

## EPFSF Briefing: EU-US Financial Market Dialogue: challenges and opportunities in the transatlantic financial marketplace

**Summary:** *The general interests of the EU and US are served by open and well-supervised global financial markets, as are the interests of issuers, investors and intermediaries. Since its launch in 2002 the informal EU-US Financial Markets Regulatory Dialogue has been successful in resolving differences in a number of areas and has become more effective in opening up markets. Recent solutions achieved in the areas of de-registration of issuers from the SEC, application of Sarbanes-Oxley rules and the Road Maps on IFRS/GAAP convergence and audit oversight are encouraging. Some see the Dialogue at a turning point because of recent developments including: the start of a critical process until 2009 by which the equivalence of both accounting and auditing need to be determined; the momentum for regulatory change in the US; the German Presidency's "New Economic Partnership" initiative; market developments including proposed transatlantic mergers which give impetus to transatlantic cooperation; and the prospect of an SEC proposal for mutual recognition (based on "substituted compliance" for exchanges and broker-dealers). These developments may bring about changes in the dialogue.*

### Introduction

The EU and the US have a clear mutual benefit in deepening their economic partnership. Established in 2002, the EU-US Financial Markets Regulatory Dialogue (henceforth 'the Dialogue') is an informal framework of communication, aimed at enhancing cooperation between the EU and US policymakers in the area of financial markets regulation through a continuous update on developments and exchanges of views. The Dialogue has brought together senior level officials from the main institutions involved, principally the European Commission and the US Treasury (supported by US securities, banking and insurance regulators) on a regular basis. It has been complemented by links between the European Parliament and US Congress; the Committee of European Securities Regulators (CESR) and the SEC; CESR and the Commodity Futures Trading Commission (CFTC); the Committee of European Banking Supervisors (CEBS)-Federal Reserve; the execution of specific bilateral and multilateral MOUs among the supervisors involved;<sup>1</sup> as well as industry-led initiatives aimed at fostering regulatory dialogue<sup>2</sup>.

Any assessment of the success of the Dialogue should not concentrate only on areas where there have been agreed resolutions to problems, but also consider the benefits from enhanced mutual understanding. The Dialogue has indeed been successful in resolving problems related to (a) the regulation of financial conglomerates; (b) the de-registration of foreign companies; and (c) the application of the Sarbanes-Oxley Act rules to certain companies. While the Dialogue helped prevent some other problems from emerging through a steady stream of communication, and has contributed to identifying and deepening knowledge of the issues faced by (d) Basel II implementation; in areas such as (e) International Financial Reporting Standards (IFRS) / Generally Accepted Accounting Principles (GAAP) convergence and "on the ground" regulatory harmonisation has been more limited. Further details are set out in Annex 1.

A number of recent developments may signal a turning point in the economic relationship between the EU and the US and may influence the future and pace of the Dialogue. On the US side, initial concerns that the election of a new Congress might usher in a period of protectionism gave way to a momentum for regulatory change and hopes for greater liberalisation, not least influenced by reports in November 2006<sup>3</sup>, January 2007<sup>4</sup> and March 2007<sup>5</sup> from various sides which in different and complementary ways pointed to the need to regain the competitiveness of the US markets among others through regulatory reform involving a more principles-based approach that would facilitate international convergence. Another significant new development is the prospect of an SEC proposal for mutual recognition for non-US exchanges and broker-dealers which, if proposed and adopted under certain conditions, could fundamentally alter the context of regulatory convergence. On the EU side, the German Presidency launched the so-called "New Economic Partnership" initiative ("NEP") in January 2007, seeking to build a structured political framework with specific guidelines and targets in numerous sectors of the economy including finance. Underpinning these changes is a series of market developments - above all proposed transatlantic mergers - which gives impetus to the need for transatlantic cooperation.

In addition to the issues covered by the Dialogue, two additional themes relate directly to the integration process of financial services across the Atlantic:

#### **(i) Transatlantic mergers**

In the recent past years the pace of economic globalisation has quickened, with more than 900 big EU-US mergers having been approved over the last few years. In the financial industry, most big players are already global players. Mergers can be a vehicle to enter a new market, as demonstrated by a number of recent entrants to US markets. Moreover, exchange consolidation, driven by economies of scale which can provide strong user efficiency gains, has crossed the Atlantic. The imminent merger of Euronext and NYSE is a first of its kind and has received significant attention from the industry and politicians. More broadly, the prospect of further exchange consolidation has fostered a call for greater regulatory convergence across the Atlantic.<sup>6</sup> Constructive dialogue between policy makers and the industry participants will be crucial to reduce the risk of regulatory spill-over in this regard and mitigate the likely adverse consequences.

There are, however, some regulatory and policy aspects of merged transatlantic entities - such as the transfer of confidential information, the effect of the US Patriot Act and the EU Takeover Directive - on which a common understanding from the Dialogue could bring benefits. Moreover, progress towards regulatory convergence and mutual recognition could improve the operation of market forces and increase the potential magnitude of merger benefits.

#### **(ii) Mutual recognition across the Atlantic – An emerging reality?**

Access by foreign broker-dealers and exchanges to the US derivatives markets has been facilitated by a special regime operated by the CFTC since 1996 and which amounts to mutual recognition based on supervisory cooperation and trust.<sup>7</sup> This regime went through a public review process in 2006, which confirmed that it constituted a coherent and well-designed approach that should continue in the future. By contrast, access of either type of entity to the cash markets subject to the SEC requires full SEC registration, dissuading European broker-dealers and exchanges, already subject to supervision in their home jurisdictions, from offering access to their services in the US.<sup>8</sup>

In December 2006, two senior officials from the SEC's Office of International Affairs published an article outlining a possible new approach. This would permit the SEC to exempt foreign exchanges and foreign broker-dealers from US securities regulation if the SEC determined they were subject to 'comparable' home-country regulation, provided that the SEC has entered into a bilateral information-sharing agreement with the foreign regulator. The bilateral agreement would be predicated upon a reciprocal treatment by the foreign regulator of US exchanges and US broker-dealers. While this is not an SEC proposal, it is being discussed publicly and it has been suggested that it could become a formal proposal during 2007. The concept was also endorsed in the recent US Chamber of Commerce report. A number of issues need to be discussed, including: the scope of the process, the application of US anti-fraud provisions, the assessment of 'comparability', the application of the reciprocity rule and the involvement of interested parties, including the financial services industry.

#### **Conclusion and Next Steps**

The short-term steps to watch include the 30 April Summit, the visit by the Parliament to the US in July, and the G7 and G8 meetings this year. The launch of the NEP could inject a greater degree of formality to the Dialogue, which would be positive by way of strengthening the political commitment and accountability, but could risk taking away the informality and 'natural' pace of the Dialogue as well as limiting its scope. In the longer term, possible reforms in the US of regulatory processes and arrangements and the further maturing of the broad network of supervisors in Europe could make it easier for the EU and US to work together. The period until the end of 2008, the deadline for both accounting and auditing, will be an important test of the Dialogue. Finally, the potential SEC actions could open up a new chapter by putting the logical next step of mutual recognition on the horizon of this long-standing relationship. The involvement of the industry remains important in this process (including the continuity of the industry's EU-US Coalition on Transatlantic Regulation), as does the need to keep in mind the global context of the Dialogue, in particular emerging markets such as China and India. Even more critically, the commercial, capital-raising and savings and investments benefits that should flow from a more open and coherently regulated transatlantic marketplace are at least as important as the improvements in regulatory practice that will be sought by the regulatory authorities.

## ANNEX 1

An overview of the current state of affairs in the main issues covered by the Dialogue is set out below:

**(a) Accounting**

Accounting emerged as an early area of potential difficulty in the transatlantic relationship in 2004 following the implementation of the IFRS in Europe but not in the US (although the US had actively shaped the IFRS through its participation in the IASB). Despite the European Commission's close cooperation with international authorities<sup>9</sup> and work towards easing the burden on 3<sup>rd</sup> country issuers subject to GAAP (which involved CESR's advice on the equivalence of US, Canadian and Japanese GAAP with IAS), an impasse of several years ensued during which significant numbers of listed companies subject to IFRS and 3<sup>rd</sup> country (including, but not only, US) GAAP faced uncertainty and, in some cases, sought to de-list to avoid the cost of reconciliation. A temporary solution was reached at the end of 2006 (a month before the effectiveness date of IFRS to such companies) when the European Commission extended by two years the transitional exemption granted to foreign companies presenting financial statements prepared in accordance with national accounting standards for the issuing of securities on EU exchanges (provided that these standards fulfil a number of conditions and the concerned authorities are engaged in the process of convergence). During the transitional period, the Parliament will be regularly briefed.<sup>10</sup> Postponing the equivalence decision aligns the EU timetable with that of the SEC, which has reiterated its commitment to working towards eliminating the need for reconciliation between IFRS and US GAAP and has published together with CESR a "Roadmap" to achieve this objective by 2009. Elimination of the SEC's reconciliation requirement by 2009 at the latest is extremely important since it is costly and an operational risk, with no offsetting benefits. In the absence of this, any future postponement of the EU application of IFRS to US companies would represent a severe setback on this issue.

**(b) Auditing**

The need for cooperation is perhaps nowhere more evident than in auditing, which is an increasingly global market. In principle the auditing timetable of the EU<sup>11</sup> follows that of accounting, with 2009 being the deadline for reaching a decision on equivalence set out in the Directive on Statutory Audit of 2006, which applies both to EU and non-EU auditors and requires 3<sup>rd</sup> country audit firms to register in each EU Member State where their clients' securities are admitted to trading. Paralleling the IFRS process, the text establishes a mechanism for the introduction of International Standards on Auditing (IAS) in the EU. Given the transposition deadline of June 2008, the Commission is consulting on how to supervise 3<sup>rd</sup> country auditors, how to assess equivalence and how to coordinate the registration procedures for such firms among EU Member States. The establishment of audit oversight bodies across Europe, along with the evolution of the newly established European Group of Auditors Oversight Bodies (EGAOB) into a European body which can be a counterpart to the US Public Company Accounting Oversight Board (PCAOB), will facilitate cooperation with the US. During the transition period, 3<sup>rd</sup> country audit firms that cannot yet benefit from equivalence can continue to use auditing standards such as US Generally Accepted Auditing Standards (GAAS) and ISAs. Finally, in March 2007, the European Commission and PCAOB agreed to work together on a "Road map" to assess the equivalence of the two audit oversight systems.

The European Commission is also consulting on the possibility of limiting the liability of auditors under certain conditions with the aim, inter alia, of reducing the risk of the disappearance of international audit networks due to insufficient commercial insurance coverage. This is a type of reform advocated in the US by the Report of the US Chamber of Commerce.

**(c) Corporate Governance**

Over the last few years, the EU and US have followed different approaches to achieve their shared goal of attaining high standards for corporate governance. In Europe, Member States have adopted a mix of principle-based and rule-based approaches. While certain aspects of corporate governance such as auditing and accounting standards and take-over rules are governed by EU law, other aspects, such as board independence, have been treated with a soft law (recommendation) approach.

The Sarbanes-Oxley Act reflects the peculiarities of the US environment such as the share ownership structure (a substantial retail shareholder base), and the continuing impact of high profile recent cases. Section 404 of the Act, which requires management and auditors to attest to the effectiveness

of an issuer's internal controls, has been at the centre of the debate, criticised by many as overly formalistic and costly. The SEC delayed the application of a certain part of the Act to foreign companies and recently proposed a package of improvements to streamline the implementation of Section 404.<sup>12</sup> Looking further ahead, European companies listed in the US might be able to benefit from a further reform in the form of greater flexibility in the implementation of the Act to be effected by the SEC, as advocated by the three reports mentioned.

Finally, the EU's initiatives to strengthen shareholder rights (in the form of the Directive on the exercise of voting rights by shareholders of companies) could form an important element of convergence with the US as the latter starts to increase its reliance on shareholder rights for effective investor protection and corporate governance (as opposed to the regulation of the companies and litigation). The Report of the Committee on Capital Markets Regulation singled out the weakness of shareholder rights in the US as being at the root of the excessive recourse to litigation. Speaking at a conference in Spain last month, the SEC Commissioner Roel C. Campos<sup>13</sup> outlined possible areas in which the SEC might work to strengthen shareholder rights.<sup>14</sup> The Dialogue would provide a useful way for the US to learn from the EU experience in this area.

#### **(d) Basel II**

During the latest visit of Commissioner McCreevy to the US in March 2007, the Federal Reserve stated publicly that the US would go ahead with the implementation of Basel II. Nonetheless, convergence could be endangered by the choices embedded in the US's Notice of Proposed Rulemaking on Basel II implementation, which differ in some respects from the Basel Accord and the choices made in Europe (though some European choices also diverge from the Basel Accord). The current proposal would appear to force EU institutions with subsidiaries in the US to implement dual systems to address differing technical requirements. Particular concerns relate to the changes made in the US to the metrics of the Accord (the definition of default and the risk parameters) – the implication for reporting burdens is particularly wide because the US are proposing that although any bank or Bank Holding Company (whether foreign owned or domestic) that is defined as a core bank would not be required to meet the minimum capital ratios, it would be required to compute and report its capital ratios in accordance with the advanced approaches, and make the required public and regulatory disclosures (i.e. Pillar 3 disclosures). This US decision widens the scope of dual reporting burdens for EU and US global groups which will be created if the US takes a different approach to definitions from that of the EU; and the gap year (the implementation in the US is being postponed until 2008, which may result in regulatory arbitrage, though some US firms believe that the advantage will rest with European firms).

Under the Basel rules regarding partial roll out, if a firm is (on a consolidated basis) using the advanced approaches, then its subsidiaries will be obliged to adopt advanced approaches in any case, unless they are eligible under the immateriality clause. It will be a different matter for EU firms who do not wish to be on advanced approaches on a consolidated level but who have US subsidiaries as there remains a debate on whether non-advanced approaches will be available in the US.

#### **(e) European private issuer de-registration from the SEC**

The debate on "de-registration" (the process for 3<sup>rd</sup> country companies ending their SEC registration, and subsequently their obligations such as Sarbanes-Oxley) goes back to 2004, when the European companies first made their concerns known to the SEC, and has been a central theme in the Dialogue since then. On 21 March 2007, the SEC adopted its final rule, to be applicable from June 2007. The decision is broadly seen as resolving the difficulties faced by European companies by incorporating many of the major criteria demanded by these companies at the start of the process. The Commission is currently reviewing the text to ensure that all comments have been taken into account.

#### **(f) CRAs**

Due to the strong international dimension of credit ratings, policy developments on credit rating agencies (CRAs) have been led by IOSCO, culminating in the December 2004 IOSCO Code of Conduct on CRAs. Since 2002, CRAs have continuously featured on the agenda of the Dialogue and the dialogue between CESR and SEC. These talks have aimed at ensuring that US and EU policy initiatives on CRAs are compatible and consistent with international initiatives agreed at IOSCO.

(g) Reinsurance Collateral

The US credit for reinsurance model law, currently reflected in individual States' laws, is highly discriminatory. It provides that US cedants may take full solvency credit for reinsurance purchased from US accredited reinsurers, but denies any credit for reinsurance purchased from non-US reinsurers, whatever the non-US reinsurers' financial strength, rating, quality of home state regulatory system, or claims-payment record in the US. Such non-US reinsurers are required to collateralise their outstanding US liabilities on a gross basis in the US, leading to significant over-funding of liabilities and substantial costs. EU Member States do not operate an equivalent discriminatory system in respect of US reinsurers trading into the EU.

After several years of discussion of this issue, the National Association of Insurance Commissioners began the process of developing a possible proposal to reform the US credit for reinsurance model law last year but its initial proposal, though it would reduce collateral requirements for highly rated non-US reinsurers, continues to treat US reinsurers more favourably. This approach breaches the principle of equal treatment favoured and advocated by the EU and the European reinsurance industry. There are still several major procedural steps to be negotiated before any change to NAIC law can occur and it is too early to predict whether there will be sufficient support for reform amongst the NAIC membership, let alone whether all States will then implement any changed model law into individual States' laws. This issue is a regular item on the EU/US regulatory dialogue agenda where the EU continually presses the US to reform its discriminatory law as soon as possible.

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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<sup>1</sup> The contacts between CESR and the SEC should be seen in the broader context of cooperation among global securities regulators and the multilateral and bilateral memoranda of understanding and exchange of information. Foremost among these is the IOSCO Multilateral Memorandum of Understanding (MoU) Concerning Consultation and Cooperation and the Exchange of Information of 2002, which facilitates oversight and enforcement through the collection and exchange of information across borders. All IOSCO members are required to become full signatories to the MOU by January 1, 2010. Moreover, IOSCO standards aimed at setting global standards cover a broad range of areas including the responsibilities of national market regulators, issuers, SROs, investment companies.

<sup>2</sup> Examples of these include initiatives by the EBF, ESG and the EU-US Coalition on Financial Regulation, a transatlantic industry group of eight trade bodies which produced a major report on industry priorities for the dialogue and included a comparative analysis of the rules of France, Germany, Spain, the UK and the SEC and CFTC.

<sup>3</sup> The Committee on Capital Markets Regulation, co-chaired by Glenn Hubbard (Dean of the Columbia Business School) and John L. Thornton (Chairman of the Brookings Institution), was set up in September 2006 and issued an interim report in November 2006 focusing on equity capital markets. During the next two years, the Committee will continue to explore issues affecting other aspects of the competitiveness of US capital markets. Among others, the Committee noted: "The United States is losing its leading competitive position as compared to stock markets and financial centers abroad. As measured by value of IPOs, the US share declined from 50 percent in 2000 to 5 percent in 2005. Measured by number of IPOs, the decline is from 37 percent in 2000 to 10 percent in 2005".

<sup>4</sup> In the preface of the study "Sustaining New York's and the US' Global Financial Services Leadership," Michael R. Bloomberg, Mayor of New York City, and Charles E. Schumer, New York State Senator, state: "(...) our regulatory framework is a thicket of complicated rules, rather than a streamlined set of commonly understood principles, as is the case in the United Kingdom and elsewhere. The flawed implementation of the 2002 Sarbanes-Oxley Act (SOX), which produced far heavier costs than expected, has only aggravated the situation, as has the continued requirement that foreign companies conform to U.S. accounting standards rather than the widely accepted – many would say superior – international standards. The time has come not only to re-examine implementation of SOX, but also to undertake broader reforms, using a principles based approach to eliminate duplication and inefficiencies in our regulatory system."

<sup>5</sup> "Commission on the Regulation of U.S. Capital Markets in the 21st Century," established by the U.S. Chamber of Commerce, recommends, among others, giving the SEC "the flexibility to address issues relating to the implementation of the Sarbanes-Oxley Act of 2002 (SOX) by making it part of the Securities Exchange Act of 1934."

<sup>6</sup> The Committee on Capital Markets Regulation stated: "Distinctions based on geographical trading venues are at best an adequate stopgap measure, but face challenges over time. The full benefits of global exchange mergers will occur when trading platforms are fully integrated based on computer technology. When this integration happens, trades will not take place in New York or London or Paris. They will take place on a satellite over the Atlantic Ocean. What home-country regulator will be responsible for, and what home-country laws will apply to, those trades? Effectively governing these trades on globally-merged exchanges will ultimately require cooperation among international regulators to produce harmonized trading rules, coordinated to assure consistency with the standards and laws of the involved national regulators. Achieving harmonized rules will be easier to the extent that rules are principles-based. Yet, reaching these harmonized rules will require compromise and cooperation. The U.S. regulator (or for that matter, any regulator) cannot impose its rules on others. Cooperation will not be easy, because national regulators are, after all, national, subject to national political oversight and pressures. But failure to produce harmonized trading rules and integrated trading platforms will deny much of the benefit of globalized exchanges. Here again, the President's Working Group can produce energy and focus for this task, which will require leadership and hard work. The Committee urges the Working Group to make the task of international coordination and rule harmonization a major priority."

<sup>7</sup> The CFTC's practice of issuing no-action letters to allow foreign boards of trade (FBOTs) to make their products available in the US (complemented by the Part 30 regime for the foreign intermediaries) is based on the principle of mutual recognition and equivalence and was reconfirmed after a CFTC review prompted by the listing by ICE Futures in London of the US WTI oil contract.

<sup>8</sup> In December 2006, two senior officials from the SEC's Office of International Affairs (Ethiopia Tafara, Director, and Robert J. Peterson, General Counsel) published a joint article entitled "A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework". Under the Tafara-Peterson proposal, the SEC would exempt foreign exchanges and foreign broker-dealers from U.S. securities regulation if the SEC determines they are subject to comparable home-country regulation, provided that the SEC has entered into a bilateral information-sharing agreement with the foreign regulator. The bilateral agreement would be predicated upon a reciprocal treatment by the foreign regulator of US exchanges and US broker-dealers.

<sup>9</sup> In its work towards improving the quality, comparability and transparency of the financial information provided by companies and ensuring the compatibility between the Accounting Directives and IFRS, the European Commission seeks to cooperate with international bodies such as International Accounting Standards Board (IASB), International Federation of Accountants (IFAC), OECD, World Bank and UNCTAD.

<sup>10</sup> In early February 2007, the European Commission appointed the seven members of the "Standards Advice Review Group", whose task is to advise the Commission on the endorsement process of IFRS and the International Financial Reporting Committee Interpretations (IFRICs). The Group will assess whether the European Financial Reporting Advisory Group's (EFRAG) opinions on endorsement of IFRS and IFRICs are "well-balanced and objective". This appointment is the last step in setting up an independent advisory group on accounting, on which the Commission decided in July 2006.

<sup>11</sup> The European Commission's work in this area focuses on the independence of audit firms, public oversight of auditors, international standards on auditing, and co-operation with 3rd countries.

<sup>12</sup> The SEC delayed the auditor attestation requirement for foreign "accelerated" filers to July 2007 and the deadline for all (foreign and US) "non-accelerated" filers to December 2007 and December 2008 for the management report and the auditor evaluation. Moreover, the SEC and the PCAOB proposed a package of improvements in late December 2006 aimed at resolving the implementation problems of Section 404 of the Sarbanes-Oxley Act.

<sup>13</sup> CNMV Corporate Governance and Securities Markets, 8<sup>th</sup> February 2007.

<sup>14</sup> He listed the following areas as important: Intermediaries voting transparency obligations; Board Member independence; easy access to remediation of violations (Director's liability); management deals transparency; management compensation controls; and shareholder access (the ability of shareholders to nominate candidates for director).