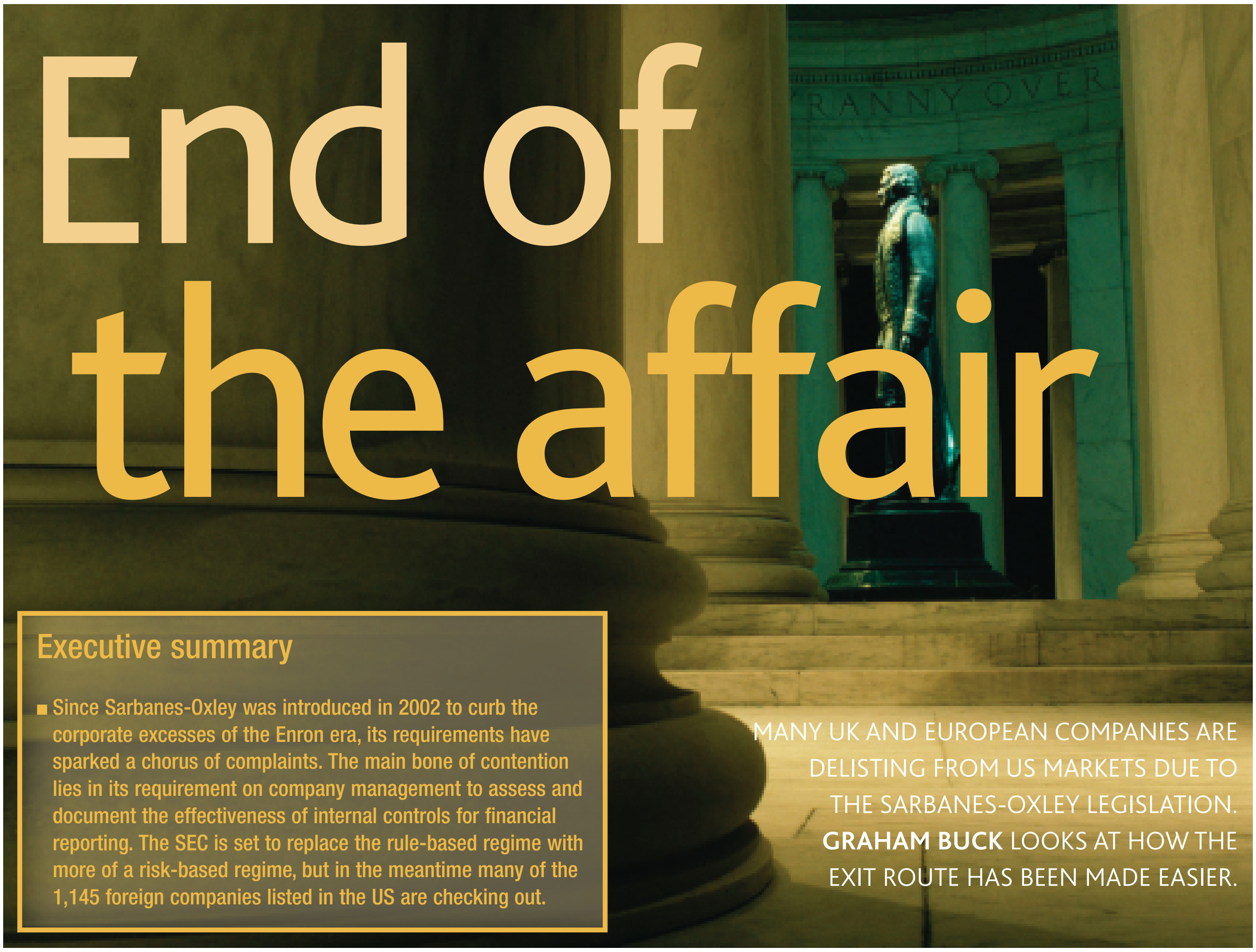


End of the affair

Executive summary

- Since Sarbanes-Oxley was introduced in 2002 to curb the corporate excesses of the Enron era, its requirements have sparked a chorus of complaints. The main bone of contention lies in its requirement on company management to assess and document the effectiveness of internal controls for financial reporting. The SEC is set to replace the rule-based regime with more of a risk-based regime, but in the meantime many of the 1,145 foreign companies listed in the US are checking out.

MANY UK AND EUROPEAN COMPANIES ARE DELISTING FROM US MARKETS DUE TO THE SARBANES-OXLEY LEGISLATION. **GRAHAM BUCK** LOOKS AT HOW THE EXIT ROUTE HAS BEEN MADE EASIER.

How times change. In the 1980s and 1990s, companies flocked to the US to raise capital. It was the world's deepest, most liquid market and businesses seeking to sell their goods and services to Americans were willing to commit to it through a US stock market listing. For many years, the New York Stock Exchange's 'The World Puts Its Stock In Us' slogan held true for what was the uncontested primary home for new listings.

The market's success was assisted by the Securities and Exchange Commission (SEC). The US financial market regulator actively encouraged foreign companies to list and helped them to access the capital markets.

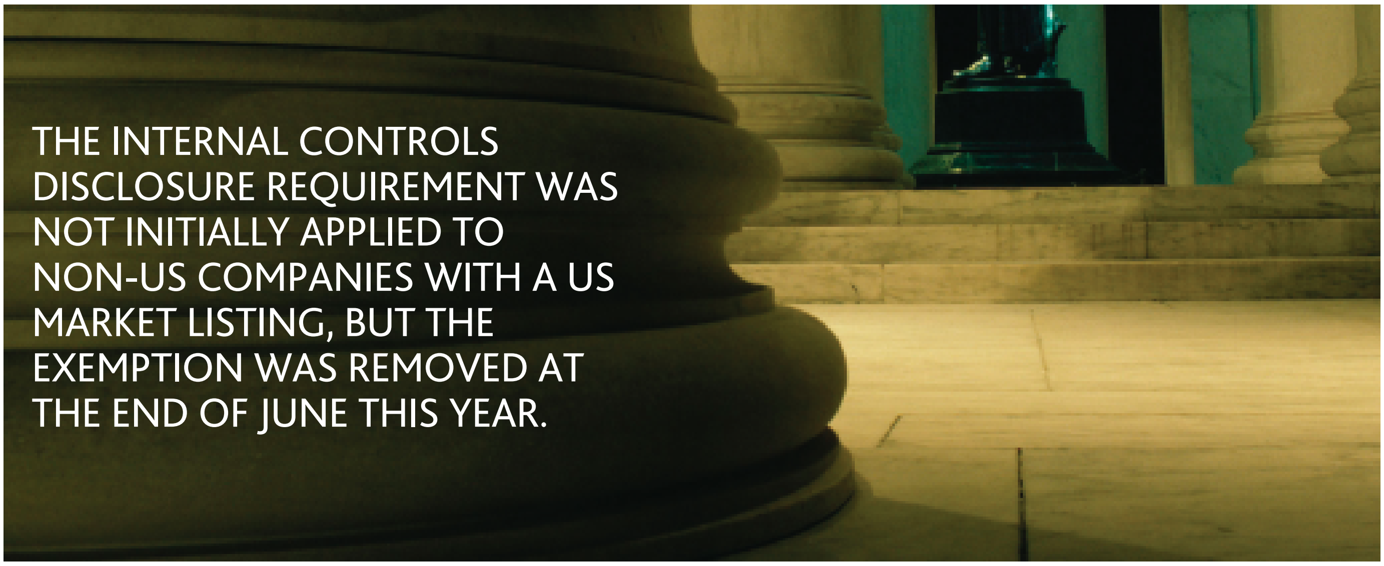
A few years on, the situation is very different. The reason can be summed up in a single phrase: the Sarbanes-Oxley Act (SOX). Since it was introduced in 2002 to curb the corporate excesses of the Enron era, SOX's financial and regulatory requirements have sparked a chorus of complaints. Although criticism is directed at the proliferation of rules and a 'box-ticking' mentality, the main bone of contention lies in section 404 of the Act, which requires company management to assess and document the effectiveness of internal controls for financial reporting. Independent auditors must then issue an attestation report to that assessment.

The principle behind s404 – that directors should certify personally that the company's accounts are accurate and that its internal controls system is adequate – seems fair enough on first appearance, but it is widely held that achieving this goal involves an overly complicated, expensive and time-consuming process of multiple checking. Even US Treasury Secretary Henry Paulson recently admitted that implementation of s404 "has proved more costly and burdensome than originally anticipated".

Another key requirement of SOX comes under section 302, which requires the signing officers for the company's financial reports – the CEO and CFO – to certify they are responsible for the company's internal controls, have evaluated those controls within the previous 90 days and have reported on their findings.

REMOVED EXEMPTION The internal controls disclosure requirement was not initially applied to non-US companies with a US market listing, but the exemption was removed at the end of June this year. Many UK and European companies, which believe the corporate governance standards and audit processes they observe in their home countries are already adequate, now face significant additional work and expense involved in complying with s404.

The legislation has persuaded many international companies to shelve their US listing plans. In recent years, other world markets have raised their profile while a more global marketplace means New York no longer dominates as the place to raise capital. And while a US listing strengthens the position of companies planning to make acquisitions in the US, SOX has probably persuaded many to focus



their merger and acquisition activities more on Europe.

More seriously for the US markets, a number of international companies that have listed on the New York Stock Exchange or Nasdaq for many years have questioned whether the benefits are now outweighed by the added burdens of complying with SOX.

Several FTSE 100 companies have already chosen to bale out over the past couple of years. ITV, telecoms group 02, Cable & Wireless, and drinks group Mitchells & Butlers all terminated their US market listings in 2005.

Last year they were joined by Royal & Sun Alliance, which had listed on the NYSE since 1999. Its reasons for quitting echo those of others that have departed: the insurer said it no longer depended on a US listing to raise capital, and the heavy annual cost of complying with SEC reporting (£10m in R&SA's case) and other requirements were no longer commensurate with the benefits. Other departures last year included France's Vivendi Universal and Australia's biggest retailer, Coles Myer.

A MAJOR OBSTACLE But for many non-US companies, escaping the strictures of SOX by delisting and deregistering with the SEC ran up against one major obstacle. A company could delist, but deregistering was permitted only if and when it had fewer than 300 US-resident shareholders. This low threshold, which few companies could satisfy, was dubbed the Hotel California effect – a nod to The Eagles' song about the establishment where guests could check out any time they liked but never leave.

Some companies responded by shrinking their US shareholder base. Cable & Wireless and R&SA launched share buyback offers to reduce the number of their US investors, The process required investigating how many ultimate shareholders were represented by each of the company's nominee holders. ITV and 02 launched compulsory cash buybacks of US shareholdings.

Then, late last year, the SEC indicated it was ready to relax the rules and make it easier for non-US companies to delist from a US exchange and deregister under the Securities Exchange Act. It followed up with an announcement in March that confirmed, as from 4 June, under Rule 12h-6 they could proceed with deregistration after first delisting, provided that the following three conditions were met:

- One-year dormancy (the company has not made a registered securities offering in the preceding 12 months);
- One-year alternative listing (the company has had its equity listed for the preceding 12 months on one or more non-US exchanges and non-US trading represents at least 55% of worldwide volume);
- One-year reporting history (the company has reported to the SEC for at least a year and filed at least one SEC report).

If these conditions are met, a company must then pass at least one of two tests. The first continues to be that its US-resident shareholders number fewer than 300 (although fewer inquiries are now necessary to verify the figure).

But a new option has been added: the company also now qualifies for deregistration if the average daily US trading of its equity over the previous 12-month period represents less than 5% of its average daily trading worldwide. This alternative has provided the means to proceed for UK blue chips seeking to delist and deregister. The procedure is relatively straightforward and the cost minimal.

In addition to delisting from the NYSE or Nasdaq, a company intending to deregister must file a new deregistration form (Form 15F) certifying that it meets the requirements for deregistration. It must also publish a notice, either at the time of filing Form 15F or earlier, advising US investors of its intention to deregister.

The filing of Form 15K effectively suspends a company's reporting obligations and there is a period of 90 days during which the SEC can object to the filing. If no objection is made, the suspension becomes permanent – unlike the previous regime, which often only suspended the obligations without a termination subsequently following.

ANNUAL SAVINGS According to the SEC, 1,145 foreign companies are listed in the US, around 29% of which are reported to qualify for deregistration. The UK has 63 companies with some form of US listing – a figure surpassed only by Canada and Israel.

Perhaps the biggest UK name to take up the opportunity of easier SEC deregistration is British Airways. The company announced in late April that it would delist its shares from the NYSE, where it has had a secondary listing since privatising in 1987, and deregister from the Securities Exchange Act.

BA says an NYSE listing means it has to report its results in accordance with US GAAP as well as with international financial reporting standards (IFRS), and anticipates annual savings of £10m from delisting and deregistering.

BA Company Secretary Alan Buchanan says the company has always tracked the number of its US shareholders and the figure is too large for there to be a realistic prospect of reducing it below 300. He says BA has always believed in strong internal controls, but acknowledges that they have been improved since the introduction of SOX.

Companies that will no longer have a full US exchange listing can still make their shares available for dealing in the US through the American Depositary Receipt programme for American Depositary Shares (ADS). An ADS represents tradable foreign shares of a company, held on deposit by a custodian bank in the company's home country The programme can be either registered or non-registered, although the latter is restricted to professional investors.

BA is taking this route. Market-makers can continue to buy and sell its US shares on the over-the-counter market. BA says its ADS programme represents only 3% of all its shares traded globally.

BA was quickly followed by pharmaceuticals group Skyepharma, which delisted from Nasdaq in May. Skyepharma's Chief Executive Frank Condella said the time and expense in maintaining a secondary listing in the US was no longer justified, as most of the group's trading volume and liquidity was on the LSE. He specifically cited s404 of SOX as costing the company £1m a year and offering limited benefits to shareholders, who were already well protected through compliance with the LSE's rules.

Like BA, Skyepharma is maintaining its ADS facility. The group's Finance Director Peter Grant says that theoretically they represent a greater investment risk in being exempted from SEC regulation, but investors still have the reassurance that the group is subject to UK reporting and corporate governance standards.

Grant says Skyepharma considered using for its ADS the OTCQX pricing bulletin board created in March by Pink Sheets, the main electronic listing and quotation system in the US for over-the-counter securities. The aim of OTCQX is to list the better-quality companies that wish to avoid the cost and regulatory burdens of SOX, distinguishing them from some of the more distressed companies that use the traditional over-the-counter market. By late May, OTCQX had signed up 11 companies, including Tate & Lyle, and had received a further 20 applications. It has ambitions for this figure to reach 100 by the end of the year.

The UK companies that have announced plans to deregister since March are not alone. Others heading for the exit in the US include France's Group Danone and its biggest reinsurer, Scor, and German chemicals giant Altana, Switzerland's Adecco staff recruitment firm, Italy's motorbikes group Ducati and Telekom Austria. Outside of Europe, Israel's Koor Industries, along with Australia's telecoms giant Telstra and packaging group Amcor are also departing.

REPLACING BUREAUCRACY As critics of SOX observed at the time, easier deregistration did not help non-US companies comply with the requirements of SOX. It simply eased the escape route of delisting and deregistration for those that wished to avoid them.

Nor does easier delisting do much to strengthen the position of US exchanges, which in recent years have lost out as potential new issuers opt for rivals such as London and Hong Kong. They can ill afford to lose existing members as well, although the SEC expresses the hope that the exodus will be offset as other new issuers are attracted to the US by a "more flexible regime".

But it's unlikely this will happen if SOX remains in its present form. So the SEC has liaised with the other main US regulator, the Public Company Accounting Oversight Board (PCAOB), in its response to critics of the legislation, issuing proposals for a less demanding s404. Although the detail is still being worked out, the overall guiding principle is to replace bureaucracy and box-ticking with a more commonsense approach; a rule-based regime would be replaced by more of a risk-based regime.

One of the main changes is that companies will no longer need two opinions from their auditors attesting to the effectiveness of their internal controls. Section 404 requires a company's checks to be signed off by an external auditor, but is vague on the scope of management and auditors' checks. This led to external audits that needlessly repeated the work of company management. The reforms aim to restore a balance between the two, with auditors relying on management's assessment of its internal controls for signing off purposes rather than then having to go through their own extra internal audit.

The SEC also offered cleared guidelines to management on the type of internal controls that would help prevent risks in financial reporting.

The more relaxed regime proposed would enable financial directors to concentrate on the areas of financial reporting that potentially carry a financial risk. Rather than implement standard controls across the board, regardless of the level of risk, they can apply broad principles across the company. They also no longer need to take external audit standards into consideration when determining how management evaluates the effectiveness of internal controls.

In May, the SEC followed up its proposals with a new set of guidelines for s404 that provide a definition of 'material weakness' and also eliminate the requirement for auditors to attest to management's process of evaluating internal controls. It claimed this would ease the burden of s404 and reduce the cost of compliance, particularly for smaller companies, by emphasising materiality.

SEC Chairman Christopher Cox added that the two changes would 'right-size' management's evaluation of its internal controls and "companies of all sizes will be able to scale and tailor their evaluation procedures according to the facts and circumstances. And investors will benefit from reduced compliance costs."

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