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Michael E. Mann

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## PRESERVING THE INTEGRITY OF FINANCIAL MARKETS IN NORTH AMERICA

*Michael E. Mann*<sup>†</sup>  
U.S. Speaker

I have 20 minutes to say what will preserve the integrity of the financial markets of North America. It is somewhat of a daunting task. I guess my disclaimer should be that I spent most of my life as a regulator and so I was always certain. Now that I am a defense lawyer, I spend most of my life explaining why things are not as clear as they seem to be. I think that is really an important starting point for what I want to talk about in terms of the integrity of the financial markets in North America.

The success of the American market is based in large part on the premise that you can actually sell integrity. The high quality of the U.S. markets is based on the integrity of its participants, of its issuers, and on the fact that there is a regulatory system that is reasonably fair, reasonably predictable, and reasonably responsive to the problems that are encountered on a day-to-day and year-to-year basis. This system has created enormous demand for the American markets. Now, you are probably all sitting there asking, "Didn't he hear about Enron?" The answer is, yes. I have heard about Enron.<sup>1</sup>

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<sup>†</sup> Michael E. Mann is a partner in the law firm of Richard Spears Kibbe & Orbe, a position he has held since 1996. Prior to entering private practice, Mr. Mann served for seven years as the first Director of the Office of International Affairs at the U.S. Securities and Exchange Commission (SEC). During his tenure, he was the principal SEC official responsible for initiating and coordinating the SEC's international capital markets program. Prior to becoming Director of the Office of International Affairs, Mr. Mann served as Associate Director in the SEC's Division of Enforcement, acting as counsel for the Commission in such cases as *SEC v. Levine*, *SEC v. Winans* (the "Wall Street Journal" case), among others. Mr. Mann has been the recipient of such honors as the Manual F. Cohen Outstanding SEC Younger Lawyer Award from the Federal Bar Association, Securities Law Committee three years out of law school, and the Chairman's Award for Excellence. A Member of the Council on Foreign Relations, Mr. Mann received a B. A. from Hampshire College and a J.D. from Antioch School of Law.

<sup>1</sup> *The Fall of Enron: Report details Enron's deception; Examiner cites auditors, lawyers and banks as part of scheme*, HOUS. CHRON., March 6, 2003, at 1, available at 2003 WL 3242126.

## ENRON

However, Enron is one of those things that needs to be responded to, because unlike John and while I am not sure that you said this I will attribute it to you anyway, principle based regulation would not have stopped Enron.<sup>2</sup> Principle based regulation would not have stopped World Com. Those were frauds. Those were bad guys doing bad things. The day that your books close and you add a receivable for \$4 billion, somebody should notice. You do not need a principle to tell them to notice these things. They should clearly notice.

If you have on your books an item that you paid \$120 million for that is non-operable, has no staff added, is based in a country like India, then somebody ought to go look at it before it is transferred to a separate vehicle that is valued at \$150 million. These were failures, and they were failures of the system, failures of the accountants, failures of the Boards of Directors, and failures of the regulators.<sup>3</sup>

## REGULATION

The fact is the most successful markets in the world, the markets in North America, attract the best investors, the best companies, the best professionals, but they also attract the best scoundrels. I think what we are seeing today, approaching the end of a boom cycle where there was enormous pressure brought to bear on the market by a desire to do better and better and better, and not to admit failure and ultimately not to see failure for what it was. That is something that has been dealt with and I will talk about this more later when we touch on Sarbanes-Oxley.<sup>4</sup> But it is not something that goes to what to me is the most critical question: do you have a regulatory scheme that can work and that will provide you value and protect as well as preserve the integrity of the financial markets in North America?

When thinking about this, I was reminded of a couple of dealings I had while at the Security and Exchange Commission. I would often go over to Germany and talk to the German regulators about their approach to the fact that they had no insider trading law and the fact that they really did not have much of a market regulatory approach.<sup>5</sup> The German's would say to me,

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<sup>2</sup> *The regulator who isn't there*, THE ECONOMIST, May 18, 2002, available at 2002 WL 7246206.

<sup>3</sup> *The amazing disintegrating firm – Enron: The tragedy of one company's rise and fall*, THE ECONOMIST, Dec. 8, 2001, available at 2001 WL 7320993.

<sup>4</sup> Sarbanes-Oxley Act of 2002 (Public Company Accounting Reform and Investor Protection Act), PUB.L. 107-204, July 30, 2002, 116 Stat. 745.

<sup>5</sup> Hans-Bernd Schäfer & Claus Ott, *Economic Effects of EEC Insider Trading Regulation Applied to Germany*, 12 INT'L REV. L. & ECON. 357, 358-60 (1992). On July 26, 1994

“You know, we have looked at the evidence. Last year, you guys brought 60 insider trading cases. We brought none. What is the problem? We have no problem here.” I said to them, “Well, you know, you do not have a law against insider trading. You do not prosecute insider trading. We do.” They would respond by arguing that they did not need insider trading laws because they did not have insider trading.

It is clear that from this example that obviously they did not know what they had. In the United States, we did. The fact that we went after it showed a desire to try to clean up what was a problem. It was a problem and I think it is important to have those problems out there. But in Germany, there were no public investors. Why? All you have to do is walk down the street and ask, “Would you invest in the securities of any company?” They would say no. When you ask why, they would tell you that the banks have all the information and they are the ones who are trading the stock. I have nothing. That is really the critical point. How do you get information out, and how do you get information out to investors so investors believe it?

We have a crisis today. The issue is how do we stem that crisis, not is the regulation bad. Often we have seen in other markets where crisis exists an attempt at a new regulatory scheme, writing of a new rulebook, changes in the way we regulate, or even considering the option of not having self-regulation. My approach would be to say what we have is a good regulatory scheme, but it needs modification. It needs to be updated. Regulation needs to be as dynamic as the business that it regulates. The thing that is most obvious from the examples of the 1990’s, both good and bad, is that the markets in North America are incredibly vital. They are incredibly dynamic. The regulator needs to be equally dynamic, as does the regulation.

What I want to do is talk a little bit about history and the future; challenges to integrity that the SEC has seen in the past and what it is confronting today. The one in the past I want to talk about is the one I know best, the problem created by internationalization. With regards to the future, I am not going to go through the Sarbanes-Oxley Act since I am sure you have all studied that paper. Rather I will focus on how Sarbanes-Oxley creates new responsibilities for gatekeepers. It designates people as gatekeepers in a way that they have never been designated before. It says you are responsible not just for what you say, but for the truth of what you say. It also says you have got to sign a certification that what you say is true. That is the portion that makes a difference, the penalty of prosecution for that signature if it turns out to be false.

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Germany adopted regulations dealing with insider trading and created a federal securities commission.

## INTERNATIONAL STANDARDS

The challenge for today is for regulators to figure out how to apply this statute, not just in the United States, but internationally. Before we get to that, let me talk a little bit about the 1980's and internationalization. In the 1980's, the issues that were confronted by the Securities and Exchange Commission dealt with maintaining the integrity of the trading markets. All of a sudden, you had markets that had always been very much domestic markets, Americans trading on the American market, becoming internationalized. You had the large universal banks moving into the United States and buying broker dealers. You had enormous interest in securities as an investment for internationalizing a portfolio. The result of that was you had insider trading from abroad. You had market manipulation from abroad. You had securities that were trading in multiple markets and this was a phenomenon that nobody understood.

You also had something else going on, which is a desire on the U.S. market side to no longer be a domestic issuing market. There was an enormous competition at that time between the United States and Great Britain to see who would be the greatest market in the world as a financial issuing market. The British in 1989 had 550 companies listed in trading from outside of their borders. The United States had about 450, 350 of which were Canadians. There was enormous pressure at the SEC to try to figure out on the one hand what to do about the fraud that was occurring on the market and on the other hand how to open the markets. With the open markets issue came the pressure to have more issuance and really increase the prospects for the American marketplace.

The principle that the SEC hit on, was one that grew out of an enforcement case.<sup>6</sup> And that is a very simple one: if you play in our markets, you play by our rules. Sounds like a perfectly reasonable thing. Got to be somewhat of a confrontation when Swiss banks started trading, and the SEC started asking who their customers were. They said, "There is the Swiss law. We cannot tell you, you know, secret." The SEC's position was basically you are trading here. Our law trumps your law. This issue went to Court, not surprisingly, an American Court agreed with the SEC.<sup>7</sup> Shortly after that, a number of colleagues and I wrote a paper called Waiver By

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<sup>6</sup> *Securities and Exchange Commission v. Banca Della Svizzera Italiana*, 92 F.R.D. 111 (Nov 16, 1981).

<sup>7</sup> "It would be a travesty of justice to permit a foreign company to invade American markets, violate American laws if they were indeed violated, withdraw profits and resist accountability for itself and its principals for the illegality by claiming their anonymity under foreign law." *Id.* at 119.

Conduct, which I think is when I first met Michael Robinson.<sup>8</sup> A large number of people thought that we had lost our minds in the extraterritorial assertion of American Law.<sup>9</sup> However, all we did was say what the U.S. Court had already said to us. What grew out of Waiver By Conduct, which we clearly know was both provocative and extraterritorial, was that everyone came forward and said negotiate. We can work this out. Our laws may be different, but this is not impossible. This can be worked out by mutual understanding and that is exactly what the SEC did.

The SEC decided that the waiver policy was not going to work, because the cost of every litigation was tens of thousands of dollars, or probably today it would be hundreds of thousands of dollars. It was incredibly slow, even when the SEC was pushing it. Not to mention it was hard to say you were very effective if you had to go after everybody in the world you had a question about, knowing that only 10 percent or so of those people were going to turn out to have done something wrong. The SEC was never going to have the resources to do it.

#### AGREEMENTS WITH CANADA

In 1988 the SEC, starting with the Canadian securities regulators, negotiated their First Memorandum of Understanding on Cooperation.<sup>10</sup> That Memorandum of Understanding (MOU) was the basis on which all cooperation between the United States and the Canadian Provinces took place. It was signed by Ontario, Quebec, and British Columbia but all of the other Provinces of Canada have agreed to work under its terms. What is interesting is that in the United States only one law needed to be changed to make it work. We had to modify the Exchange Act to give the SEC the power to cooperate with foreign authorities and to gather evidence using subpoena powers.<sup>11</sup> In Canada, every provincial law in the country had to be changed.<sup>12</sup> The United States could have made it an executive agreement or

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<sup>8</sup> Concept Release Requesting Comments Concerning a Concept To Improve the Commission's Ability To Investigate and Prosecute Persons Who Purchase or Sell Securities in the U.S. Markets From Other Countries 31 S.E.C. Docket 14, Release No. 34-21186, (July 30, 1984), *available at* 1984 WL 559194; Notice of Issuance of Concept Release and Request for Comments, 16 SEC. REG. & L. REP. 1305 (Aug. 3, 1984).

<sup>9</sup> Brian L. Nelson, *Insider Trading Originating Abroad and "Waiver-By-Conduct,"* 19 INT'L LAW. 817 (1985).

<sup>10</sup> Memorandum of Understanding United States Securities and Exchange Commission and Ontario Securities Commission, Quebec Security and Exchange Commission, British Columbia Securities Commission (Jan. 7, 1988), *reproduced at* 21 Sec. Crimes Appendix 28 (2003).

<sup>11</sup> Insider Trading and Securities Fraud Enforcement Act of 1988, PUB. L. NO. 100-704, 102 Stat. 4677.

<sup>12</sup> *See*, Saskatchewan Statutes; The Securities Act, 1988, S.S. 1988-89, c. S-42.2, S.S.

even potentially a treaty. That would be very difficult for Ontario, possibly Quebec. The idea of the MOU's is something that was also applied to the issuing markets and was to open dialogues with countries.

The Multi-Jurisdictional Disclosure System (MJDS) that was established between the United States and Canada was based on the idea that mutual recognition is too hard, our systems are too hard to reconcile, even between Canada and the United States.<sup>13</sup> Instead of having both sides saying lets not try, we created a basis for recognizing that we can put this together. It was a very common sense approach to what is a problem that everyone in the world spends an enormous amount of time on today. When you look at what is going on in the accounting area, I think you will see there are a lot of reasons to look not for mutual recognition, but to look at employing an MJDS model.

These markets grew enormously and this growth was in large part because of the phenomenon of cooperation; cooperation that has gone along very well for the last 20 years. The failure of Enron, the failure of Andersen, the failures of companies in the United States and outside the United States, on the basis of accounting misdeeds are something that really has created a new problem. As I have been saying all along, this is a new problem that regulation needs to solve.

Acronyms like GAAP and GAS and the FASB and IASB are things that are surprisingly part of the vernacular.<sup>14</sup> I was talking to my 11 year old, debating with her about how much money she had in her savings account. She claimed it was a factor of ten greater than I did and demanded a restatement when I told her that I was not going to give it to her. She really knew what was going on. She had been reading the papers. And people know what Sarbanes-Oxley is, as well. It is an attempt to bring the accounting for corporations in the United States into a new world where information is made available in an understandable way and where it is tested in a clearer way. I think that it fits well within the framework that already exists in the United States.

There was an enormous debate when Sarbanes-Oxley was first proposed and then again when it was passed, about whether it went too far. I am on both sides of this fence. On the one hand, if anybody has ever read the

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1988-89, c. S-42.2, as am. S.S. 1989, c. 15, s. 3 amend in 1988 and 1989; Quebec Statutes; Securities Act; S.Q. 1982, c. V-1.1, c. 21, s. 134; c. 64, ss. 561-563; c. 84, s. 700(16) amended in 1988; Nova Scotia Statutes; Securities Act, R.S.N.S. 1989, c. 418, s. 150; Manitoba Statutes; The Securities Act; Part XI, Insider Trading; R.S.M. 1988, c. S50, s. 108; 108; Newfoundland and Labrador Statutes; Securities Act; Part XX, Insider Trading and Self-Dealing; R.S.N. 1990, c. S-13, s. 107-121.

<sup>13</sup> Securities Act Release No. 6841, 44 SEC Docket (CCH), at 56-57 (July 24, 1989).

<sup>14</sup> Generally Accepted Accounting Principles (GAAP); General Accounting Standards (GAS); Financial Accounting Standards Board (FASB); International Accounting Standards Board (IASB).

Exchange Act of 1934,<sup>15</sup> which established the United States SEC, you will notice that there is no other country in the world, the bounds of the securities laws of the United States are completely unfettered. The only thing that was left out was giving the SEC its own military budget. It is a very uninternational statement. No territory of the United States is ever mentioned. Sarbanes-Oxley is the same way. I do not think that that is necessarily bad. What it calls on is for the regulator to do the right thing, to see where the limitations are, and apply them.

The thing we are facing right now with Sarbanes-Oxley that is really so difficult, is the fact that if you take General Motors who is audited right now by Deloitte & Touche in about 50 states of the United States and 156 countries around the world. Each partnership of Deloitte & Touche that does that is chartered in each state, and in each country. Applying the rules to each of those foreign accountants, whether they are in Uzbekistan, China, or Michigan is an enormous task. Sarbanes-Oxley says all of those accountants are regulated by the SEC. All of them have to register with the SEC. All of them have to be licensed by the new licensing board that has been created. All of them have to agree to give their work papers to the new accounting board and to the SEC. All of their employees who work on the audits have to agree to come to the United States or make themselves available to testify if there is ever a question asked. That is all pretty reasonable. If you are going to issue securities in the United States, describe yourself to American investors, and lie your accountants should have to come in and tell you the truth. Sarbanes-Oxley fills a void that did not exist before the internationalization of the markets.

I am not in favor of giving the SEC a police force or a squadron of Marines when they come back from Iraq to go off and get these auditors in every country. What needs to happen is for the SEC to take a page out of the book of the past and look for the new regulator. Rather than assert their authority, which is unfettered here, to assert agreements that get them to the bottom of their regulatory needs. The real challenge for the regulators is to figure out how in the near term they can structure cooperation in such a way that it will be allowed to work.

I would note that when they had a round table last week to discuss the international aspects of Sarbanes-Oxley, the Canadian Chartered Accountants came forward and said they would be willing to sign the first memorandum of understanding. Canada sits in an enormously important position, because accountancy is relatively similarly situated despite the cross border differences. The prospect for cooperation is great because our legal systems, privacy laws, and Constitutional rights against

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<sup>15</sup> Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (June 6, 1934).



self-incrimination are so similar. There is an enormous basis to do what was done in 1988; creating a new understanding that would facilitate the Sarbanes-Oxley law and provide a type of reciprocity on a mutual basis to the accountants.

### CONCLUSION

The last point I would make is to return to the first point I made. One of the responses to Sarbanes-Oxley is to say all this could be fixed if we just had one set of accounting principles, one super regulator who was taking care of all these things. It reminds me of a visit I had right before the fall of the Berlin Wall with the Soviet Minister of Finance. At the time he was asking a group of us if we should we have two regulators; one for futures and one for stocks. At that time we were having a huge fight with the Commodity Futures Trading Commission. The Chairman of the SEC shot back at him, "You should have one regulator. There is no question, one is always better." The Minister looked at him and said, "You know, we tried that one regulator thing. It just does not work."

The point that I am making is that it is not a matter of consistency, because you will never have consistency. The Spanish are going to apply the principles differently, because they speak Spanish and because their companies are different. The Koreans are going to do it differently. The Americans are going to do it differently. The Australians are going to do it differently. We should not try to make everyone the same. What we need to do in order to protect the integrity of the American market is recognize those differences, identifying the principles that are the foundation of that integrity, and then give the regulators through cooperative means, the ability to enforce them. Thank you.