form 20-F must include specified information about DC&P, as discussed in § 5.04[4] below.
- The annual report on Form 20-F must disclose the conclusions of the principal executive officer and the principal financial officer concerning the effectiveness of the issuer's DC&P as of the end of the fiscal year. [152]

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SEC rules do not provide procedures for the conduct of the evaluation of DC&P, but the SEC has stated that it expects each issuer to develop a process that is consistent with its business and internal management and supervisory practices. [153] In practice, the procedures are generally designed to provide a basis for the certifications the CEO and CFO must provide, as discussed in § 5.04[4] below. The SEC has also recommended, but not required, that an issuer establish a disclosure committee, which would be responsible for considering the materiality of information and determining disclosure obligations on a timely basis. According to the SEC, a disclosure committee might be expected to include the issuer's (i) principal accounting officer or controller, (ii) general counsel or other senior legal officer with responsibility for disclosure matters who reports to the general counsel, (iii) principal risk management officer, (iv) chief investor relations officer (or an officer with equivalent responsibilities) and (v) other officers or employees, including individuals associated with the issuer's business units, to the extent deemed appropriate. [154]

[4] Officer Certifications

[a] Section 302 Certifications

SEC rules adopted pursuant to § 302 of the Sarbanes-Oxley Act require that an issuer's annual and quarterly reports under the Exchange Act must include personal certifications of the issuer's principal executive officer and

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principal financial officer, or persons performing similar functions. [155] The certification must be filed as an exhibit to the report. For a foreign private issuer, this requirement applies to the annual report on Form 20-F but not to reports on Form 6-K. [156] § 302 certifications are considered filed as part of the report, and are subject to the civil antifraud provisions under § 18 of the Exchange Act and automatically incorporated in the issuer's Securities Act registration statements.

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The language of the certification is specifically set forth in Form 20-F. [157] It requires each certifying officer to state that he or she has reviewed the report, and that based on his or her knowledge, the report contains no material misstatements or omissions.

The certification then requires each officer to state that based on his or her knowledge, the financial statements and other financial information included in the relevant report fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report. The information captured by this "fair presentation" standard is not just the financial statements and related notes. It also includes selected financial data, MD&A and other financial information included in the report. The SEC has stated that this standard addresses the financial information in a report viewed in its entirety and is broader than a requirement to present financial information in conformity with generally accepted accounting principles. It encompasses the selection of appropriate accounting policies, proper application of those policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events, and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows. [158]

The certification then requires each certifying officers to acknowledge responsibility for establishing, maintaining and "properly" designing disclosure controls and procedures and internal control over financial reporting for the issuer. Each officer must state that he or she has (i) evaluated the effectiveness of DC&P and presented conclusions about such effectiveness; and (ii) disclosed in the report any change in ICFR, occurring during the period covered by the report, that has materially affected or is reasonably likely to materially affect ICFR. Each officer must also state that he or she has disclosed, based on the most recent evaluation of ICFR, to the issuer's auditors and audit committee (i) all significant deficiencies and material weaknesses in the design or operation of ICFR that are reasonably likely to adversely affect the issuer's ability to record, process, summarize and report financial information and (ii) any fraud (regardless of materiality) involving management or other employees having a significant role in such internal control.

The terminology used in the certification reflects the requirements of SEC rules relating to internal control over financial reporting and disclosure controls

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and procedures. [159] The wording of the certification must be in the form specified and may not be changed in any respect, even if the change would appear to be inconsequential in nature. [160] It must be signed directly by the specified officers and may not be signed pursuant to a power of attorney. [161]

In addition to being subject to liability under the Exchange Act generally in connection with the filing of a report, an officer providing a false certification could be subject, in his or her personal capacity, to SEC actions for violating § 13(a) or § 15(d) of the Exchange Act and to private actions for violating §§ 18 and 10(b) of the Exchange Act and Rule 10b-5 thereunder. [162]

[b] Section 906 Certifications

A separate set of officer certifications is required pursuant to § 906 of the Sarbanes-Oxley Act. [163] Section 906 requires that each periodic report containing financial statements filed by an issuer with the SEC must be "accompanied by" a written statement of the issuer's chief executive officer and chief financial

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officer (or equivalent thereof). The statement must certify that the report fully complies with the requirements of § 13(a) or § 15(d) of the Exchange Act and that the information it contains fairly presents, in all material respects, the financial condition and results of operations of the issuer. Unlike the certification required by § 302 and Rules 13a-14 and 15d-14, the certification required by § 906 does not contain a qualification relating to the "knowledge" of the certifying officer. Nevertheless, it is common practice to include such a qualification, particularly in light of the qualification contained within § 302 itself and because knowledge is a requirement for the criminal penalties under § 906.

Like § 302 certifications, § 906 certifications must be filed as exhibits to an annual report on Form 20-F, [164] but are not required to be filed with a report on Form 6-K. However, § 906 certifications are furnished to, rather than filed with, the SEC. [165] Accordingly, § 906 certifications do not give rise to liability under § 18 of the Exchange Act, and they are not automatically incorporated by reference into an issuer's Securities Act registration statements. [166]

Section 906 imposes criminal liability for inaccurate certifications knowingly or willfully furnished by a certifying party. [167] The penalties consist of up to (i) 20 years' imprisonment and a fine of U.S. $5,000,000 for anyone who willfully certifies such statements or (ii) ten years' imprisonment and a fine of U.S. $1,000,000 for anyone who otherwise certifies such statements, in either case, knowing that the report does not comport with all the relevant requirements.

Footnotes

123 § 13(b)(2) of the Exchange Act. In contrast, the FCPA's anti-bribery provisions apply both to issuers and to "domestic concerns," which is defined as all U.S. citizens, nationals and residents, and all companies that have their principal place of business in the United States or are organized under U.S. law. 15 U.S.C. § 78dd-2(h)(1). The anti-bribery provisions apply to a domestic concern regardless of whether the activity related to the bribe has any other connection to the United States. 15 U.S.C. § 78dd-2(i)(1). For an issuer that is not a "domestic concern," the anti-bribery provisions only apply if the bribe occurs in connection with U.S. interstate commerce. 15 U.S.C. § 78dd-1(a). In addition, the FCPA's anti-bribery provisions apply to a non-U.S. person or company if it, or any person acting on its behalf, performs any part of the acts of bribery while in the territory of the United States. 15 U.S.C. § 78dd-3(a). For corporate entities, in summary, the FCPA's anti-bribery provisions apply to any company that (i) is organized under U.S. law or has its principal place of business in the United States, (ii) is an issuer and uses U.S. interstate commerce in furtherance of a bribe, or (iii) acts within U.S. territory in aid of a bribe. *See* § 11.08[1][a] for a more detailed discussion of the FCPA.

124 *See* Criminal Division of the U.S. Department of Justice and the Enforcement Division of the U.S. Securities and Exchange Commission, A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT (2102) ("The FCPA Guide") ("Although the FCPA's accounting requirements are directed at "issuers," an issuer's books and records include those of its consolidated subsidiaries and affiliates.").

125 15 U.S.C. § 78m(b)(6).

126 § 13(b)(2)(A) of the Exchange Act.

127 § 13(b)(2)(B) of the Exchange Act.

128 *See supra* Note 123.

129 *See*, *e.g.*, Order, *In re GlaxoSmithKline plc*, SEC Release No. 79005 (Sept. 30, 2016) (bribes by GSK's China-based subsidiary and a China-based joint-venture result in accounting provision violations by GSK itself; no anti-bribery provision liability is imposed).

130 *See*, *e.g.*, Order, *In re LAN Airlines, S.A.*, SEC Release No. 78402 (July 25, 2016) (payment to consultant for a "study" when company knew that no actual study would be performed); FCPA GUIDE at 39 ("Bribes are often concealed under the guise of legitimate payments, such as commissions or consulting fees.").

131 PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated

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with An Audit of Financial Statements, was adopted in PCAOB Release No. 2007-005 (May 24, 2007). The PCAOB's initial standard for internal control reporting, adopted in 2004, was Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, adopted in PCAOB Release No. 2004-001 (Mar. 9, 2004). Auditing Standard No. 5 revised the standards in response to extensive criticism of the burdens imposed on issuers and auditors by internal control reporting.

132 The initial holiday for a new reporting company is reflected in Rules 13a-15 and 15d-15 and in Instruction 1 to Item 15 of Form 20-F.

133 Rule 13a-15(a) and Rule 15d-15(a) under the Exchange Act.

134 Rule 13a-15(c) and Rule 15d-15(c) under the Exchange Act. The SEC provided extensive guidance on how to evaluate effectiveness in Release No. 34-55929 (June 20, 2007).

135 Issuers generally use the framework developed by an organization called the Committee of Sponsoring Organizations of the Treadway Commission or "COSO." The current version of the COSO framework is Committee of Sponsoring Organizations of the Treadway Commission, Internal Control–Integrated Framework (2013). *See* SEC Release Nos. 34-47986 (June 5, 2003) and 34-55929 (June 20, 2007) (each specifically identifying the 1992 COSO framework as meeting the criteria in Rules 13a-15(c) and 15d-15(c) under the Exchange Act, but stating that other control evaluation frameworks could also be acceptable).

136 Rule 13a-15(d) and Rule 15d-15(d) under the Exchange Act. This requirement applies to changes in any fiscal year for a foreign private issuer and in any fiscal quarter for a domestic issuer. The separate requirement to evaluate changes was adopted not to implement § 404, but to track language in the officer certification requirement in § 302 of the Sarbanes-Oxley Act. For a domestic issuer, this is a significant additional requirement because it is quarterly as well as annual.

137 Item 15(d) of Form 20-F.

138 Item 15(b) of Form 20-F.

139 *See* § 3.01 at Note 22 for a discussion of the definition "large accelerated filers."

140 Item 15(c) of Form 20-F. When the auditor's report on internal control is included in a Securities Act registration statement, the auditor's consent is required under Rule 436 under the Exchange Act. Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports-Frequently Asked Questions (rev. Sept. 24, 2007) ("2007 FAQs"), Question 9.

141 2007 FAQs, Questions 2 and 15.

142 2007 FAQs, Question 3.

143 Rules 13a-15(f) and 15d-15(f) under the Exchange Act. The expression "internal control over financial reporting," is arguably narrower than the term "internal controls" used in § 404 itself, because it relates only to financial reporting. *Cf.*, *e.g.*, Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (Public Company Accounting Oversight Board, 2010) (including controls over the completeness and accuracy of operating and other nonfinancial information used as audit evidence). The SEC's definition of internal control over financial reporting distinguishes the subject of § 404 reporting from the separate requirements concerning "disclosure controls and procedures"—sometimes referred to as "DC&P"—that the SEC had developed independently of the Sarbanes-Oxley Act. *See infra* § 5.04[3].

144 The terms are defined in Item 1.02(a)(4) of Regulation S-X and Rule 12b-2 under the Exchange Act. The terminology was developed based on prior auditing standards in Auditing Standard No. 2, adopted by the PCAOB in 2004, and then incorporated in Auditing Standard No. 5, which replaced Auditing Standard No. 2 in 2007. It was then added to SEC rules in 2007. SEC Release No. 33-8809 (June 20, 2007) and SEC Release No. 33-8810 (June 20, 2007) (adopting definition of material weakness); SEC Release No. 34-56203 (Aug. 3, 2007) (adopting definition of significant deficiency). The analogous requirements applicable to a domestic issuer are in Item 9A of Form 10-K and Item 307 of Regulation S-K.

145 Item 15(b)(3) of Form 20-F. *See* SEC, Staff Statement on Management's Report on Internal Control Over

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Financial Reporting (May 16, 2005), Part E (guidance on disclosures required when reporting a material weakness). The definition of material weakness refers to the preparation of interim financial statements, but the SEC staff takes the view that this reference is not applicable to a foreign private issuer. 2007 FAQs, Question 13.

146 2007 FAQs Question 4.

147 Prior to enactment of the Sarbanes-Oxley Act, the SEC had proposed rules under which (a) the CEO and CFO of a reporting company would be required to certify certain matters in connection with the company's quarterly and annual reports under the Exchange Act and (b) a reporting company would be required to maintain disclosure controls and procedures. SEC Release No. 34-46079 (June 14, 2002). Section 302 of the Sarbanes-Oxley Act included a certification requirement that differed from the SEC's proposals. SEC Release No. 34-46300 (Aug. 2, 2002) (summarizing the differences between the SEC proposals and the statutory requirements). When the SEC implemented the § 302 certification requirement, it also adopted its prior proposal to require an issuer to maintain and report on DC&P. SEC Release No. 33-8124 (Aug. 28, 2002).

148 Rules 13a-15(e) and 15d-15(e) under the Exchange Act.

149 SEC Release No. 33-8124 (Aug. 28, 2002), 67 Fed. Reg. 57,276, at 57,281 (Sept. 9, 2002) (text accompanying nn.72–74).

150 Rules 13a-15(a) and 15d-15(a) under the Exchange Act.

151 Rules 13a-15(b) and 15d-15(b) under the Exchange Act.

152 Item 15(a) of Form 20-F.

153 SEC Release No. 33-8124 (Aug. 28, 2002).

154 SEC Release No. 33-8124 (Aug. 28, 2002).

155 Rules 13a-14 and 15d-14. These rules apply to any reporting company, including a company that files Exchange Act reports "voluntarily," for example with a suspended reporting obligation under § 15(d). SEC Division of Corporation Finance: Sarbanes-Oxley Act of 2002—Frequently Asked Questions (Nov. 8, 2002, revised Nov. 14, 2002), Question 9. The persons performing the specified functions at the time of filing must provide certification, whether or not they had those functions during the period covered by the report. *See* Questions 13–15.

156 Domestic issuers are required to provide certifications in annual reports on Form 10-K and quarterly reports on Form 10-Q.

157 Form 20-F, Instructions as to Exhibits, paragraph (12). The analogous requirements for domestic issuers are in Regulation S-K, Item 601(b)(31). *See* Form N-CSR, Item 11(a) for certifications applicable to registered management investment companies. *See* Rules 13a-14(d), 13a-14(e), 15d-14(d) and 15d-14(e) under the Exchange Act and Item 601(b)(31)(ii) of Regulation S-K for certification requirements applicable to asset-backed issuers, as defined in Regulation AB.

158 SEC Release No. 33-8124 (Aug. 28, 2002), 67 Fed. Reg. 57,276, 57,279 & n.56 (Sept. 9, 2002) (citing Rule 12b-20 under the Exchange Act).

159 *See supra* §§ 5.04[2] and 5.04[3].

160 *See* SEC Release No. 33-8238 (June 5, 2003).

161 Rules 13a-14(c) and 15d-14(c) under the Exchange Act. A number of considerations arise in connection with the application of Rules 13a-14 and 15d-14 to foreign private issuers. Some foreign private issuers must make nuanced determinations as to which persons serve as principal executive officer and principal financial officer and which body functions as the audit committee. In certain countries, such as Germany, different corporate bodies and officials have primary responsibility for disclosure and financial reporting and cannot, under home-country law, delegate such responsibility. In those instances, certifications by principal executive officers and principal financial officers could expose such officers to liability in the United States for misconduct by those different corporate bodies and officials.

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162 In various cases, the SEC has sought monetary penalties and injunctive relief against officers who allegedly signed false certifications. In two cases filed not long after the Sarbanes-Oxley Act came into force, the SEC alleged that the issuer filed reports purporting to contain unqualified audit opinions although, in fact, the auditors had not provided signed audit opinions. *SEC v. Cedric Kushner Promotions, Inc.*, SEC Litigation Release No. 19485 (Dec. 5, 2005); *SEC v. Rica Foods*, SEC Litigation Release No. 18293 (Aug. 18, 2003). In a number of more recent cases, the SEC has sought civil penalties for false certifications under Rules 13a-15 and 15d-15. *See*, *e.g.*, *SEC v. Gupta*, SEC Litigation Release No. 21451 (Mar. 15, 2010) (SEC action against executives who understated extent of company funds paid as executive perquisites in certified disclosure documents); *SEC v. Jenkins*, SEC Litigation Release No. 21149A (July 23, 2009) (SEC civil action against CEO who allegedly received bonuses and stock sale profits while company was committing accounting fraud); *SEC v. Sherman*, SEC Release No. 34-72723 (July 30, 2014) and *SEC v. Cummings*, SEC Release No. 34-72722 (July 30, 2014) (SEC action against executives for misrepresenting to external auditors and the investing public the state of its internal controls over financial reporting); and *SEC v. Ormand*, SEC Release No. 77346 (Mar. 10, 2016) and *SEC v. Krueger*, SEC Release No. 77344 (Mar. 10, 2016) (SEC action against executives who failed to evaluate applicable internal control over financial reporting standards and concluded the company had no material weaknesses).

163 Rules 13a-14(b) and 15a-14(b). § 906 of the Sarbanes-Oxley is codified as 18 U.S.C.1350.

164 Although, read literally, § 906 would apply to reports on Form 11-K required to be filed by certain employee benefit plans, the SEC and DOJ have concluded that § 906 certifications do not need to accompany reports on Form 11-K. *See* SEC Release No. 33-8400 (Mar. 16, 2004) 69 Fed. Reg. 15,594, 15,609 n.146 (Mar. 25, 2004).

165 Form 20-F, paragraph (13)(b) to instructions as to Exhibits.

166 Form 20-F, paragraph (13)(b) to instructions as to Exhibits; *see also* SEC Release No. 33-8238 (June 5, 2003).

167 One interesting aspect of § 906 is that the penalties apply to noncompliance with the terms of the certification, but the statute does not explicitly provide that a failure to file triggers the potential liability. *But see* Letter from Daniel J. Bryant, Assistant Attorney General, Department of Justice, to the Honorable Joseph R. Biden, Jr. (Dec. 26, 2002) (stating that willful failure to file a § 906 certification would trigger the criminal provisions of 15 U.S.C. § 78ff).

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U.S. Regulation of the International Securities and Derivatives Markets, § 5.05, OTHER CORPORATE GOVERNANCE REQUIREMENTS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 5.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Prohibition on Personal Loans to Executive Officers and Directors

Section 402(a) of the Sarbanes-Oxley Act [168] prohibits an issuer [169] and its subsidiaries from directly or indirectly extending, maintaining, renewing or

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arranging for an extension of credit in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of the issuer. [170] There is no materiality threshold or de minimis exception. [171]

Section 402(a) raises a number of interpretive issues with respect to practices that involve the provision by an issuer of a benefit that may have some but not all of the features of a loan. Among the practices it may prohibit are loans inherent in split-dollar life insurance arrangements, after-tax leveraged co-investment programs and certain cashless exercises of options. Practitioners have sought to clarify the scope of § 402's prohibitions by interpreting the statutory language, most notably with respect to the words "arranging" and "extension of credit in the form of a personal loan." [172]

The concept of "arranging" for purposes of § 402(a) is generally believed to require some level of issuer involvement in the making of a loan by a third party to the director or executive officer. Limited facilitation of a personal loan, such as providing information or confirming that the issuer will comply with its existing obligations to a director or executive officer, should not constitute "arranging," but more substantial levels of facilitation or participation by the issuer may be deemed to be "arranging." [173] Given the conflict of interest-oriented policy of § 402(a), the use of issuer assets, or facilitation by the issuer of any transaction that could influence directors or executive officers, is more likely to involve "arranging." There may also be circumstances in which an

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issuer arranges a transaction but should not be viewed as "arranging" a "personal loan," particularly if the nature of the loan feature is incidental to the transaction (for example, an issuer could permissibly develop a broad-based employee benefit program involving incidental loans that are available on the same terms to all participants). [174]

The wording of § 402(a) suggests that only certain "extensions of credit" are subject to its prohibition and that they must meet two separate requirements. First, the transaction must take the form of a loan, and not merely be an extension of credit. [175] A transaction that involves an element of extension of credit but that is primarily intended to confer an immediate or deferred compensation benefit on the individual for services rendered (analogous to salary or bonus), and does not require repayment of fixed amounts, would presumably not be deemed a loan. Second, the loan must be a "personal loan." Presumably, if the primary purpose of the loan from the perspective of the issuer is to advance its business (other than merely through benefiting executive officers and directors of the issuer), it would not be deemed a "personal loan." Where an extension of credit is made in the ordinary course of business primarily for business purposes, but involves limited ancillary personal credit, it would also presumably not be considered to be a "personal loan." For example, business travel advances and use of company credit cards and company cars may involve limited ancillary personal use but presumably would not be subject to the § 402(a) prohibition because the arrangements are primarily for the benefit of the issuer,

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not the employee, and are not personal loans within the ordinary meaning of that term. [176]

Section 402(a) provides limited exceptions for extensions of credit for home improvement, manufactured housing, consumer credit, open-end credit, charge cards and margin loans by a broker or dealer registered under the Exchange Act to an employee of that broker or dealer (other than to acquire stock of the broker or dealer). [177] Extensions of credit pursuant to any of these exceptions must be (i) provided in the ordinary course of a consumer credit business, (ii) of a type generally made available by the issuer to the public and (iii) made

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on market terms that are no more favorable than those offered by the issuer to the general public. [178] These exceptions may not, however, be available to most issuers because, among other reasons, most issuers that are not financial institutions cannot meet the ordinary course of consumer credit business requirement.

Section 402(a) also exempts loans made by Federal Deposit Insurance Corporation (the "FDIC") insured banks subject to certain existing U.S. insider lending restrictions. The SEC extended this exemption to qualifying foreign banks and their affiliates under certain circumstances. [179] A foreign bank qualifies for the exemption if the laws or regulations of the foreign bank's home country require the bank to insure its deposits or be subject to a deposit guarantee or protection scheme or the Federal Reserve Board has determined that the foreign bank or another bank in its home jurisdiction is subject to comprehensive consolidated supervision by its home-country supervisor. [180] The exemption requires that the loans must (i) be on arm's-length, market terms, (ii) be made pursuant to a benefit or compensation program that is widely available to employees and does not give preference to executive officers or directors over other employees or (iii) have received the express approval of the bank supervisor in the foreign bank's home jurisdiction.

[2] Disgorgement of Incentive Compensation Following Restatements

Three different provisions of the federal securities laws provide for a mechanism colloquially referred to as a "clawback"—a requirement that issuer personnel return compensation to the issuer after a restatement of the issuer's financial statements. First, § 304 of the Sarbanes-Oxley Act requires the chief executive officer and chief financial officer of an issuer to reimburse it for all bonuses and other incentive-based or equity-based compensation received, as well as all profits realized from sales of issuer securities, in the 12-month period following the first public issuance or filing of reported financial statements that are later restated due to material noncompliance with any financial reporting requirement as a result of misconduct. [181]

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The term "misconduct" is not defined in the Sarbanes-Oxley Act, but it is generally understood not to be limited to personal misconduct of the chief executive officer or chief financial officer, and the SEC has brought a number of proceedings against chief executive officers and chief financial officers under § 304 when such officers were not personally charged with the underlying misconduct. [182] The phrase "profits realized" is also not defined, so it is unclear how the cost basis of securities sold during the 12-month period is to be determined, whether by means of a matching concept similar to § 16(b) of the Exchange Act or otherwise. [183] Similarly, the reference to compensation "received" during the 12-month period leaves unanswered questions regarding whether, in the case of option compensation for example, it is the grant of the compensation, its vesting or its payment that will control.

The Sarbanes-Oxley Act also does not specify the means of enforcement for § 304, which provides that the chief executive officer and chief financial officer of a company required to prepare an accounting restatement as a result of misconduct "shall reimburse" the issuer. However, the Ninth Circuit has provided some guidance by holding that there is no private right of action under § 304. Only the SEC is entitled to bring actions under the provision. [184] In addition, a company is not permitted to release or indemnify its chief executive officer or chief financial officer for disgorgement liability arising under § 304. [185]

The second "clawback" requirement is under § 10D of the Exchange Act (introduced by § 954 of the Dodd-Frank

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Act), which directs the SEC to impose an analogous obligation in respect of all executive officers of all listed issuers. Rule 10D-1, implementing § 10D, has been proposed by the SEC but not adopted as of year-end 2016. [186] The proposed rule would require national security exchanges to adopt listing rules requiring all listed issuers to adopt, disclose and implement written policies to recover any incentive-based compensation from current and former executive officers that was received based on materially erroneous financial information. As proposed, Rule 10D-1 would apply to foreign private issuers.

The clawback under proposed Rule 10D-1 would be triggered by an accounting restatement and apply to incentive-based compensation received by

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an executive officer [187] during the three fiscal years preceding the date the accounting restatement is triggered. The clawback amount would be the pre-tax amount received by the current or former executive officer to the extent it exceeds what the executive would have received if compensation were determined based on the restated financial statements. Indemnification of executive officers by the issuer is prohibited with respect to clawback liabilities. [188] Under the proposed rule, issuers would have limited discretion to choose not to pursue a clawback claim, [189] although foreign private issuers would be permitted to forgo recovery as impracticable if the recovery would violate the home country's laws. [190] Further, the proposed rule would require disclosure of specified information regarding completed, ongoing and forgone recoveries, with executive officer names and specified amounts.

There are a number of important differences between these proposed listing rule and the obligation in § 304 of the Sarbanes-Oxley Act. First, the proposed rule would require the issuer to seek reimbursement, rather than requiring the issuer's officers to make reimbursement. Issuers, rather than just the SEC, would have the right (and obligation) to pursue their officers. Second, reimbursement would be sought from all current and former executive officers, rather than just the current chief executive officer and chief financial officer. Third, there would be no requirement of misconduct on the part of either the issuer or the individual in connection with the restatement. Fourth, the measure for recovery would be the amount of incentive-based compensation in excess of that which would have been paid to the executive officer based on the restated financial statements, rather than the entire amount of such compensation, plus proceeds of stock sales. Finally, the recovery period would be three years before the date the issuer becomes required to prepare restated accounts, rather than one year following the first public issuance or filing of the financial statements that were later restated.

The third clawback provision is § 956 of the Dodd-Frank Act, which charges appropriate federal regulators with jointly issuing rules regulating incentive-based compensation at certain covered financial institutions. [191] The rules must prohibit incentive-based compensation arrangements that encourage inappropriate risks by providing excessive compensation or that could lead to a material financial loss and must require financial institutions to disclose

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incentive-based compensation arrangements to the appropriate federal regulator. [192] The National Credit Union Administration, the Office of the Comptroller of the Currency, the FDIC, the Federal Housing Finance Agency, the Board of Governors of the Federal Reserve System and the SEC have each released versions of the proposed rule. The proposals apply to banks and a broad range of financial institutions with average total consolidated assets over $1 billion, with a tiered applicability for institutions with average total consolidated assets of between $50 billion and $250 billion (Level 2) and those with assets above $250 billion (Level 1). [193]

Among other things, the proposed rules would require incentive-based compensation payable to senior executive officers or "significant risk-takers" at a Level 1 or Level 2 institution to be subject to a seven-year clawback of between 40-60% of incentive compensation, depending on the employee title and the level of the institution, with a substantial portion of incentive-based compensation payable to be deferred. [194] Potential amounts of incentive-based compensation are limited to specific target measures. The rules would also require governance oversight, with boards of directors, or a committee delegated therefrom, to approve all incentive-

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based compensation payable to senior executive officers and charge the board with maintaining records documenting guidelines to approving and implementing incentive-based compensation-related decisions. [195]

[3] Lawyers' Professional Responsibility Rules

The Sarbanes-Oxley Act required the SEC to promulgate rules setting forth minimum standards of professional conduct for lawyers appearing and practicing before the SEC in the representation of an issuer. [196] Among other things, rules adopted by the SEC to implement § 307 of the Sarbanes-Oxley Act adopt so-called "up-the-ladder" reporting requirements and clarify, through the means

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of a safe harbor, the extent to which the conduct of foreign attorneys is regulated. [197]

The principal features of the SEC's up-the-ladder reporting procedures are:

- An attorney appearing and practicing before the SEC [198] in the representation of an issuer [199] owes his or her professional and ethical duties to the issuer as an organization, and not to the issuer's officers, directors or employees.
- Whenever an attorney appearing and practicing before the SEC in the representation of an issuer becomes aware of evidence of a material violation [200] of securities laws or breach of fiduciary duty, or a similar violation, by the issuer or by any officer, director, employee or agent of the issuer, the attorney must report the evidence to the issuer's chief legal officer ("CLO") or to both the CLO and the chief executive officer.
- Upon receiving such a report, the CLO must cause such inquiry into the reported matter as he or she reasonably believes is appropriate to determine if a material violation has occurred, is ongoing or is about to occur, and (i) if the CLO reasonably finds no material violation, or concludes after being advised by outside counsel (and consulting the audit committee) that the issuer has a colorable defense to the reported violation, then he or she must notify the reporting attorney of that conclusion and its basis or (ii) if, instead, the CLO concludes that a material violation has occurred, is ongoing, or is

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  about to occur, he or she must take reasonable steps to ensure the issuer adopts remedial measures, including sanctions if appropriate.
- A reporting attorney who receives what he or she reasonably believes to be an appropriate and timely response from the CLO has no further obligation. If the reporting attorney does not receive an appropriate and timely response from the CLO, or if the attorney believes that it would be futile to report to the CLO or chief executive officer because either or both may be implicated in the misconduct, the attorney must report the evidence to either the audit committee of the issuer's board of directors or to another board committee consisting solely of independent directors. If the issuer has neither an audit committee nor such an independent committee, the attorney must, in the absence of an appropriate response from the issuer's CLO, report the evidence to the full board of directors. The CLO must inform the reporting attorney of any course of action taken in response to the attorney's report.
- A reporting attorney who receives what he or she reasonably believes to be an appropriate response from the audit committee, independent committee of the board of directors or the board itself has no further reporting obligation. If the reporting attorney does not reasonably believe the issuer has made an appropriate response within a reasonable time, the attorney must inform the CLO, the chief executive officer and directors to whom the attorney originally reported that belief and the reasons behind it. [201]
- An attorney may avail himself or herself of an alternative reporting procedure under which an attorney may report evidence of a material violation to a qualified legal compliance committee ("QLCC") established by the issuer, rather than to the issuer's CLO (the CLO may also refer reports to the QLCC),

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if the issuer has elected to establish a QLCC, thereby satisfying his or her obligations (with no requirement to assess the appropriateness of the issuer's response to the reported evidence).

- (i) An attorney retained to investigate reported evidence of a material violation must inform the CLO of the results of the investigation, (ii) unless the investigating attorney and the CLO each reasonably believes that no material violation has occurred, is ongoing or is about to occur, the CLO must notify the issuer's board of directors, an independent board committee, or the QLCC

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of the results of the investigation, (iii) if the CLO does not do so, the investigating attorney must report up-the-ladder and (iv) the investigating attorney has no duty to make such a report if such attorney was retained or is directed by the CLO to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer in any investigation or proceeding arising from the alleged misconduct, in which case the CLO must nevertheless keep the board informed as to the progress and outcome of the investigation or proceeding. [202]

In response to widespread concerns raised by non-U.S. attorneys over the reach of § 307, the SEC created a safe harbor from the reporting requirements for a "non-appearing foreign attorney." To qualify as a "non-appearing foreign attorney," an attorney:

- must be admitted to practice in a foreign jurisdiction;
- cannot hold himself or herself out as practicing, or give legal advice regarding, U.S. federal or state securities or other laws; [203] and
- must conduct activities that would constitute appearing and practicing before the SEC only (i) incidentally to, and in the ordinary course of, his or her foreign law practice or (ii) in consultation with U.S. counsel.

Attorneys who satisfy the above conditions are exempt from the reporting requirements set forth in the rules. [204] Although the rules do not exempt all foreign attorneys, the scope of the work customarily performed by most foreign attorneys should allow them to qualify for the exemption. In addition, attorneys practicing outside the United States are not required to comply with the requirements set forth in the rules to the extent that such compliance is prohibited by applicable foreign law. [205]

[4] Conflicts Between Whistleblower Procedures and Foreign Law

The requirement that the audit committee maintain whistleblower procedures—a channel for confidential, anonymous submissions by employees

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of concerns regarding questionable accounting or auditing matters [206]—may raise concerns under privacy, personal data and labor laws in other jurisdictions, particularly the European Union ("EU"). Similar concerns could arise with respect to the protections and financial incentives for whistleblowers introduced pursuant to the Sarbanes-Oxley Act and the Dodd-Frank Act. [207]

In particular, whistleblower procedures implemented by EU affiliates of U.S.-listed companies must comply with the requirements set out by the national personal data protection laws of the EU member states transposing Directive 95/46 [208] (the "Data Protection Directive"). An advisory body established under the Data Protection Directive, called the Article 29 Data Protection Working Party, adopted an opinion (the "Article 29 Opinion") providing guidance on the application of the EU's data protection laws to whistleblowing programs in the areas of accounting, internal controls, auditing matters, antibribery, banking and financial crimes. The Article 29 Opinion emphasizes, among other matters, the provision of clear and complete information about the whistleblowing programs, the rights of incriminated persons and security of data processing operations.

Although the Article 29 Opinion is not binding on the courts or data protection authorities of the EU member

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states, it has played an important role in the interpretation and application of national personal data protection laws by the data protection authorities and jurisdictions in the various EU member states. As an illustration, the Article 29 Opinion is substantially similar to the "unified authorization" adopted by the French *Commission Nationale de l'Informatique et des Libertés*, the authority responsible for administering the French personal data protection law ("CNIL"), [209] under which the CNIL will deem authorized certain whistleblower procedures required to be implemented pursuant to the Sarbanes-Oxley Act establishing internal control procedures in the areas of finance, accounting, banking and anti-corruption matters, provided that they meet certain criteria for the protection of personal data.

The SEC staff raised several concerns as the Article 29 Opinion relates to whistleblower requirements under the Sarbanes-Oxley Act, which include (i) local handling of reports, (ii) discouragement of anonymous reporting,

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(iii) possible limitation in the scope of employees covered and (iv) time limits for data retention. [210]

[5] Code of Ethics

Item 16B of Form 20-F requires a registrant to disclose in an annual report on Form 20-F whether it has adopted a code of ethics that applies to the principal executive officer, principal financial officer, principal accounting officer or controller or persons performing similar functions. If it has not adopted such a code of ethics, it must explain why it has not. [211] If a registrant has a broad code of ethics that applies widely, the requirements of Item 16B apply only to the portions of the document that apply to the senior officers described. [212]

If the registrant has a code of ethics, it must either file the code as an exhibit to the annual report on Form 20-F, post the text of the code on its website [213] and disclose in the annual report on Form 20-F that it has been so posted, or undertake in the annual report on Form 20-F that it will provide the code to any person who requests a copy and explain how to obtain it.

The term code of ethics is defined as written standards reasonably designed to deter wrongdoing and promote:

- Honest and ethical conduct, including ethical handling of actual or apparent conflicts of interests between personal and professional relationships.
- Full, fair, accurate, timely and understandable disclosure in SEC-filed or submitted reports and documents, as well as other public communications.
- Compliance with applicable governmental laws, rules and regulations.
- Prompt internal reporting of code violations to the persons identified in the code or other appropriate persons.
- Accountability for adherence to the code.

A registrant is required to disclose in its annual report on Form 20-F if during the fiscal year it has granted a waiver, explicit or implicit, from the code of ethics to one of the specified persons to whom it applies. The registrant must

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disclose the name of the waiver grantee and the nature of the waiver. [214] It must also disclose any amendment in the annual report. [215] There is an exception for a registrant that discloses the waiver or amendment on its website within five business days following the event, if the website address where the information can be found appears in its most recent annual report on Form 20-F and the information remains on its website for at least 12 months. The registrant must also retain the information for at least five years. [216]

[6] Shareholder Approval of Stock Issuances

The NYSE and Nasdaq each has a policy requiring a listed company to obtain shareholder approval for any

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issue of common stock (with exceptions including public offerings or certain private offerings for cash) equal to 20% or more of its voting power outstanding prior to such issue. [217] The NYSE has historically not applied this policy to foreign private issuers. Nasdaq permits companies to follow home country practice so long as companies meet certain disclosure and opinion requirements. [218]

[7] Trading Windows

Many listed issuers adopt policies restricting directors, officers and often other employees from trading in the issuer's securities during specified periods when there is a heightened risk that the company, or the individuals subject to the policy, have access to material non-public information about the company. These restricted periods are often referred to as "blackout periods," and they usually begin around the end of each fiscal quarter and end several days after results for the period are announced. The converse period, when trading is permitted, is often referred to as a an "open window" or "window period." These policies are not required by law, but trading by such persons on the basis of material non-public information may violate the law. The policies are a common prophylactic that serves to protect individuals from the risk of insider trading, to support disciplinary action if insider trading occurs, to protect the issuer's general counsel or others from having to make case-by-case judgments on the permissibility of

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trading, and to protect the issuer from controlling person liability in the event of insider trading. [219]

[8] Disclosure of Corporate Governance Differences

A U.S. exchange-listed foreign private issuer is required to provide, in its annual report on Form 20-F, a concise summary of significant ways in which its corporate governance practices differ from those followed by U.S. companies under the exchange's listing standards. [220] The instructions specify that this disclosure is intended to be a brief and general discussion, as opposed to a detailed item-by-item analysis. In practice, companies typically disclose this information in a table illustrating the differences.

Practices of reporting foreign private issuers in meeting this requirement vary. Some use a tabular presentation that tracks the requirements of the applicable listing rules and sets forth the issuer's corresponding practices, which are typically based on the legal or listing requirements of its home jurisdiction. Others present a more synthetic discussion of the U.S. requirements and refer to the issuer's own, more complete description of its corporate governance practices appearing elsewhere in its annual report. The principal areas of focus in these disclosures would typically include: [221] the requirement that the majority of the board consist of independent directors, except for the board of a "controlled company" as defined in the exchange rules (generally, where more than 50% of the voting power is held by an individual, group or other company); different independence standards for directors; the requirement that the board meet periodically in "executive session," i.e., without management representatives; the requirement for majority-independent nominating and governance committees, except at a controlled company; the requirement for a fully independent compensation committee, except at a controlled company; the requirement to hold a shareholder vote on equity compensation plans; and the requirements to disclose corporate governance guidelines and a code of business conducts and ethics.

[9] Exchange Certification and Affirmation Requirements

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As noted *supra* in § 5.01, both NYSE and Nasdaq exempt foreign private issuers from most of their corporate governance-related rules. [222] However, each of them requires certain certifications, affirmations or disclosures.

A NYSE-listed foreign private issuer is subject to two certification requirements under exchange rules. First, the chief executive officer must promptly notify the NYSE in writing if he or she becomes aware of any non-compliance with any applicable corporate governance rule of the NYSE. [223] Second, the issuer must submit an

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executed written affirmation annually and an interim written affirmation under specified circumstances. [224] The contents of each affirmation, and the circumstances under which an interim affirmation is required, are set forth in forms published on the NYSE website. The annual affirmation must describe the issuer's compliance with the audit committee requirements of Rule 10A-3 and its disclosure of significant differences between its corporate governance practices and those required of listed domestic issuers. The interim affirmation is required within five business days if:

- An audit committee member who was deemed independent is no longer independent;
- A new member is added to the audit committee;
- The company or a member of the audit committee is no longer eligible to rely on or choosing to no longer rely on a previously applicable exemption from Rule 10A-3 on audit committees;
- A member has been removed from the audit committee resulting in the issuer no longer having a Rule 10A-3 compliant audit committee; or
- The company determines it no longer qualifies as a foreign private issuer. [225]

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A Nasdaq-listed foreign private issuer is required to provide Nasdaq with prompt notification after an executive officer becomes aware of any noncompliance with the requirements of any corporate governance requirements under Nasdaq's listing rules. [226] A Nasdaq-listed foreign private issuer is also subject to the rule providing that voting rights cannot be disparately reduced or restricted through any corporate action or issuance. [227]

Footnotes

168 § 13(k)(1) of the Exchange Act. Investment companies registered under § 8 of the Investment Company Act are exempt from § 402(a).

169 "Issuer" is defined for this purpose to include any issuer that has filed a registration statement that it has not withdrawn, even if the registration statement has not yet become effective, so an issuer going public must address any outstanding loans earlier in the registration process than might otherwise be expected.

170 *See*, *e.g.*, *In the Matter of Goodfellow*, SEC Admin. Proc. File No. 3-12117 (Dec. 1, 2005). In *Goodfellow*, the SEC alleged that the chief executive officer and the chief financial officer of a foreign private issuer (later acquired by a U.S. issuer) authorized interest-free loans to themselves from the issuer and imposed a cease-and-desist order. In response to the officers' claim that the loans were mere "advances," the SEC noted that § 402(a) does not distinguish between loans and advances. *But see infra* Note 176 regarding indemnification advances.

171 This prohibition became effective immediately upon the passage of the Sarbanes-Oxley Act, but it grandfathered loans outstanding at that time, so long as no material modification to any term or renewal of those loans occurs. The prohibition on "maintaining" loans means that any extension of credit must be extinguished before a foreign company becomes a U.S. reporting issuer, for example by conducting a U.S. public offering.

172 While these words are the same as those used in §§ 7 and 11(d) of the Exchange Act, the policies behind §§ 7 and 11(d) are fundamentally different from the policy underlying § 402(a). Accordingly, many practitioners believe that § 402(a) does not necessarily require the same reading of the concepts of "extension of credit" and "arrange". *See* outline authored by a group of 25 leading law firms, including ours, *Sarbanes-Oxley Act Interpretive Issues Under § 402—Prohibition of Certain Insider Loans* (Oct. 15, 2002) (the "§ 402 Outline").

173 *See RingsEnd Partners, LLC/EBIC Program* (avail. Mar. 4, 2013). While the no-action letter addresses a specific compensatory program, it does provide examples of "ministerial or administrative activities" in which an issuer may engage without running afoul § 402(a).

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174 *See generally* § 402 Outline.

175 As a result, the fact that a transaction may, for example, be deemed for other purposes under the Exchange Act (including under the margin regulation provisions of § 7 and prohibitions on extensions of credit for new issues contained in § 11(d)) to involve an extension of credit is not sufficient to trigger the § 402(a) prohibition.

176 *See generally* § 402 Outline. In 2006, the Southern District of New York addressed directly the issue of indemnification advances, declaring that "[t]he Court need not for present purposes define "personal loan," but an advance of defense costs pursuant to state law and corporate by-laws is not within that term. The Sarbanes-Oxley Act does not prohibit such advances." *Envirokare Tech, Inc. v. Pappas*, 420 F. Supp. 2d 291, 294 (S.D.N.Y. 2006).

177 Read literally, however, the exception does not apply to margin loans to employees of the parent of the broker or dealer.

178 § 402(a) of the Sarbanes-Oxley Act.

179 Rule 13k-1 under the Exchange Act.

180 *See*, *e.g.*, the Federal Reserve Board Order *HSH Nordbank AG, Hamburg/Kiel, Germany*, 89 Fed. Res. Bull. 344.

181 The SEC has relied on the equitable relief provisions of § 305(b) of the Sarbanes-Oxley Act to extend this disgorgement power to include all compensation received after allegedly fraudulent conduct has occurred. For examples of cases in which the SEC has sought disgorgement of profits resulting from misconduct, *see*, *e.g.*, *SEC v. Gupta*, SEC Litigation Release No. 21451 (Mar. 15, 2010) and *SEC v. Mercury Interactive, LLC*, SEC Litigation Release No. 20964 (Mar. 20, 2009).

182 *See SEC v. Moore*, SEC Litigation Release No. 22241 (Jan. 30, 2012); *SEC v. O'Leary*, SEC Litigation Release No. 22074 (Aug. 30, 2011); *SEC v. Jenkins*, SEC Litigation Release No. 21149A (July 23, 2009). The Ninth Circuit has also held that § 304 "allows the SEC to seek disgorgement from CEOs and CFOs even if the triggering restatement did not result from misconduct on the part of those officers." *SEC v. Jensen*, 835 F.3d 1100, 1114-1115 (9th Cir. 2016).

183 Under the short swing profit rules of § 16(b), multiple purchases and sales may be matched to create profit even where no net economic gain is realized. *See* § 6.04[2][b].

184 *In re Digimarc Corp. Derivative Litigation*, 549 F.3d 1223 (9th Cir. 2008).

185 *See Cohen v. Viray*, 622 F.3d 188 (2d Cir. 2010). The rationale for this position was that such agreements frustrate the SEC's power to pursue the public's interests in § 304 enforcement actions.

186 SEC Release No. 33-9861 (July 1, 2015).

187 Section 10D of the Exchange Act does not define executive officers, but the proposed rule applies to officers subject to §16 of the Exchange Act.

188 SEC Proposed Rule 10D-1(b)(1)(iv) of the Exchange Act. The proposal would not preclude executives from purchasing insurance. SEC Release No. 33-9861 (July 1, 2015).

189 Non-pursuit of claims would be permissible only if it were impracticable because it would impose undue costs to the issuer or its shareholders. *See* SEC Release No. 33-9861 (July 1, 2015).

190 SEC Release No. 33-9861 (July 1, 2015).

191 § 956 of the Dodd-Frank Act.

192 § 956 of the Dodd-Frank Act.

193 76 Fed. Reg. 21170 (Apr. 14, 2011).

194 76 Fed. Reg. 21170 (Apr. 14, 2011). Awards that vest solely on the basis of continued employment are not considered incentive-based compensation.

195 76 Fed. Reg. 21170 (Apr. 14, 2011).

196 § 307 of the Sarbanes-Oxley Act; *cf.* Letter from Giovanni P. Prezioso, General Counsel, SEC, to J.

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Richard Manning, President, Washington State Bar Association, and David W. Savage, President-Elect, Washington State Bar Association (July 23, 2003) (citing federal case law, in response to a proposed ethics opinion of the Washington State Bar Association counseling lawyers against making disclosure permitted by the SEC's rules implementing § 307 of the Sarbanes-Oxley Act, for the proposition that rules adopted by the SEC, as a federal agency, would preempt any conflicting state rules governing attorney professional conduct).

197 17 C.F.R. § 205.1–205.7.

198 "Appearing and practicing" before the SEC consists of (i) transacting any business with the SEC, including communications in any form, (ii) representing an issuer in a SEC administrative proceeding or in connection with any SEC investigation, inquiry, information request or subpoena, (iii) providing advice in respect of the U.S. securities laws or SEC rules or regulations regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC (this includes providing such advice in the context of preparing, or participating in the preparation of, any such document), or (iv) advising an issuer as to whether information or a statement, opinion or other writing is required to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC. 17 C.F.R. § 205.2(a).

199 "Representation of an issuer" is defined as "providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer." 17 C.F.R. § 205.2(g). Counsel to underwriters would not be covered by the reporting requirements because such counsel do not provide legal services to the issuer. *See* SEC Release No. 33-8185 (Jan. 29, 2003).

200 "Evidence of a material violation" is credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing or is about to occur. 17 C.F.R. § 205.2(e). This standard, while objective, takes into account the fact that there may be a range of views an attorney could hold without being unreasonable.

201 In 2003, the SEC proposed for comment two alternative provisions that would have extended the obligations of a reporting attorney. These came to be referred to as "noisy withdrawal" (where an attorney is obligated under specified circumstances to resign and notify the SEC of having done so) and "reporting out" (where an attorney is obligated to resign and the issuer must notify the SEC). This proposal was never withdrawn or acted upon. *See* SEC Release No. 33-8186 (Jan. 29, 2003) (solicitation of public comments).

202 17 C.F.R. § 205.1–205.7

203 One example of conduct that might constitute holding oneself out as practicing U.S. federal or state securities laws might be distributing business cards highlighting one's admission to a U.S. state bar.

204 Although a CLO who qualifies as a non-appearing foreign attorney is exempt from the reporting requirements under § 307 of the Sarbanes-Oxley Act, he or she is required to conduct an investigation upon receiving a report of a violation from a reporting attorney.

205 17 C.F.R. § 205.6(d).

206 § 5.0[2][a].

207 § 11.07[1][c].

208 Directive 95/46/EC of the European Parliament and of the Council of October 24, 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data. As from May 25, 2018, this Directive will be replaced by Regulation (EU) 2016/679 of the European Parliament and of the Council of April 27, 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (the "General Data Protection Regulation").

209 CNIL unified authorization n° AU-004 adopted December 8, 2005, as amended on October 4, 2010.

210 *See* Letter from Ethiopis Tafara, SEC Director, Office of International Affairs, to Peter Schaar, Chairman of Article 29 Data Protection Working Party (June 8, 2006).

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211 Item 16B of Form 20-F.

212 Instruction 2 to Item 16B of Form 20-F.

213 The code of ethics must remain accessible on the website for as long as the registrant chooses to disclose its code of ethics via its website and is obligated to file an annual report on Form 20-F. Instructions to Item 16B of Form 20-F.

214 Item 16B(e) of Form 20-F.

215 Item 16B(d) of Form 20-F.

216 Instruction 4 to Item 16B of Form 40-F.

217 NYSE LISTED COMPANY MANUAL 312A.03(c); NASDAQ LISTING RULES 5635(d).

218 NASDAQ LISTING RULES 5615(a)(3), 5615(b).

219 Section 306(a) of the Sarbanes-Oxley Act and Regulation BTR (Blackout Trading Restrictions) also restrict trading in issuer securities by directors and executive officers during a pension plan blackout period. *See* § 6.06[3].

220 Item 16G of Form 20-F. Both NYSE and Nasdaq also require this disclosure. NYSE LISTED COMPANY MANUAL 303A.11; NASDAQ LISTING RULES 5615(a)(3)(B). In addition, Nasdaq requires a foreign private issuer conducting an IPO to disclose in its registration statement and on its website each requirement it does not follow and describe home country practice. NASDAQ LISTING RULES 5615(a)(3)(B)(ii).

221 This description uses NYSE listing requirements by way of illustration; Nasdaq listing requirements differ in their details but cover essentially the same matters. *See supra* Note 6.

222 NYSE LISTED COMPANY MANUAL 303A.00 (exemption from most NYSE governance rules for foreign private issuers following home country practice); NASDAQ LISTING RULES 5615(a)(3) (exemption from most Nasdaq governance rules for foreign private issuers following home country practice) and 5615-3 (requiring a foreign private issuer to provide an opinion of counsel concerning home country practice). Both exchanges have rules requiring notice to the exchange under specified circumstances, which may include circumstances relating to governance. *E.g.*, NYSE LISTED COMPANY MANUAL 204.10 (requiring notice to the exchange of any change in officers or directors).

223 NYSE LISTED COMPANY MANUAL 303A.12(b).

224 NYSE LISTED COMPANY MANUAL 303A.12(c).

225 NYSE, Instructions for Submission of Foreign Private Issuer § 303A Written Affirmations.

226 NASDAQ LISTING RULES 5625.

227 NASDAQ LISTING RULES 5640.

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