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Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

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For Information Contact:

Kenneth Dam
(773) 702-0216
Richard Herring
(215) 898-5613
Hal Scott
(617) 495-4590

Statement of the Shadow Financial Regulatory Committee

on

Toward a Single Trans-Atlantic Market in Financial Services

February 9, 2004

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 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.