

The EU-US Financial Markets Dialogue: From Damage Control to Pro-active Integration

Summary: *Closer transatlantic financial market dialogue – at the level of politicians, regulators and industry – has already yielded good results in terms of damage control, “dispute resolution” and prevention. Dialogue must now move towards policy coordination and market integration. The latter promises substantial benefits in the shape of lower transaction costs, higher liquidity and less home bias. The guiding principle for market integration should be a progressive convergence of rules sufficient to secure adequate equivalence. On the part of the US, this means giving ground on some issues where they are perceived as being “extraterritorial” and making progress on accounting standards; on the part of the EU, the EU must understand that recognition of equivalence will only be acceptable for the US provided the EU can guarantee consistent and high supervisory quality for all 25 member states. While it is true that the faster and deeper the EU’s financial market integration, the greater its credibility as a unified regulatory market, if that process of integration reduces the prospect of regulatory convergence between US and EU rules, it will reduce commensurately the prospect of a simpler and more coherent framework of regulation that can be held in common between the US and the EU.*

Strong institutional framework for transatlantic financial dialogue

There are several official and private sector fora in which financial regulatory issues are discussed. On the official side, the European Commission and the US Treasury (with the involvement of the SEC, the Federal Reserve and National Association of Insurance Commissioners -NAIC) established the informal Financial Markets Regulatory Dialogue (FMRD). The FMRD is – at least officially –modest in ambition aiming at the avoidance of conflict and mutual understanding; it does not target mutual market opening, not the least, because neither of the two partners has law-making power by itself. The FMRD is complemented by (1) the execution of a specific MOU between the SEC and CESR to establish a process for information-sharing and cooperation regarding the development of rules, (2) a parliamentary dialogue between the European Parliament and the US Congress, and (3) private sector contributions to the official dialogues (TABD, TPN, Securities Industry Association, AmCham EU, EU-US Coalition on Financial Regulation). However, a commitment from the official side to ensure transparency in the form of regular updates on past meetings as well as advising stakeholders of upcoming issues would be equally beneficial.

Strong economic base to build upon

Further EU-US financial market integration would be a logical extension of the intensive economic inter-linkage between the two economic blocs on either side of the Atlantic: The US and the EU are the two largest economic areas in the world, accounting for more than 40% of global GDP (at PPP), half of global trade, 80% of global outward FDI flows and 60% of inward FDI flows. Nearly 60% of US corporate assets abroad are located in the EU, while Europe provides 75% of all foreign investment stock in the US. The transatlantic partners are also financial giants and closely linked in this area: together they account for 2/3 of global stock market capitalization and bond volume outstanding. Gross transactions by EU investors in US equities jumped by a factor of 18 between 1990 and 2000 to USD 2,623bn; the other direction saw a factor of 14 to a volume of USD 1,937bn. Many European and US financial sector players have a strong and growing presence in both jurisdictions.

Objectives of a closer transatlantic dialogue

The objectives of a closer transatlantic dialogue can be divided into four categories:

- **Damage prevention:** Uncoordinated regulatory action creates regulatory spillovers which might negatively affect financial institutions. Recent examples include the Sarbanes-Oxley Act (SOX), some provisions of the USA Patriot Act, and the EU’s Financial Conglomerates Directive. To avoid damage, it would be useful if better regulation approaches, which regulators on both sides of the Atlantic are committed to, included due consideration of potential repercussions beyond the intended scope of the rules.

- *Damage control:* Even with closer dialogue there will, inevitably, be instances when negative spillovers will occur. In such instances, the existence of a well-established, smoothly functioning dialogue will help to limit the damage done, as transatlantic partners will be able to draw on established communications channels personal relations and mutual trust. The more intensive dialogue already bears fruit in this respect: for instance, the dispute about the extraterritorial impact of SOX was defused.
- *Policy coordination in multilateral fora:* The EU and the US are key members in multilateral fora that are engaged in rule-setting for global financial markets (WTO, IOSCO, FSF; FATF, Basel based committees). With a coordinated approach, the two giants could and should shape the results of negotiations in these fora. The ongoing negotiations in the WTO's Doha round and a possible regulation of rating agencies are cases in point.
- *Pro-active market opening:* Ideally, the transatlantic financial market dialogue should be forward-looking and attempt to remove obstacles to the integration of financial markets across the Atlantic. This objective has seen the least action, even though the EU and the US could achieve welfare gains if they actively sought mutual recognition of their respective regulatory frameworks. It has been estimated that full transatlantic financial market integration could reduce transactions costs by 60% and raise trading volume by almost 50%, together resulting in a reduction in the costs of capital of 9% for listed companies¹. It would, of course, also eliminate the duplicative costs that firms with a dual listing incur. Finally, it would help to reduce, if not eliminate home-bias in investors' portfolios, increasing risk-adjusted returns.

Issues for discussion

The guiding principle for transatlantic financial market integration should be a gradual convergence of rules resulting in mutual recognition of equivalence. On that basis, the general principles of home country control and passporting can then be applied.

Accounting standards: Accounting standards are by far the most important issue, not only because of looming deadlines, but more importantly because they constitute a pre-condition for progress on many other issues, such as listing standards. Recognition of equivalence would enable companies to use a single standard in both markets, which would do away with costly reconciliation of accounts. In April 2005, the US presented a "roadmap" for measures that would make recognition of equivalence acceptable to the US by 2009 at the latest. The success of the roadmap hinges on the further progress in the convergence project between IASB and FASB. The EU Commission will have to decide on the equivalence of US-GAAP with IFRS. CESR's advice to the Commission on equivalence considered that US GAAP (as well as Canadian and Japanese accounting standards) was generally equivalent to IFRS, but mentioned a list of "remedies" a US issuer would have to make. Importantly, these remedies could be handled through disclosure, not reconciliation.

Listing: Listing rules, in general, impose comparable obligations on companies in each jurisdiction. In detail, however, requirements can differ substantially, raising the costs of transatlantic listings. Substantial progress has been made in the recent past by including the provisions on equivalent treatment of companies domiciled in third countries in the EU's Prospectus Directive and the Transparency Directive. At the same time, EU companies tapping the US capital market must – in addition to fulfilling EU requirements – comply with the obligations in place in the US, raising the cost of capital for currently more than 300 European companies. As mentioned above, progress on the issue of converging accounting standards appears to be a vital prerequisite with regard to any further efforts towards establishing mutual recognition of listing rules.

Delisting and deregistration: These are of more immediate concern. Convergence should be reached on de-listing rules, so that companies have the option of an efficient market exit, which safeguards investors' interests, while avoiding unpredictable and disproportionate costs and burdens on issuers. A firm that de-lists from the NYSE is still required to fulfil all reporting requirements unless it can prove that the number of US-based shareholders had fallen below 300. Alternative criteria should therefore be sought that would allow European companies to deregister.

¹ Ben Steil, "Building a transatlantic securities market", published by ISMA and the Council on Foreign Relations New York 2002

For instance, trading volumes, when monitored over a suitable period, might be considered a reasonable proxy for the interests of US-based shareholders. The SEC has promised to take action in this area.

Cross-border trading in equities: Whereas EU licensed brokers can directly access US regulated stock-markets, this is not the case for US brokers wanting to trade European shares, because of long-standing US rules, now being looked at as part of a market structure review. Consequently, US investors must pay intermediaries or European companies must produce costly substitutes such as ADRs. (It is noteworthy, though, that European derivatives exchanges have been allowed to provide direct access in the US since 1997.) Having direct access to EU markets would allow US brokers to trade directly on EU stock markets, thereby reducing the need for dual listing by EU firms. Furthermore, market integration would benefit if key regulatory requirements were harmonised, such as those concerning best execution standards, treatment of client assets, the definition of customer groups (retail vs. professional), allocation procedures and research distribution roles.

SEC Registration: Due to strict regulations, dating back more than 60 years, firms are basically required by default to seek SEC registration or stop acting for clients who were for example originally based in the UK but who subsequently relocated to the US. Seeking SEC registration is time consuming and complicated, and the ongoing requirements such as those relating to annual audits are potentially onerous and expensive. In December 2004, the US authorities published new rules relating to hedge funds which we would like to be extended more widely in respect of classifying US clients.

Basel II: Diverging approaches in the EU and the US would hamper the efforts of EU firms with US operations to establish an integrated risk management and to streamline supervisory reporting. Banks therefore advocate a more coordinated approach by banking supervisors towards solving the so-called home-host-issues for internationally active groups, particularly on Pillar II issues.

Fight against financial crime: 2. An understanding along with the US should be achieved that would create legal protection for European banks against applications of Section 319-a USA Patriot Act. Currently, this extraterritorial legal risk threatens, in particular, European banks with business ties to countries and persons that are sanctioned by the US but not by the EU.

The US will only accept EU rules as equivalent, if the EU can credibly show that European regulatory standards and the quality of their enforcement are on the same high level throughout the EU. This is a challenge, given the EU's passport regime and divergent regulatory cultures, but cooperation among regulators via the Lamfalussy committees, CESR, CEBS and CEIOPS is already making a strong contribution in this regard.

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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