

EU-US COLLABORATION AND COMPETITION: REGULATION OF FINANCIAL MARKETS

Summary: The EU and US together account for the bulk of international capital flows. Levels of portfolio investment, mergers and acquisitions as well as foreign direct investment (the EU and US have around €500 billion invested in each other) underline the degree to which the two economies are integrated. Similarly, the US and EU are predominant in many aspects of securities transactions and banking flows. European and US firms compete extensively in each other's markets. They are also customers of and providers of services to each other and are therefore strong proponents of transatlantic regulatory convergence and the avoidance of overlapping or conflicting regulatory frameworks. High profile debates over legislation and policy with potential extra-territorial impact have implications for trillions of euro of transatlantic business and international investment decisions. Given the importance of global capital markets to the two economies, transatlantic leadership on financial issues is central to their economic interests. In recognition of this, EU and US authorities have stepped up efforts to ensure regulatory dialogue. The financial industry on both sides of the Atlantic support these initiatives and believes they can deliver long term benefits to companies, consumers and the wider economy.

1. Background

Together, EU and US equity markets represent 80% of global financial markets. US holdings of overseas securities have increased eight-fold in the last decade. In recent years, US purchases of non-US stocks have increased to around \$95 billion. Purchases of European stocks form the majority of this increase. At the same time, holdings by foreign investors in US stocks and bonds are now four times the 1990 level with EU investors accounting for a large part of this increase. Total transactions between US and foreign investors in US shares have ranged between \$3-5 trillion per year during the past 3 years, while annual bond transactions ranged from \$8-12 trillion. 82 US companies have equity listings in Germany, 69 in the UK, and 17 in France. EU company listings in the US now exceed 250, with 151 NYSE listings and a further 104 listings on NASDAQ. In 2002, European companies raised a total of €42 billion via primary equity public offerings in the US.

During the 1997 WTO financial services talks, the EU and US opted not to make any market access requests of one another. This is primarily because, for the most part, national treatment in the EU and US is applied. While foreign entrants may find aspects of domestic regulation to be burdensome or simply different to that which they are familiar with, these complaints were felt to be better tackled bilaterally.

The trend therefore has been to encourage EU-US convergence on the regulation and supervision of financial markets as well as on the legal and governance framework as determined by company law, corporate governance and accounting standards. The conclusions of the EU-US Summit in May 2002 called for a transatlantic regulatory dialogue on financial services to form part of a "Positive Economic Agenda". A number of meetings between the Treasury, SEC and Federal Reserve, on the US side, and the European Commission's DG Internal Market for the EU have subsequently taken place. Most recently, Commissioner Bolkestein and a number of senior Commission officials met in Washington DC with many of the top US policy makers. Discussions have also taken place between the European Parliament and US Congress. The Transatlantic Business Dialogue has also launched a Financial Markets Dialogue focussed on the Sarbanes-Oxley Act, accounting standards and exchange trading screens.

2. Agenda items under the EU-US regulatory dialogue

By its nature, the transatlantic Regulatory Dialogue has no fixed agenda. Nevertheless, a series of issues have been clearly identified by participants as items of concern and discussed on several occasions in the past 18 months.

Sarbanes Oxley

The 2002 Sarbanes Oxley Act resulted in the application of many provisions of the new statute to foreign companies with reporting obligations to the SEC as well as the auditors and lawyers who provide services to those companies. The Act establishes a regime for company audit committees that was criticised as inconsistent with the usual governance procedures of many non-US companies which are subject to their own domestic company law provisions. The SEC has worked to address these inconsistencies through exemptive rules. For example, it recognises that non-executive employees may serve on an audit committee of a non-US company if the employee is appointed under a collective bargaining agreement or co-determination statute. Similarly, if a non-US company has a two-tiered board system, the SEC applies its audit committee requirements only to the audit committee of the supervisory board. Outstanding issues remain to be resolved. The Act imposes onerous requirements on non-US accounting firms that provide audit services for non-US companies, or that play a substantial role in audits. As things stand, non-US auditing firms would be required to register with the newly formed Public Company Accounting Oversight Board (PCAOB) and become subject to inspections, investigations and potentially disciplinary actions by it. Ongoing discussions between the European Commission and the PCAOB aim to find a compromise that would be acceptable to the European authorities and yet meet the new US requirements for investor protection. Press reports of Commissioner Bolkestein's recent meetings with the PCAOB show promise of a solution being found including such ideas as co-registration. As a first result the US has postponed the deadline for registration of non-US companies within the PCAOB for 60 days until July 2004.

Data Protection

The EU Data Protection Directive requires that Member States prohibit the transfer of personal data to other countries outside the EU that have not been deemed to provide an "adequate" level of privacy protection. The US benefit from special regime called "safe harbor principles", which is based on a voluntary participation of companies, but excludes financial services companies. The US financial services sector has sought, for some time, an adequacy determination from the EU so that transatlantic flows of data do not remain subject to the possibility of a data stoppage. They argue that the safe harbour arrangements and provisions for standard contract clauses are not well suited to the financial sector and that existing sectoral measures on data protection (e.g. provisions in the Gramm Leach Bliley Act, as well as potential civil liability for misuse of personal data) ensure a high level of data protection and are sufficient to warrant a finding of adequacy. Exchanges between the authorities on both sides continue with a view to finding practical solutions to this set of problems.

Trading Screens

Currently, foreign securities exchanges in the US are accorded national treatment when they register as a US exchange. They are effectively prohibited by the SEC from directly accessing the US market without first registering as a US exchange, in which case they would be

simultaneously subject to both the EU and the US Regulatory regimes. An exception to this is the US Commodity and Futures Trading Commission (CFTC) authorizing under certain conditions of the use of screens of foreign exchanges for products that fall under its jurisdiction, e.g. fixed income products and non-equity derivatives. EU exchanges demand direct access to US investors by placing trading screens on the desks of US broker-dealers. (Very large US institutional investors de facto trade on non-US Exchanges, a fact borne out by the decreasing use of American Depositary Receipts (ADR) trading. The SEC's concerns over granting such access relate to retail investor protection and are twofold relating first to the fragmentation and differing market practices in European markets (their differing trading systems, supervision, disclosure, etc.) and second to the differing accounting and corporate governance standards that apply to the range of entities underlying the securities products that would be offered. European exchanges argue that the new Investment Services Directive and updated standards for regulated markets should largely overcome the first concern. The second may be less easily resolved at least until IAS are more widely accepted and planned corporate governance and company law reforms are implemented throughout the EU. A focus on practical examples may help better to resolve this issue.

Financial Conglomerates Directive

The FCD requires the lead European regulator of a non-EU parented financial conglomerate to decide whether the supervisory regime applying to the parent company is "equivalent" to the principles of consolidated supervision set out in EU Directives. If the supervisory regime in a non-EU jurisdiction is judged not to be equivalent, the lead regulator of the conglomerate's EU entities is required to take action. Options include becoming the global consolidating supervisor for the whole group, requiring the group to establish an EU holding company for all its EU activities, and apply consolidated supervision at that level, or acting to take alternative measures that meet the principles of consolidated supervision, and to report these to the European Commission and other EU regulators. Member States are required to apply the directive's provisions to firms' accounts for the financial year beginning in 2005. In practice this means that regulators must have all the relevant rules in place by mid-2004, and to have had discussions with other regulators and groups to identify the lead regulator for each group and issue guidance on equivalence. The EU and US are currently in discussions aimed at ensuring that the supervisory regime in the US for non-Fed regulated groups is in a position to be judged equivalent by the EU ahead of the directive coming into force. As part of this process, the SEC recently announced the issuance of a new consolidated oversight regime for groups it regulates.

3. Future Agenda Items

In addition to the above points, which have been discussed on several occasions by EU and US interlocutors, other issues pertaining to the financial markets have raised questions that will require early discussion between the two sides to ensure timely resolution.

Issues relating to convergence of accounting standards loom large and are already being touched on in the dialogue. The SEC and the Financial Accounting Standards Board (FASB) have recognised the importance of the EU's emphasis on accounting principles as well as detailed rules. At the same time, the International Standards Accounting Board (IASB) has been developing detailed rules in many areas to supplement the EU's traditional reliance on general accounting principles. A formal process aimed at full convergence is underway but will take

time and is unlikely to be complete by 2005 when the regulation applying IAS to EU listed companies comes into force.

Furthermore, the Prospectus Directive and Transparency Obligations Directive have “equivalency” requirements implying that, if US accounting rules (US GAAP) are not deemed equivalent to IAS for the purposes of those directives, non-EU companies that are required to draw-up prospectuses or publish ongoing financial reports with regard to their EU-listed securities will have to restate their financial accounts under IAS. While the desire to ensure consistent disclosure to investors is understandable, market uncertainty relating to the treatment of foreign issuers is already having an impact on issuer behaviour. This being the case, the regulatory dialogue may provide an opportunity to address this issue at an early stage and provide clarity to the markets, in order to avoid disincentives to foreign issuers seeking to expand security issuance in the European capital markets.

4. Conclusions

The challenge for the EU and US over the coming years will be to build on the positive start made in the regulatory dialogue in order to facilitate forward thinking and mutual prior consultation on legislation with potential extraterritorial effects; to identify common future legislative goals and common or compatible solutions wherever possible; and to discuss existing extraterritorial issues constructively. This has been recognised by the European Commission’s stated desire, in following up on the Financial Services Action Plan, to focus on what it terms the “external dimension” of EU policy. Critical to meeting the challenge will be ensuring appropriate representation in the dialogue given the different regulatory agencies and other bodies involved on both sides. There may, for example, be a need in future to involve state regulators from the US or national regulators or CESR for the EU. Industry on both sides of the Atlantic should be closely involved, especially in identifying areas for future work. Finally, the broader political perspective must be retained, meaning there is also a strong case for strengthened relationships and increasing understanding between key financial services legislators and their staff in the European Parliament and the US Congress and between the US Department of the Treasury and Member State finance or economy ministries.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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Morgan Stanley
Nordea Bank
San Paolo IMI Bank
Société Générale
Svenska Handelsbanken
UBS AG

Annex: List of US regulatory agencies

Federal Reserve Bank (Fed) www.federalreserve.gov

US central bank founded by Congress in 1913. In addition to conducting monetary policy, the Fed has primary responsibility in the US for financial system stability, prudential supervision and regulation of the commercial banking sector. The Fed's Chairman is Alan Greenspan. Vice Chairman Roger Ferguson represents the Fed in international policy groups such as the Financial Stability Forum and the Basel Committee where the Fed leads the US delegation.

Securities and Exchange Commission (SEC) www.sec.gov

Federal regulator for securities markets and market participants established by the US Congress in 1934 in response to the 1929 stock market crash. The SEC is comprised of five presidentially appointed Commissioners, four Divisions and 18 Offices. It has approximately 3,100 staff and is headquartered in Washington, DC, with 11 regional and district offices. The SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934

Financial Accounting Standards Board (FASB) www.fasb.org

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated US organization for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports. They are officially recognized as authoritative by the SEC. FASB is currently chaired by Robert H. Herz whose term runs until 2007.

Commodity Futures Trading Commission (CFTC) www.cftc.gov

Congress created the Commodity Futures Trading Commission (CFTC) in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the US and to protect market participants against manipulation, abusive trade practices and fraud. James E. Newsome, who has been appointed by the president for a 5 years term until 2006, chairs the CFTC.

Public Company Accounting Oversight Board (PCAOB) www.pcaobus.org

The PCAOB is a private sector, non-profit corporation, created by the 2002 Sarbanes-Oxley Act, to oversee the auditors of public companies. In June 2003, the SEC appointed former President of the New York Federal Reserve and former Basel Committee Chairman, William J. McDonough as PCAOB Chairman.

Office of the Comptroller of the Currency (OCC) www.occ.treas.gov

Charters, regulates, and supervises all national banks. Also supervises the federal branches and agencies of foreign banks. Headquartered in Washington, D.C., it has six district offices plus an office in London to supervise the international activities of national banks. The OCC was established in 1863 as a bureau of the U.S. Department of the Treasury. The OCC is headed by the Comptroller (currently John D. Hawke), who is appointed by the President for a 5-year term.

Office of Thrift Supervision www.ots.treas.gov

The Office of Thrift Supervision (OTS) is the primary regulator of all federally chartered and many state-chartered thrift institutions, which include savings banks and savings and loan associations. OTS was established as a bureau of the U.S. Department of the Treasury in 1989. Its current Director is James E. Gilleran.