

## News Bulletin

October 15, 2008



# SEC Adopts Foreign Issuer Reporting Enhancements

## Introduction

On September 23, 2008, the Securities and Exchange Commission (“SEC”) issued its final rules relating to the reporting requirements of foreign private issuers (“FPIs”).<sup>1</sup> These new rules are based on proposals that the SEC issued earlier this year.<sup>2</sup>

The SEC refers to these changes to the reporting requirements as the “Foreign Issuer Reporting Enhancements.” The rule amendments:

- shorten an FPI’s deadline for filing an annual report on Form 20-F from six months to four months after the end of its fiscal year;
- reduce the frequency with which foreign issuers must test their eligibility to use the rules and forms that are applicable to FPIs to once per year;
- increase the circumstances and filings in which an FPI must provide a detailed U.S. GAAP reconciliation under Item 18 of Form 20-F;
- eliminate the ability of certain FPIs to omit segment data from their U.S. GAAP financial statements;
- add disclosure requirements relating to:
  - changes in, and disagreements with, their auditors;
  - the fees and charges paid by holders of American Depositary Receipts (“ADRs”), or by the depositary to the FPI; and
  - differences in the FPI’s corporate governance practices under applicable stock exchange listing rules as compared to U.S. companies; and
- make the “going private” provisions of Rule 13e-3 applicable to the SEC’s recently amended rules relating to deregistration of FPIs.

<sup>1</sup> A “foreign private issuer” is a corporation or other entity organized outside of the U.S. that either has (a) 50% or less of its outstanding voting securities held of record by U.S. residents or (b) if more than 50% of its voting securities are held by U.S. residents, none of the following are true: (1) a majority of its executive officers or directors are U.S. citizens or residents; (2) more than 50% of its assets are located in the U.S.; and (3) the issuer’s business is administered principally in the U.S. The SEC’s adopting release containing the final rules may be found at: <http://www.sec.gov/rules/final/2008/33-8959.pdf>.

<sup>2</sup> Morrison & Foerster’s February 2008 summary of the initial proposals may be found at: <http://www.mofo.com/news/updates/files/13546.html>.

As discussed in more detail below, these rule changes will have differing degrees of impact upon the compliance burdens faced by FPIs. In some respects they will reduce the compliance burdens of FPIs; in other respects, they will increase the compliance burdens.

### Filing Deadline for Form 20-F

As a result of the amendments, FPIs will be required to file their annual reports on Form 20-F within *four months* after the end of their fiscal year end.<sup>3</sup> This amendment reflects a two month reduction from the existing six month deadline. However, the final rules do not impose the three month deadline that the SEC had initially proposed for “accelerated filers” and “large accelerated filers.” The SEC had received a substantial number of comment letters objecting to the shorter period.

FPIs will be provided with a significant amount of time to prepare for this change. An FPI will become subject to this accelerated filing requirement beginning with its first fiscal year ending on or after December 15, 2011.

Some FPIs are likely to encounter special challenges with respect to this amendment. For example, some issuers need substantial time to reconcile their non-U.S. GAAP or non-IFRS financial statements to U.S. GAAP, or to translate their non-U.S. documents into the English language. In a limited number of cases, these rules may even require FPIs to file their annual reports earlier in the U.S. than they do in their home jurisdictions.

### Timing of Determination of FPI Status

**General.** Qualifying as an FPI enables a foreign issuer to use the SEC’s special forms and rules that apply to FPIs, such as Form 20-F for annual reports. Most issuers find compliance with these rules somewhat easier than the corresponding rules that apply to U.S. companies.<sup>4</sup> The new rules provide that a foreign issuer will need to determine whether it satisfies the SEC’s definition of an FPI only once each year; the determination will be made on the last business day of its second fiscal quarter.

In contrast, under the current rules, a foreign company’s failure to qualify as an FPI at any time during the year will result in the immediate loss of FPI status. An immediate loss of FPI status can be problematic for a company, as it could require the company to change its reporting practices and conventions during a reporting period, without any preparation time. Accordingly, the change will ease the monitoring burden, and provide greater certainty to those FPIs that are on the borderline of qualifying. For example, under the current rules, an issuer that has slightly less than 50% of its shareholders located in the U.S. could immediately lose its FPI status if transactions in the secondary market, the exercise of stock options by U.S. employees or other transactions result in increased U.S. ownership. Under the new rules, an issuer of this kind will have time to rectify before the evaluation date any issues that arise during the year that would otherwise jeopardize its FPI status.

Under the amended rules, effective as of December 6, 2008, an issuer that determines that it does not qualify as an FPI as of the last day of its second fiscal quarter of one fiscal year will become subject to the U.S. reporting requirements on the first day of the following fiscal year. In contrast, and as an additional benefit to FPIs, if a company determines that, as of the last day of its second fiscal quarter, it qualifies for the first time as an FPI, it may begin to *immediately* apply the rules and forms of an FPI, including for the remainder of that fiscal year.

Although there is no requirement that an issuer notify the market of its change in status, it is anticipated that some issuers that become subject to the change will make a public announcement in a press release or in their SEC

<sup>3</sup> In this regard, these amendments reflect the SEC’s reduction of the deadlines for U.S. issuers to file annual reports and quarterly reports, which was effected following the enactment of the Sarbanes-Oxley Act of 2002. However, the adopting release (page 80) notes that approximately one-third of FPIs currently file their annual reports on Form 20-F within 120 days after their fiscal year end. The new deadline may not affect these issuers.

<sup>4</sup> For example, FPIs are not required to file Form 10-Qs and Form 8-Ks, have a longer deadline to file their annual report (even after giving effect to the amendments described in the previous section), are not subject to the SEC’s proxy rules, and have fewer requirements with respect to executive compensation disclosure.

filings. An announcement of this kind would help avoid investor confusion. For example, investors in a company that ceases to qualify as an FPI could be notified that such company will begin to file Form 10-Qs and Form 8-Ks.

**Application to MJDS Issuers.** The amendments also affect Canadian issuers subject to the SEC's "multijurisdictional disclosure system" in several ways.

- As is the case for other foreign companies, a Canadian issuer will test its status as an FPI only as of the last business day of its second fiscal quarter.
- A Canadian issuer would continue to test its eligibility to file annual reports on Form 40-F based on all of the other requirements of that Form, including the public float requirement, *at the end of its fiscal year*.<sup>5</sup>
- As to public offerings by MJDS issuers under the Securities Act of 1933, an issuer would need to be eligible to use the MJDS registration statement *at the time of filing*.

### Additional Disclosure Requirements

The "Foreign Issuer Reporting Enhancements" are also designed to enhance (that is, "increase") the *disclosures* that FPIs must make in their registration statements and Securities Exchange Act of 1934 ("Exchange Act") reports. In some respects, these amendments conform the required disclosures made by FPIs to those of U.S. companies.

**Changes in, and Disagreements with, Auditors.** Beginning with their first fiscal year ending on or after December 15, 2009, FPIs will be required to report information that is similar to that which is already required of U.S. issuers under Item 304 of Regulation S-K and Item 4.01 of Form 8-K. These requirements, which will be set forth in new Item 16F of Form 20-F, include disclosure of a change in auditor during the FPI's most recent two fiscal years or any subsequent interim period, and disclosure of the circumstances of the change, including any disagreements as to the application of accounting principles. To some extent, this information is required to be disclosed by listed companies under the rules of the NYSE. FPIs will be required to include this information in their annual reports on Form 20-F, as well as their registration statements on Forms 20-F, F-1, F-3 and F-4.

As is the case with the requirements applicable to U.S. issuers, the prior auditors will have the opportunity to review the FPI's disclosures and to set forth any disagreement as to those disclosures.

**ADR Fees.** FPIs will be required to disclose information about the fees and other charges paid in connection with sponsored ADR facilities in their annual reports on Form 20-F. Although these fees are often available from other publicly available sources, such as the deposit agreement or its exhibits (the deposit agreement is a required exhibit to a Form F-6 for an ADR program), the SEC determined that better and more convenient disclosure of this information would be helpful, in light of its impact upon investors.

The new disclosure requirement, set forth in Item 12.D.3. and 4 of Form 20-F, will cover payments paid by investors to effect transactions,<sup>6</sup> as well as payments that FPIs receive from depositaries in connection with their sponsored ADR programs. These payments must be disclosed on a per-payment basis. In order to permit depositaries and FPIs to make any necessary changes to their contractual arrangements in light of the new disclosure requirements, this information need not be disclosed until an FPI files its annual report for its first fiscal year ending on or after December 15, 2009.

<sup>5</sup> In order to use Form 40-F as an annual report, a Canadian issuer must, among other things, (a) have been subject to the periodic reporting requirements of a Canadian regulatory authority for at least one year and be current in its requirements and (b) have a public equity float of at least U.S. \$75 million. Accordingly, under the amendments, it is possible that a Canadian issuer could remain eligible to file the FPI forms, such as Form 20-F, but to no longer qualify for the MJDS.

<sup>6</sup> These fees include, among other things, charges for depositing underlying shares, receiving dividends, selling or exercising rights, and withdrawing a security.

**Differences in Corporate Governance Practices.** Under the new rules, FPIs will be required to disclose in their annual reports on Form 20-F the significant ways in which their corporate governance practices differ from the practices of U.S. companies listed on the same exchange.<sup>7</sup> The NYSE and Nasdaq exempt FPIs from many of their corporate governance requirements but require those FPIs to disclose these differences in their annual reports.<sup>8</sup> Accordingly, because many FPIs already prepare these disclosures, the additional compliance burdens are not necessarily extensive. Accordingly, these requirements will begin to apply to FPIs beginning with their first fiscal year ending on or after December 15, 2008.

### Amendments to Financial Reporting Requirements

**Limited U.S. GAAP Reconciliation.** The amendments will eliminate, in most cases, the limited U.S. GAAP reconciliation option set forth in Item 17 of Form 20-F. Under these amendments, all FPIs that are required to provide a U.S. GAAP reconciliation will need to do so under Item 18 of Form 20-F.<sup>9</sup> Previously, FPIs could rely on the Item 17 reconciliation option if they were listing a class of securities on a U.S. exchange without conducting an offering, registering their securities under Section 13(g) of the Exchange Act, or conducting certain limited types of offerings, such as investment grade securities.

This rule change is significant to those issuers that relied upon the less burdensome reconciliation requirements of Item 17 and that do not prepare financial statements in accordance with IFRS (as issued by the IASB).<sup>10</sup> A reconciliation under Item 17 must include: a discussion of reconciling differences; a reconciliation of net income for each year and any interim periods presented; a reconciliation of major balance sheet captions for each year and any interim periods; and a reconciliation of cash flows for each year and any interim periods.<sup>11</sup> However, the Item 18 reconciliation requirements are substantially more detailed; an issuer that prepares its financial statements under these requirements must provide all of the information required by U.S. GAAP and Regulation S-X, in addition to the reconciling information specified in Item 17.<sup>12</sup>

In order to provide FPIs with sufficient time to comply with the new Item 18 requirements, FPIs will be required to comply with these provisions beginning with their annual reports for their first fiscal year ending on or after December 15, 2011.

**Omission of Segment Data.** Under the amendments, Item 17 of Form 20-F will be modified to eliminate the instruction<sup>13</sup> that permits certain FPIs to omit segment data from their U.S. GAAP financial statements and to have a qualified U.S. GAAP audit report as to this omission. In adopting this rule, the SEC noted that only approximately five foreign private issuers have used this accommodation during the past few years. In addition, FPIs that file financial statements prepared in accordance with IFRS, as issued by the IASB, must include segment data.

This amendment will apply to the financial statements for an FPI's first fiscal year ending on or after December 15, 2009.

**Significant Acquisitions.** In its proposing release, the SEC considered whether FPIs should provide financial information in their annual reports for completed acquisitions that reach the "50% significance test."<sup>14</sup> However, the SEC did not adopt this change, in light of, among other considerations, commenters' concerns about the lack of

<sup>7</sup> These requirements will be set forth in new Item 16G of Form 20-F.

<sup>8</sup> The NYSE also permits these disclosures to be made on the FPI's website. Section 303A.11 of the NYSE Listed Company Manual; Nasdaq Rule 4350(a)(1).

<sup>9</sup> However, required third-party financial statements, such as those filed for acquired companies, may continue to be prepared under Item 17.

<sup>10</sup> Financial statements prepared in accordance with IFRS, as issued by the IASB, need not be reconciled to U.S. GAAP.

<sup>11</sup> These reconciliation requirements are set forth in Item 17(c)(2) of Form 20-F.

<sup>12</sup> See Item 18(b) of Form 20-F.

<sup>13</sup> Instruction 3 to Item 17 of Form 20-F.

<sup>14</sup> See Rule 1-02(w) and Rule 3-05 of Regulation S-X.

timeliness and usefulness of the information. The SEC indicated that it will continue to consider the proposal, and it is possible that the provision may be re-proposed with changes at a future date.

## Going Private Transactions

Finally, as part of these amendments, Rule 13e-3 under the Exchange Act, relating to “going private transactions,” will be modified to reference the SEC’s March 2007 deregistration rules that are applicable to FPIs.<sup>15</sup> Rule 13e-3 requires an issuer or its affiliate, as applicable, to file a Schedule 13E-3 that contains detailed disclosures as to its plans with respect to the proposed transaction. This amendment helps clarify that a transaction which has either a reasonable likelihood or a purpose of making an FPI eligible to deregister under the new rules will trigger the provisions of Rule 13e-3.

## Conclusion

The new rules contain a mix of provisions, some of which help FPIs or add minor burdens to their reporting requirements. Others, such as the new Form 20-F filing deadline and the requirement to provide an Item 18 reconciliation to U.S. GAAP, will be more burdensome to many FPIs. As to these latter requirements, the SEC sweetened the medicine to some extent, by providing for relatively long transitional periods before compliance with these new rules becomes mandatory. During the course of the next several years, we will have the chance to observe just how burdensome the entire package will be and whether it will discourage any FPIs from listing, or remaining listed, in the U.S.

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<sup>15</sup> These rules may be found at: <http://www.sec.gov/rules/final/2007/34-55540.pdf>. A client alert summarizing these rules may be found at: <http://www.mofo.com/news/updates/bulletins/11119.html>.