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Three steps to defuse the accounting oversight row

Disagreements over accounting oversight are testing relations between US and European regulators. Michael Mann and Edward J. Waitzer suggest a way to defuse the row.

In what may be one of the saddest moments for world markets comes a report that the European Union is considering using trade-type sanctions against US accounting firms, issuers and financial service firms to punish them for the extraterritorial excesses of the Sarbanes-Oxley act. Rather than turning the recent stock market scandals into an opportunity for restoring public confidence in and building co-operation among markets, we may now face a political fight over whose standards can be applied in the most punishing way. The outcome is inevitable: those that matter – markets, issuers and investors – lose an opportunity of historic proportions to use the current “crisis” to strengthen and unify world markets.

The argument from the US is simple: “If you play in our markets, you play by our rules.” It comes at a time when, for a variety of reasons, the US view of its role and relationships on the world stage is particularly black and white. There is little to be gained by attacking that view without advancing credible and constructive alternatives. The EU rules with respect to company accounting, controls and public auditors are not viewed as setting the same standards. US law requires all companies that register and sell their stock in the US (and their auditors), whether US based or not, to submit to the jurisdiction of the US and comply with their rules. Accordingly, the US will assert authority to register and oversee

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foreign and domestic issuers and their accounting firms in its markets.

The argument from Europe is equally simple: “Recognise the validity of our rules and exempt us from yours or we’ll make you play by ours.” The EU believes its rules are just as good as those in the US. If the US refuses to exempt its companies and auditing firms from the Sarbanes-Oxley act, the EU may apply its rules to US issuers and accountants. Moreover, to show how seriously the fight could become, the EU has just written new requirements for financial conglomerates, and threatens to apply those rules to US firms as well.

Regulatory chauvinism

Ironically, the potential retaliatory application of regulation could make the world’s financial markets the most highly (albeit ineffectively) supervised in history. The more likely result is that such regulatory chauvinism and redundancy will result in stifling the development of these markets and reduce access to capital for all companies. What is even more unfortunate is that the legitimate goals of the US – to improve oversight of financial reporting – and the EU – to develop a scheme by which high quality regulation can bridge the gap between various countries’ rules – can be reconciled through cooperation. The basis for such cooperation should be three basic principles.

Three principles for cooperation

First, regulation should focus on investor protection and market efficiency. There is no question that firms that issue securities in the US or supply audit services to such issuers are subject to US jurisdiction. In the debate over the Sarbanes-Oxley act, no one has argued that investors or regulators are not entitled to receive the information required under the law. The issue for discussion, then, should be the nature and relevance of the information and how it might best be provided and utilised in a manner that avoids undue costs, duplication or gaps and encourages global regulatory cooperation and capacity.

Second, differing systems of regulation can co-exist, and indeed thrive together, based on the recognition of mutual interest in the effective application and policing of rules applicable in each market. The goal that one system “recognise” the validity of another, while intellectually intriguing, may be impractical and unnecessary. The concept of recognition requires one to compare rules in the abstract and ignore the fact that the manner in which rules are interpreted, applied and enforced differ no matter what the rules say. The immediate challenge is to develop deeper and more practical knowledge of how the rules will be applied on a cross-border basis.

Finally, the key to investor protection is the ability to gather information, no matter

where it is located, and effectively prosecute wrongdoing in the market where it occurred, no matter from where it emanated. The policy choices and instruments are more subtle than those the US has deployed to address national security concerns. Market regulators, while powerful, cannot deploy Blackhawk helicopters to eradicate cross-border fraud. Their effectiveness is rooted in cooperation. While substantial progress has been made to build such relationships, much has been learned from recent scandals about the need to redouble those efforts to facilitate true international law enforcement efforts.

The question is where and how to start. Left at a theoretical stage the concept of cooperative oversight may seem to any hard-nosed regulator to be little more than a high-minded aspiration. Only through the practical negotiation of a tough and predictable bilateral understanding can the power of this concept be understood. Such initiatives are not without precedent: the SEC's first cooperation agreement was developed to track down insider traders hiding behind the shield of Swiss secrecy. Thereafter the Canadian provincial securities regulators negotiated the first broad-based cooperation agreement with the SEC. That agreement, in essence, lays the foundation for achieving the goals of the Sarbanes-Oxley act across sovereign borders.

The recently released staff study of the US SEC, which recommended that accounting standards should be developed using a principles-based (or "objectives-oriented") approach and urging continued efforts on convergence of US, foreign and international accounting standards reaffirms a commonality of purpose amongst financial sector regulators. Hopefully, this underlies recent public statements by the chairman of the US Public Company Accounting Oversight Board that he expects to reach agreement with officials from Europe, Canada and Japan as to the extra-territorial application of the board's proposed rules. There is too much at stake to allow such common cause to be eroded by political agendas.

In the end, international financial markets will thrive if regulatory cooperation is enhanced. Hopefully, it should be the sum of the contributions from multiple jurisdictions that will protect investors. Regulators have a unique opportunity to build that system now. The question is whether they can use the imperative borne of national legislation to establish a new more comprehensive and effective cooperative regime for oversight of the international markets that exist today.