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on the U.S.-E.U. Financial Markets Dialogue

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Chairman Oxley, Ranking Member Frank, and distinguished members of the Committee. Thank you for permitting me to testify today on matters relating to the informal U.S.-E.U. Financial Markets Regulatory Dialogue. I am the Nomura Professor of International Financial Systems at Harvard Law School. I will be reading a statement prepared by myself and Kenneth Dam, the Max Pam Professor of Law at the University of Chicago Law School and Senior Fellow at the Brookings Institution, and formerly Deputy Secretary of the Treasury.

Our testimony begins with an assessment of the effectiveness of the Dialogue. While the Dialogue has made a significant contribution to better relations with the E.U., it has failed to resolve the most important issue confronting the two markets, whether or not the U.S., like the E.U., will accept international accounting standards. We also believe the Dialogue should be more proactive in removing obstacles to the development of an efficient Trans-Atlantic Market in Financial Services; its role should not be limited to fire fighting. Finally, we believe that the Dialogue needs to include additional government participants and to become more transparent.

Many of the ideas in this testimony are based on Statement No. 203 of the Shadow Financial Regulatory Committee of February 9, 2004, entitled "Toward a Single Trans-Atlantic Market in Financial Services," a copy of which is appended to this statement.

Effectiveness

The Dialogue process began in March 2002, and now takes place on more or less a quarterly basis. On the U.S. side, the Treasury has taken the lead with the Federal Reserve and the Securities and Exchange Commission (SEC) also participating. The E.U. Commission is the sole interlocutor for the E.U. Commissioner Bolkestein and Alexander Schaub, Director-

General for the Internal Market and Financial Services, have been the key E.U. participants.

The most successful result of the Dialogue has been to temper the application of Sarbanes-Oxley to foreign firms, some of which had great difficulty in simultaneously complying with the new Act and their own laws. The SEC sought to accommodate these firms by adopting a flexible approach to the Act's requirements. For example, countries like Germany requires half of its supervisory board, which oversees the auditors), to be composed of labor representatives. The SEC allowed German companies to meet the Sarbanes-Oxley auditor independence requirements, even though such employees would not be considered independent in the U.S. In fact, it was the SEC itself, working with the E.U., member states and E.U. firms, which implemented these changes. The Dialogue had no formal role in the regulatory process. However, we believe the presence of the Treasury's broad perspective on U.S.-E.U. relations and its deep concern with the health and efficiency of capital markets, may have contributed to the willingness of the SEC to react sympathetically to E.U. concerns. Absent more formal regulatory consolidation in the U.S., the Dialogue serves a useful purpose in coordinating U.S. policy. In this sense, the Dialogue is as much an internal process among U.S. regulators as it is an external process with the E.U.

The Dialogue has also played an important role in addressing issues created by the E.U's proposed Financial Conglomerates Directive. This proposal would subject U.S. holding companies with operations in the E.U. to E.U. regulation unless these holding companies were subject to "equivalent" U.S. regulation. Conglomerates by their very nature cut across different financial activities–banking, securities and insurance. Both the Federal Reserve and the SEC had a direct concern about whether their own holding company regulations (newly adopted in the

case of the SEC) met the equivalence test. It is very useful for different functional U.S. regulators to discuss these issues among themselves, as well as with the E.U.

We believe the Dialogue has been less important in dealing with issues addressed in international fora, like issues arising out of the new generation of bank capital standards (Basel II) formulated by the Basel Committee on Banking Supervision. The U.S. through the Federal Reserve and the Treasury's Office of the Comptroller of the Currency, has had full participation in the formulation of these standards. The U.S. has decided to implement Basel II only for the most sophisticated and international U.S. banks, even though the E.U. plans to apply Basel II to all of its banks. While this has generated some tension between the U.S. and E.U. representatives on the Basel Committee, it is unlikely that the Dialogue can do much to change the outcome already agreed to by the Treasury and the Reserve Board.

The most noteworthy shortcoming of the Dialogue is its failure to resolve a potential crisis that may be precipitated by the E.U.'s anticipated adoption of international accounting standards (IAS) in 2005. Currently, under SEC regulations, foreign firms may only issue securities or have their securities traded in the U.S. public markets if such firms either state their accounts in or reconcile their accounts to U.S. GAAP. Absent a change in SEC policy, E.U. firms which state their accounts in IAS will be unable to access the U.S. public market. This could lead the E.U. to take the position that U.S. firms could no longer use U.S. GAAP in the E.U. market. This could have a severe effect on U.S. firms issuing capital abroad and further increase the segmentation between the U.S. and E.U markets. This is an important issue that must be resolved.

This is not the occasion for a full examination of whether the SEC should permit foreign

firms to use IAS. Suffice it to say that we believe it should because: (1) there is no evidence that U.S. GAAP is a better accounting standard than IAS; (2) IAS are by definition international, administered by an organization that the U.S. took a significant role in creating and consisting of standards that U.S. helped formulate; (3) IAS and U.S. GAAP are not that far apart, and the FASB-IASB Convergence Project has reduced the differences; (4) maintaining the requirement for U.S. GAAP in the U.S. does not necessarily increase investor protection since U.S. investors are forced to buy foreign securities abroad in less regulated markets; and (5) U.S. public trading venues will lose important sources of revenue as a result of the fact that the trading of unregistered foreign securities will only take place abroad.

In the case of Sarbanes-Oxley, the U.S. Treasury may well have served to broaden the SEC's perspective. In the case of accounting standards, it is not even clear what the Treasury's perspective is. If the Treasury favors permitting IAS in the U.S. it has yet to persuade the SEC. The year 2005 is just around the corner. This is an issue to which this Committee needs to give special attention.

A Broader Initiative

As the Shadow Financial Regulatory Committee stated in February, we believe the Dialogue should be broadened beyond solving particular problems, to embracing the positive agenda of creating a single Trans-Atlantic Market in Financial Services. The goal of this effort would be to remove barriers to cross-border transactions, particularly in capital markets where significant barriers remain.

The Trans-Atlantic Market in Financial Services is currently divided by different disclosure rules, not only with respect to accounting standards. While U.S. and E.U. adoption of

basic disclosure rules of the International Organization of Securities Commissioners (IOSCO) have helped breach the gap, significant differences remain with respect to complicated disclosure issues like management predictions, or what securities lawyers call forward-looking statements. The difference between E.U. and U.S. disclosure requirements is further complicated by the multiplicity of disclosure rules within the E.U. Under existing law, the E.U. allows an issuer to issue its securities throughout the E.U. under the disclosure rules of its home country–the single passport system. The E.U. is now rejecting this approach because it did not work–only Deutsche Telecom has used the home-country system to make a pan-E.U. securities offering. The single passport system failed to work because, in fact, host countries were still permitted to impose additional disclosure requirements to meet the particular needs of their investors, e.g. tax effect of the offering, and because of the need to translate offering documents into the language of each host country. The E.U. is now in the process of adopting a Common Prospectus and a common approach to continuous disclosure through two new Directives. Further, it has created a new body, the Committee of European Securities Regulators (CESR) to facilitate these efforts. The SEC should start working with the CESR to harmonize disclosure rules so that the two sides could develop a common Trans-Atlantic prospectus and ongoing disclosure rules.

There is also much to be done in creating common distribution rules, with respect to matters like the use of research reports during public offerings and requirements for the delivery of prospectuses. One should also look at the new initiatives in the U.S. and E.U. on market structure. Given the increasing internationalization of the trading in securities markets, we should be looking at market structure from an international perspective. There is also need for further thinking on ways to resolve enforcement differences between the two sides of the

Atlantic. A joint SEC-CESR committee could also work on these matters. We commend the SEC for beginning to take steps in meeting with CESR but much more needs to be done.

Principles

In our view, an effective Trans-Atlantic Market in Financial Services would be best achieved through common regulatory rules and enforcement throughout the U.S. and E.U. While this might forestall regulatory competition, which can restrain regulatory excess and lead to innovation, these theoretical benefits are more than outweighed by the cost savings and efficiencies achievable by common rules. The two sides of the Atlantic can still compete over ideas for what common rules we should have, and how they should be changed over time. Common rules will take time to achieve but we must make this a priority and start serious efforts at convergence now.

We do not believe the "equivalence" alternative offered by the E.U. is workable for rules pertaining to the offering of securities.. The equivalence approach would require the U.S. to allow E.U. firms to offer securities in the U.S. under E.U. rules (which include the rules of various member states as well as the E.U.'s own rules). As we have pointed out, this home country approach for securities offerings has not even worked within the E.U. , and is in the process of being replaced by harmonized rules in the form of the Common Prospectus.

There is a place for the equivalence principle, but it is in the regulation of firms and not transactions like securities offerings. The U.S. currently uses a type of equivalence test with respect to the operation of U.S. branches of foreign banks in the U.S. We permit a foreign bank to establish and operate a branch in the U.S. if the bank is subject to "effective" consolidated supervision in its home country, even though such supervision may be different in content and

approach to our own. The Federal Reserve has developed a methodology to assess the effectiveness of foreign supervision. Similarly, an equivalence test has been used for holding company regulation, as under the E.U. Financial Conglomerates Directive. We further note that the Public Company Accounting Oversight Board (PCAOB) will permit a foreign audit firm to rely on its home country inspection, without the need for additional U.S. inspection, depending on the independence and rigor of the home inspection. Again, the foreign regulatory approach need not be identical; it must be equivalent in the sense of meeting U.S. standards.

The equivalence test as applied to regulation of firms is workable because there are ways to measure whether the foreign regulatory approach is equivalent. Regulation of firms is principally aimed at insuring their safety and soundness and avoiding their failure. One can measure failure rates. In the case of audit firms one can make an assessment as to whether the foreign inspectors have a means to determine whether the auditors they inspect are independent and rigorous.

Transaction requirements pertain to the rules for offering securities, whether they relate to disclosure, methods of distribution or enforcement. These transaction requirements are driven by investor protection concerns. How does one measure or even begin determining whether a particular disclosure rule of the E.U. is the equivalent of our own in protecting investors? We believe convergence is the proper approach for transaction requirements.

Process

We conclude with a few thoughts on process. We believe, as does the Shadow Financial Regulatory Committee, that at some stage of the Dialogue there will need to be more structured governmental participation on both sides of the Atlantic. The U.S. and E.U. should consider

including the Commodities Futures and Trading Commission (CFTC) and state insurance commissioners on the U.S. side. The E.U. is increasing its focus on insurance and reinsurance regulation and the U.S. needs to provide input from its side. The E.U. also needs to have some member state representation. While E.U. financial regulation is significant, many important areas, like enforcement, are still left to member states. We should also consider whether this should be a U.S.-E.U. Dialogue or a U.S.-Europe Dialogue. If it is the latter, states like Switzerland, and even Russia, may need to be included in some fashion.

Toward a Single Transatlantic Market in Financial Services

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For several years the U.S. government has carried on an Informal Financial Markets Dialogue with the European Commission in order to narrow the differences between the different financial regulatory systems. The Shadow Financial Regulatory Committee believes that the time has come to consider the issues in a broader context: what would be required for the development of a single Trans-Atlantic market in financial services. Further, it is time to consider whether the present regulatory approaches make sense in a 21st century economy.

On the U.S. side, the Treasury has taken the lead in cooperation with the Securities and Exchange Commission (SEC) and the Federal Reserve, even though some of the issues involve other regulators. On the European side, the Commission has carried on the Dialogue without participation by member country regulatory authorities. As the name implies, the Dialogue is informal, with public disclosure limited to occasional speeches and fact sheets. Similarly, consultation with and advice from the private financial sector have also been informal.

Although the individual issues are well known to the private firms directly involved, the public policy dialogue has necessarily been limited. The Committee believes that the issues being discussed in this Dialogue are of importance not just to the financial services industry, but also to the U.S. and European economies more broadly. Although the governmental institutions and individuals involved are well informed and well motivated, we believe that the visibility of the issues under discussion needs to be raised but also to the U.S. and European economies more broadly. Although the governmental institutions and individuals involved are well informed and well motivated, we believe that the visibility of the issues under discussion should be raised.

The present Dialogue takes the substance of the existing regulatory schemes as given without conducting any cost-benefit analysis to determine whether particular regulations, either on the U.S. or the EU side, make sense in a 21st century economy. We believe that higher goals and broader economic examination of the underlying issues would be desirable.

From the standpoint of goals, the vision of a single Trans-Atlantic market in financial services will help to raise our sights and thereby the quality of the results. The economic benefits of recent financial innovation and transformation have been limited by outmoded regulation. And the costs of complying with the divergences among jurisdictions have been borne by private firms with predictable consequences for economic efficiency. We believe that the goal of a single Trans-Atlantic market in financial services, as well as the adoption of principles to resolve differences, would provide a framework for faster progress and greater achievement.

What follows is a summary of some of the key regulatory issues that confront the Dialogue, as well as a consideration of some principles that might guide agreement, and questions of process.

Some Regulatory Issues

First is the 2002 Sarbanes-Oxley Act, which extended new rules of governance to foreign firms whose securities trade in public markets in the United States. While SEC implementation of these rules has accommodated the principal concerns of European issuers, particularly in the area of the need for independent directors on the audit committee, certain issues remain. There is the question as to how the registration and inspection standards of the Public Company Accounting

Oversight Board (PCAOB) will be applied to foreign auditing firms. In addition, Europeans are concerned with the "no exit" feature of U.S. regulation that requires all companies with more than $10 million in assets and more than 300 shareholders to comply with Sarbanes-Oxley even if they were to drop their exchange listings and discourage trading of their securities in the U.S.

Second is the scheduled adoption of International Accounting Standards (IAS) by the EU in 2005, which may prohibit U.S. companies from continuing to issue securities in the EU under U.S. GAAP. It is not even clear whether countries currently trading under U.S. GAAP in Europe will be grandfathered. There is particular concern that the EU may not accommodate U.S. GAAP in the EU if the SEC fails to allow foreign firms to use IAS in issuing securities in the United States. While the Convergence Project undertaken by the Financial Accounting Standards Board and the International Accounting Standards Board is seeking to bring about convergence in the two sets of rules, it is far from certain that this effort will be complete by 2005. Complicating this exercise are important issues concerning which rules are adopted when they differ substantially and the balance between rules and principles.

Third is the divergence of views on the implementation of the Basel II Accord in 2007. The U.S. has indicated that it will apply only these standards to "internationally active" banks. The EU, on the other hand, envisions applying all of the standards to all banks and securities firms in the EU.

Fourth is the question of the effect of the EU's proposed Financial Conglomerates Directive on U.S. securities firms that are currently unregulated at the holding company level. The EU Directive would subject these firms to EU conglomerate regulation unless these firms are subject to "equivalent" U.S. regulation. The SEC has proposed a new form of holding company regulation, which it hopes will satisfy the equivalence test, but this has yet to be decided by the EU.

In addition, there are other areas of concern: different standards for data protection and privacy, the inability of EU stock exchanges to set up trading screens in the United States without being fully subject to U.S. regulation, differences in approaches to electronic trading systems, particularly those involving internalization, and differences in takeover rules.

Principles

If, contrary to our suggestions above, the Dialogue proceeds along its current narrower path, it would be useful to reach agreement on general principles to guide negotiations. Traditionally, the United States has followed the national treatment approach under which foreign firms operating in the United States are fully subject to U.S. rules, such as the requirement that foreign firms file reports using U.S. GAAP and comply with the CEO/CFO financial statement certification requirement of Sarbanes-Oxley. There have also been attempts to harmonize rules in formal ways, Basel II serving as a major example. To a great extent, the EU has adopted still another approach, mutual recognition, within its internal financial market. Mutual recognition requires the host state to recognize the validity of the home state's rules, assuming some minimum level of harmonization. The United States has generally been unwilling to accept mutual recognition principles in dealing with the EU, although it has adopted a mutual recognition system (with some important exceptions) with respect to Canadian firms issuing securities in the United States and to U.S. firms issuing securities in Canada. In addition, the United States has generally accepted home country regulation, albeit as a necessity, with respect to the regulation of foreign banks operating in the U.S. through branches.

Two other principles have been put forward more recently. First, the EU Commission has advocated an equivalence approach, whereby it would accept U.S. regulation that was equivalent to its own, even though the details might be quite different. Indeed, the Financial Conglomerates Directive adopts an equivalence approach. The United States has used the test as well in some areas. For example, foreign mutual funds registering in the United States are exempted from certain features of the Investment Company Act of 1940 if they are subject to equivalent rules abroad. Second, the SEC has advocated a convergence approach, indicating its willingness to accept EU regulation that has converged with but may not be identical to the U.S. rules. How these principles would actually be applied to the issues now under discussion has yet to be determined.

Process

As noted above, the Treasury, the SEC and the Federal Reserve represent the United States, while the European Commission represents the EU, even though other regulators may be consulted. At some stage there will need to be additional, more structured governmental participation on both sides, that would include the CFTC and state insurance commissioners on the U.S. side and key national regulators on the EU side, as well as self-regulatory organizations on both sides of the Atlantic. It will also be necessary to take into account non-EU countries in Europe, principally Switzerland. Discussions among government officials and regulators can result in more regulation as a "compromise". But

less regulation should also be an option in many areas and thus the views of private sector observers as well as the financial community should weigh heavily in the ultimate conclusions of the Dialogue.

Conclusion

The Shadow Committee applauds the efforts of the U.S.-EU Informal Financial Markets Dialogue to narrow the differences between the two financial regulatory systems. At the same time, however, we urge the participants in the Dialogue to raise their sights to achieve the more ambitious goal of developing a single Trans-Atlantic market in financial services. This approach should involve not simply an ad hoc resolution of current regulatory differences, but should involve a careful cost-benefit analysis of each aspect of regulation to ensure that we achieve a financial system that serves the real economy in the most efficient way.

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