

Transatlantic Dialogue on Financial Services

The Stakes in the Transatlantic Dialogue

The importance to the European financial industry of a transatlantic dialogue on financial services is a consequence of the importance of the U.S. financial sector and of the growing integration of markets across the Atlantic. Against this background, the need for a continuous and comprehensive dialogue has been underlined by two recent developments: in Europe, the drive towards market integration across the national borders of member states; and in the U.S., the revival of financial regulatory activity following widespread accounting and governance malpractice in 2001-2002.

A mutually beneficial integration

Traditionally, there has been no symmetry on both sides of the Atlantic in the development of capital markets: the U.S. has benefited for decades from a favourable environment resulting from a large domestic market for products and financial services, a single currency, a strong body of federal legislation, established nationwide regulatory agencies such as the SEC and the Federal Reserve. This led to the development of vibrant capital markets and the emergence of leading global investment banks and other financial services providers. Europe's financial market, however, has long remained fragmented into much smaller units across national boundaries. This has restrained the large-scale development of the financial industry in a number of European countries.

Against this background, the continuous development of cross-Atlantic financial activity has been a key feature of the past decade. This development has affected all aspects of transatlantic activities:

- European issuers have strongly increased their U.S. presence: around 300 EU-based companies list American Depositary Receipts (ADRs) on the NYSE or Nasdaq, and the total number of ADRs listed on U.S. national exchanges has increased threefold between 1995 and 2000¹. This trend has reduced since 2001 due to changing market and regulatory conditions.
- Large investors have diversified their portfolios on both sides of the Atlantic by buying the other side's securities. Foreign ownership of European listed companies has vastly increased throughout the past decade without creating any significant problems of political acceptance. Similarly, the volume of European purchases and sales of U.S. corporate equity increased seven-fold between 1995 and 2000 from \$200m in 1995 to over \$1.4 bn in 2000².
- Major industry players have strengthened their international presence in a competitive marketplace where national borders tend to disappear. Most

¹ Measured in share volume; source: Security Industry Association (2001), Bank of New York

² Source: U.S. Treasury Bulletin, Table CM-V-5

striking has been the leading position of U.S. players in most areas of the capital markets intermediation. For example, U.S.-based companies account for:

- four out of the five top global brokers for international debt issuance³;
- four out of the five top global brokers for equity issuance⁴;
- the five largest global custodians, with a cumulated market share of 63%⁵;
- the two main worldwide credit rating agencies⁶.

While the U.S. holds the lead, Europe comes a clear second as far as financial services are concerned, despite the rise of the Asian economies. In the business areas mentioned above, the top 10 league table include only U.S. and European (including Swiss) companies. Compared with the situation before the bursting of the Japanese stockmarket bubble, European industry leaders have been strengthened by a decade of vibrant transatlantic market activity.

In some markets, the strengthening of Europe's position has been significant. One example is international bond issues: new euro-denominated bond issues now represent roughly the same volume as new dollar-denominated issues, even though the outstanding volume of bonds denominated in US Dollars still remains predominant due to the weight of existing bonds. From January 1999 to August 2003, gross euro-denominated bond issues by governments and international corporations totalled €5,200bn while issues denominated in US dollars totalled \$5,170bn.

More generally, an ample body of research has established that the development of more liquid, deeper and more highly capitalised markets reduce the cost of capital for publicly-listed companies and increase economic growth. Therefore, the growth of transatlantic capital market activity is beneficial for both the U.S. and Europe.

A new context

Since the end of the 1990s, two major events have contributed to a reshaping of transatlantic financial services. In Europe, financial market integration has made considerable progress, thus increasing the openness of European markets to U.S. players; in the U.S., a "regulatory revival" has occurred in the wake of a number of corporate and accounting scandals. This revival affects transatlantic relations.

³ Source: Euromoney (www.euromoney.com), 2003; the only non-U.S. player in the top 5 is Deutsche Bank.

⁴ Source: Euromoney (www.euromoney.com), 2003; the only non-U.S. player in the top 5 is CSFB.

⁵ Source: www.globalcustody.net, 2003

⁶ The third one, Fitch, while French-owned, has its headquarters split between New York and London.

European Market Integration: following the creation of the Euro, the European Union has embarked on a major effort to foster the integration of European capital markets and the creation of a European level playing field in financial services. This effort has been conducted vigorously since 1999 under the leadership of Internal Market Commissioner Frits Bolkestein. The Financial Services Action Plan (FSAP) unveiled in May 1999 and largely implemented since, the decision to endorse International Accounting Standards for all European publicly-listed companies, the decision to implement the so-called Lamfalussy Process, and the recent launch of an Action Plan on Company Law and Corporate Governance (May 2003), are prominent aspects of this endeavour⁷.

The integration of European markets remains mostly limited to wholesale markets and is unfinished in major areas, especially public regulation. Nevertheless, the changes incurred in the last few years have resulted in an opening of Europe's markets. This has benefited U.S. players and more generally led to enhanced interaction between the European and U.S. financial communities.

U.S. Regulatory Revival: the discovery of accounting and corporate governance malpractice in certain large U.S. corporations, starting at the time of Enron's collapse in late 2001, led to a shake-up of financial regulation not seen since the early 1930s. It is not an overstatement to characterize this trend as a "regulatory revival", following the *laissez-faire* attitude predominant during the previous decade.

The Sarbanes-Oxley Act of July 2002 has created a host of new regulations. The SEC's profile, after some turmoil in 2002, has been considerably raised with the appointment of William Donaldson. Its budget has more than doubled as a consequence of Sarbanes-Oxley and subsequent appropriation bills. A new agency, the Public Company Accounting Oversight Board (PCAOB) has been created under the SEC's leadership to oversee the activity of public auditors, and is led by the highly respected William McDonough. The financial research field has been impacted by a \$1.4bn settlement in April 2003 which involved the largest U.S. investment banks. The SEC has started intensive reviews of the role of financial rating agencies, mutual funds, hedge funds and other professions; auditors too may find themselves again in the regulatory limelight. Finally, certain large exchanges have themselves been forced to rework their regulatory processes following the executive-pay scandal which led to the NYSE chairman's resignation. The role of NYSE "specialists", which is at the core of their trading system, has also come under heavy criticism.

This intense regulatory activity is not set to end soon, in spite of concern about red tape. The SEC has newfound ambitions and the resolve to pursue them. A steady flow of headline news on financial malpractice (recent examples include HealthSouth, Freddie Mac and the mutual fund industry) makes strong political opposition to regulatory change unlikely. Moreover, there is some consensus that recent scandals have been detrimental to all market players. The avoidance of

⁷ These plans have been assessed in more detail within Eurofi's Workshop No.1.

similar dysfunction in the future is worth pursuing even at the expense of more public regulation.

The U.S. regulatory revival has led to new transatlantic issues, as several U.S. regulations, e.g. the Sarbanes-Oxley Act, have an effect on all U.S.-listed companies, including those based in Europe, and their public auditors. This is often resented by European players, especially in the wider context of U.S. wariness of multilateral discussions. In the new transatlantic context, growing European openness means that Europe's financial industry is increasingly affected by renewed regulatory activity in the U.S., but is not able to wield much direct influence on it. If left unchecked, this imbalance might lead to a perception of unfairness and to political opposition to the whole process of market opening in Europe.

Therefore, there is a need for a reinforced transatlantic dialogue. In the absence of such dialogue, there is a certain risk of a politically-driven reversal of the European capital markets' trend towards more openness.

Hot Topics for Transatlantic Dialogue: A Quick Review

This is not intended to be a comprehensive analysis of current transatlantic topics regarding financial services, but rather an attempt to highlight some of the most sensitive current issues to illustrate the general need for an active transatlantic dialogue, both at public and private-sector level.

Accounting standards: Endorsement of IAS/IFRS in the United States

Europe's adoption of international accounting standards / international financial reporting standards (IAS/IFRS⁸) is a decision of considerable importance. This plan was floated in 2000 and formally adopted in July 2002. It has been put into practice with the endorsement in September 2003 of all existing IAS except two. The two remaining standards, IAS 32 and 39 on accounting for financial instruments, are still under discussion: the issue of including sight deposits in macro hedging is, in particular, of crucial importance. One can also note the serious reservations of the European insurers to the IASB's projects. In both cases, the European financial industry stresses the systemic risks involved in the IASB's proposals. Nevertheless, in principle from Fiscal Year 2005 on, European publicly-listed companies will report their consolidated financials under IAS/IFRS. A step-by-step extension to non-publicly-listed companies seems likely, although details may vary from one member state to another.

Simultaneously or following Europe's decision to broadly endorse the IAS, there has been a similar momentum for IAS adoption by several other countries, especially Commonwealth countries (Australia, New Zealand, South Africa) and non-EU European countries (Norway, Ukraine, Russia). With those decisions, IAS/IFRS are set to gradually become the predominant reference for public company accounting throughout the developed world. The resulting end of accounting standards

⁸ In spite of the difference in names, IAS/IFRS is a single set of standards: IAS are the standards first adopted before 2001, and IFRS are the ones first adopted after that date.

fragmentation, which made it sometimes quite difficult to compare company accounts from one country to another, is welcomed by capital market participants worldwide as a considerable step forward.

However, there is one significant exception to this process—namely, the United States. The U.S. has hitherto refused to allow reporting under IAS/IFRS by companies listed on its territory, which must report financials under U.S. Generally Accepted Accounting Principles (GAAP) as set by the Financial Accounting Standards Board (FASB), a private-sector group overseen by the SEC.

The official rationale for the U.S. refusal so far to endorse IAS/IFRS is that U.S. GAAP are higher-quality standards which ensure better investor protection. However, recent experience suggests that this rationale is no longer true. The governance of the International Accounting Standards Board (IASB), after extensive reform in 2000-2001, sets a standard for independence from political and industry interests at least equal with FASB. Surveys of investors and corporate executives alike show that the perceived level of quality of IAS/IFRS is as high, if not superior, to the one of U.S. GAAP⁹.

IASB and FASB have formally pledged to do their best efforts towards convergence of their respective sets of accounting standards (“Norwalk agreement”, September 2002) and have started to work on concrete steps towards convergence. However, most observers within the industry think that the success of this policy is bound to be fairly limited in the foreseeable future, as there is no strong incentive for it in the current institutional setting. Moreover, the convergence approach is unsatisfactory from a governance standpoint:

- if the convergence process is mostly one-sided (e.g., if it results in the IASB effectively aligning itself on FASB’s positions, or *vice versa*), it undermines the very independence of one of the two standard-setters;
- if it is more fairly balanced, it means that both standard-setters have to cope with a major constraint which is not in their original mandate. For example, the IASB’s “Constitution” sets an aim of “a single set of high quality, understandable and enforceable global accounting standards” without mentioning as a primary requirement that such standards must be compatible with FASB’s views.

As a result, the parallel objectives of standard-setter independence, high-quality standards and convergence might not prove mutually compatible over time.

⁹ In one specific case at least, stock-options accounting, the IASB has clearly appeared more independent and more in a position to set high-quality standards than the FASB. There is widespread consensus among investors and accounting specialists that granting stock options is an expense and should be reported as such in a company’s income statement. However, FASB’s earlier attempt to require expensing of stock options has been successfully opposed by the U.S. Congress in 1993-94 following intense lobbying by the high-tech industry and various other corporate interests. Even now, after widespread outrage on the abuse of stock options during the technology bubble, FASB has not yet made their expensing an obligation in the U.S. and is waiting for the IASB to adopt an expensing rule first.

The most reasonable solution appears to be for the U.S. to allow (or even require) reporting under IAS/IFRS by companies publicly listed on its exchanges. No serious objection to such a move has been expressed in the public debate. Eurofi therefore hopes that the SEC, which is the key decision maker on accounting standards to be used by publicly-listed companies, will soon evolve from its present position and allow the use of IAS/IFRS as an alternative to U.S. GAAP.

Accounting Standards: IASB working processes

Parallel to the issue of IAS/IFRS adoption in the U.S., Eurofi thinks it necessary to further explore possible improvements in the IASB's working processes.

The quality of the IASB's consultation process draws much criticism from Europe's financial industry. The positive aspect of this process is that it has, in several cases, provoked the industry to work together and to come up with compromise proposals on proposed accounting standards. But the IASB has until now seemed to be less than willing to take full account of its own proposals' likely consequences on segments of the financial services sector and has instead chosen to focus only on issues of accounting doctrine.

Eurofi wishes the IASB to give more substance to its own consultation process and to engage more with the financial industry to have a fuller view of the possible consequences of its proposals. The IASB should also engage more with national governments as some of its proposals may have an impact on some governmental policies.

There is little doubt in Eurofi's view that an improved consultation process and better recognition by the IASB of the impact of proposed accounting standards would improve the likelihood of recognition of IAS/IFRS by the U.S. regulatory authorities as has been suggested above.

In Eurofi's view, it is also in the interest of the IASC Foundation to act on the issue of geographical balance of the IASB's members and to gradually open that membership through appropriate search and selection of highly-skilled candidates in a wide range of countries.

While these are not pure transatlantic issues, they certainly do have an impact on the transatlantic debate on accounting standards, which will probably remain a hot topic of discussion in the years to come.

Remote Access to Securities Trading Platforms ("Trading Screens")

While trade intermediation costs for home participants have been reduced and are now quite low on most developed countries' securities exchanges, this is not true as far as transatlantic activity is concerned. In particular, regulatory constraints in the United States make it difficult and costly for non-U.S. corporations to access its investors' capital. Either U.S. investors must pay multiple redundant intermediaries to

trade these shares on one of Europe's stock exchanges, or the issuing companies must pay lawyers, accountants, and a U.S. exchange to produce costly substitutes (American Depositary Receipts or ADRs) for these shares in the United States¹⁰. Currently, approximately 300 EU-based companies list ADRs in the U.S., of which nearly two third on the NYSE and almost all others on Nasdaq.

A sensible and, in Eurofi's view, perfectly attainable solution to this unsatisfactory situation would be to allow European exchanges to expand access to their electronic trading technology to mature market participants (i.e., brokers and institutional investors) in the U.S. This would allow U.S. investors to buy and sell the actual shares of the companies already listed on European exchanges, more simply and cheaply than they currently buy and sell the substitute ADRs on the NYSE or Nasdaq. Of course, the same possibility would be offered to U.S. exchanges in Europe.

However, the SEC has not seemed to be willing to help on this issue in recent years. Eurofi thinks that an easier and less costly access to Europe's markets would be a net benefit to U.S. investors and to the U.S. economy; a protectionist attitude, in this area as in others, would not be in the U.S.' interest. Europe's players could, and should, build support from a significant U.S. constituency of investors and financial intermediaries in promoting transatlantic access to both continents' exchanges.

This setting already partly exists in the area of futures trading, which in the U.S. is overseen by the Commodity Futures Trading Commission (CFTC) and not the SEC¹¹. There is no apparent reason not to extend it to the markets regulated by the SEC. Of course, any future opening of the U.S. market to EU-based exchanges should be matched by strict reciprocity on the European side.

Oversight of Public Auditors

The Sarbanes-Oxley Act of July 2002 created a new Public Company Accounting Oversight Board (PCAOB) with oversight authority over the auditors of all companies publicly listed in the U.S., national or foreign. As such, the Act empowers the PCAOB to regulate and inspect European auditors of a European company as soon as the latter is U.S.-listed.

This stems from the Congress' legitimate will to protect American investors but might lead, if carelessly implemented, to a perception of blatant unilateralism from the point of view of European players. Some form of recognition of equivalence between the PCAOB and its European counterparts seems necessary to mitigate that perception

¹⁰ This development draws extensively on the report published by the International Securities Markets Association (ISMA) in cooperation with the New-York-based Council on Foreign Relations, *Building a Transatlantic Securities Market*, by Benn Steil, December 2002.

¹¹ Eurex and Euronext.liffe, Europe's leading futures markets, have met some success in their recent expansion into the U.S., which Eurex is currently planning to step up in spite of fierce opposition by Chicago-based futures exchanges.

and avoid the risk of outright reciprocal measures. This topic is currently under active discussion between the EU and the U.S.

Financial Conglomerates Directive (FCD)

In this case, the concern is on the U.S. side as the initiative comes from the EU. The discussion on the FCD proves to be an interesting illustration of the necessity of balanced recognition of regulatory “equivalence”: the EU would waive the supervision requirements on US-based conglomerates if the U.S. adopts a regulation equivalent to the FCD. This topic is a work in progress as the U.S. regulation, christened the “Investment Bank Holding Company Act”, is still in the process of being drafted.

Improving the Dialogue

These topics illustrate the importance of an in-depth, regular and informed flow of information and discussion across the Atlantic on financial services issues.

On a wide range of issues, there is little fundamental difference between the views held by Europe’s policymakers and their counterparts in the U.S. For example, the Sarbanes-Oxley Act of July 2002 has introduced important new policies on public disclosure of internal control processes within listed corporations; on the separation of audit and consulting activities; and on public oversight of the auditing profession. Those three policies, while new in the U.S., are basically uncontroversial in Europe and have been widely adopted there. In France for example, all three are dealt with to some degree in the recently-voted *Loi de Sécurité Financière* (Financial Security Act), although some public oversight of auditors has already existed for several years. Similar provisions have been recently adopted in many EU member states.

One of the main virtues of a transatlantic dialogue is to coordinate initiatives on both sides of the Atlantic, both in terms of timetables (so that market participants have to comply to similar regulatory changes at the same time in both market environments) and of precise content (in order to avoid minor, non-essential discrepancies which add costs to compliance without improving investor protection).

More fundamentally, both the U.S. and Europe are committed to the development of highly efficient, liquid and competitive markets which reduce to a minimum their companies’ cost of capital and therefore foster economic growth. In this light, an enhanced transatlantic dialogue on financial services is a way to jointly attain a shared objective.

At European Commission level, an informal “Financial Markets Regulatory Dialogue” was implemented in March 2002 and involves senior European Commission officials together with those from US Treasury, the SEC and the Federal Reserve Board. This initiative was included in the EU-US “Positive Economic Agenda” launched by Presidents Prodi and Bush in May 2002. The meetings take place either in Washington or Brussels, approximately every three months. The process involves both (i) an *ex ante* exchange of information on legislative and regulatory development, allowing both sides to identify and resolve potential regulatory

inconsistencies at an early stage; and (ii) *ex post* action to settle disputes and defuse frictions arising from the financial rules applied in either jurisdiction. This dialogue is informal and complements existing multilateral and bilateral structures such as IOSCO, the Basel Committee, or GATS.

The existence of such a dialogue at Commission level is extremely helpful and is warmly welcomed by Eurofi. The same is also true for the parallel process of discussion between the European Parliament and the U.S. Congress.

However, many issues dividing both sides of the Atlantic are regulatory rather than trade issues, and as such might progress further if dealt with between regulatory interlocutors. The SEC, for instance, does not see the European Commission as an equivalent regulatory body.

One of the difficulties of this dialogue stems from the excessive fragmentation of national regulatory and supervisory systems in Europe. A major step to reduce this fragmentation has been the "Lamfalussy process" which is now being implemented in the securities area and should be extended soon to banking and insurance. Eurofi would welcome more structured involvement by CESR in the Commission-led regulatory dialogue, as well as by the parallel committees to be formed shortly in the banking and insurance areas.

We would also urge the committees under the Lamfalussy process to work harder to get more harmonized regulation in Europe. In addition to its intrinsic benefits in terms of better integration of Europe's markets, such an effort could only strengthen the European Union in its dialogue with the U.S. authorities.

In addition, Eurofi would strongly encourage more active participation of the financial services industry in the transatlantic regulatory debate. The Industry should become more proactive in regulatory developments earlier on. It should also review whether the processes which exist to identify industry priorities and feed input to the European Commission, national authorities and regulators could be improved. There is probably scope for more active co-operation on financial services issues between players on both sides of the Atlantic. A co-ordinated industry response, where possible, would substantially improve the transatlantic dialogue for all parties.

Eurofi is strongly committed to the debate and intends to go on developing relevant contacts with its U.S. counterparts in the years to come.

Eurofi Contact Persons:

- Nicolas Véron, partner, ECIF (www.ecif.info), rapporteur of the Eurofi workshop on the Transatlantic Dialogue on Financial Services
- Didier Cahen, secretary general of Eurofi
Phone (+33)1 53 89 35 66
E-mail cahen.didier@wanadoo.fr