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US-EU REGULATORY CONVERGENCE:
CAPITAL MARKETS ISSUES

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# US-EU Regulatory Convergence: Capital Markets Issues

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Abstract

The U.S. and the E.U. are the two most important areas in terms of capital raising and securities trading, so together they constitute the "G-2" of the capital markets. Through informal leadership, the G-2 can help resolve some important regulatory issues between the U.S. and the E.U. while providing precedents for the global capital markets. The key issues in the U.S. include: reconciliation of accounting systems, extraterritorial application of Sarbanes-Oxley, and U.S. access to E.U. trading screens. The key issues in the E.U. include: E.U. restrictions on pension management, differential treatment of financial conglomerates, and no uniform E.U. rules on takeovers.

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# US-EU Regulatory Convergence: Capital Markets Issues

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## Analytic Introduction

The "G-2" concept posits that there are certain aspects of international economic relations where the European Union and the United States can, and should, be willing to provide leadership for the world economy. Trade policy has operated in a de facto G-2 context for most of the past forty years and is doing so today under the leadership of Pascal Lamy and Robert Zoellick. Competition policy has largely followed such an operating framework in recent years despite recent cases of transatlantic disagreement. A third area that could follow this pattern is regulatory convergence in the financial sector.

America and Europe dominate most aspects of international capital flows, as detailed in the Factual Background section of this paper. Mergers and acquisitions as well as foreign direct investment, where the US and EU each has a stake of about $500 billion in the other, illustrate the point. Similarly, the US and EU are globally predominant in many aspects of securities transactions and banking flows. Transatlantic leadership on financial issues would be appropriate in light of the European and American collective strength of experience in global capital markets.

At the same time, there is now a pressing need for new G-2 initiatives on financial issues. The debates over International Accounting Standards, application of the new Sarbanes-Oxley legislation and the EU Takeover Directive have serious repercussions. Resolution of these issues, or lack thereof, potentially impacts trillions of euros worth of international investment decisions.

In response, the staff of the relevant US and EU public agencies have stepped up their efforts to discuss areas of regulatory concern. These efforts have improved the quality of the transatlantic dialogue and have led to a narrowing of differences in certain areas. However, from the perspective of the business community, the US and EU need to resolve the existing regulatory issues and work on more forward-looking relationship building — to promote convergence of rules and regulatory culture where possible, thereby preventing future disputes from arising.

In this context, the G-2 could provide political impetus at the very highest levels of the US and EU governments to reach transatlantic consensus in a variety of areas, as detailed below. On some specific financial regulation issues, mutual recognition agreements (MRAs) may be the desirable route. On other financial topics, harmonization of national practices may turn out to be the preferred alternative. These are readily available approaches through which the G-2 could exercise effective leadership, and we recommend strongly that they be pursued. Such efforts in the area of capital markets would engage large numbers of responsible officials on both sides of the Atlantic — potentially building sizeable transnational regulatory relationships and coalitions that would in turn strengthen the evolving G-2 process, to avoid future disputes if possible and meet future challenges when necessary.

**With the recent erosion of EU-US relations in the area of foreign policy, efforts to enhance US-EU convergence in the area of capital markets take on a new urgency. In our view, cooperation in the regulation of capital markets could play a major role in helping to improve the overall relationship between the US and the EU.**

## Factual Background

EU-US regulatory convergence has particular importance for global capital markets and global economic growth. As the interdependence of national economies increases, so too does the global capital raising and capital allocation process. The number of multiple tranche securities offerings in the EU and the US has risen significantly during the 1990s. Most global multinationals have financing needs reaching beyond the capabilities of their local markets to handle alone, so they are frequently listed on multiple exchanges around the world. Access to local capital markets has helped them to eliminate exchange rate risk, broaden their shareholder base to include local markets where they operate, facilitate mergers and acquisitions outside their home market by using local currency stock as the acquisition currency, increase their visibility in non-home markets and generally gain exposure to the various local markets where they operate.

From an investor perspective, global capital markets present attractive opportunities for portfolio diversification. US holdings of overseas securities have increased eight-fold in the last decade. The NYSE expects US investors to double the non-US component of their equity portfolios from 5% to 10%. European equities will form the majority of this increase. Flows in the other direction, holdings by foreign investors in US stocks and bonds, are now four times the 1990 level.

The heart of interdependent capital markets is the relationship between US and European corporate issuers and investors. Looking at the figures puts this relationship into context. The US and EU equity markets combined represent 80% of the global financial markets. Capital raising and trading flows between the EU and the US have grown enormously. The number of EU company listings in the US now totals 255, with 151 NYSE listings and a further 104 listings on NASDAQ. 82 US companies are listed in Germany, 69 on the London Stock Exchange, and 17 in France. For a variety of obvious reasons, the number of European (including non-EU) companies listed on NASDAQ fell significantly in 2002. However, there were 19 new European corporate listings on the NYSE in 2001, and 5 in 2002. In 2001, the 174 European listed companies had a combined market capitalization of $3.4 trillion. This compares with 74 Asia Pacific companies at $0.9 trillion and 103 Latin American companies at $0.2 trillion.

In 2002, European companies raised a total of €42 billion via primary equity public offerings. Of this amount, an estimated 15% was raised in the US, largely through Regulation 144A quasi-private placements. These figures do not take into account additional capital raised through secondary offerings. Figures for Asian and Latin American offerings in the US have been mere fractions of comparable European offerings in the US.

In terms of secondary market trading, transactions in US equities between US investors and foreign investors (individuals and institutions) have ranged from $3 to 5 trillion per year during the past 3 years, while bond transactions ranged from $8 to12 trillion per year. In recent years, US equity purchases of non-US stocks have increased to around $95 billion, and happen frequently through stock swaps in the context of mergers. Net US purchases of non-US bonds declined during the mid-1990s. Net total sales by US investors of foreign securities totaled $27 billion in the first three quarters of 2002.

Factors contributing to these trends include the stock market boom, multinational capital formation, substitution of equity for other methods of capital raising (driven by privatization), as well the growth of an equity culture and corporate bond market in Europe (facilitated by the introduction of the euro).

While these statistics suggest that regulatory barriers have not prevented the development of a transatlantic capital business, there was relatively little pressure during the 1990's to reduce the regulatory differences that did exist between the US and EU in the financial area. However, the adverse publicity associated with US corporate scandals and the American legal response to these scandals has intensified interest in reconciling these differences.

Regulatory issues relating to the EU-US capital markets have been reviewed in several contexts during the 1990s. In the trade context, during the 1997 WTO financial services sector round of talks, the EU and US did not make any market access demands of one another. This was not so much because there were few remaining barriers, but rather because the remaining barriers were codified in national regulations, which for the most part are not applied any differently to domestic financial firms than to foreign firms. Therefore, these issues were not deemed WTO appropriate. An additional dynamic was that the EU and US broadly agree on the need for a liberal market access regime for financial services; and both have a similar interest in putting the priority on encouraging other countries, including the more economically advanced developing countries, to open up market access in financial services.

Efforts at regulatory convergence between the EU and US are long-standing, but pride in legislative and regulatory prerogatives (e.g., EU Financial Conglomerates and Data Protection Directives), or simply political *force majeure* (e.g., Sarbanes-Oxley Act), have tended to get in the way. However, recent revelations surrounding Enron and WorldCom have thrown the issues into sharper relief, in particular corporate governance and accounting standards. The steady interlocking of markets, as well as the intensification of regulatory dialogue, appear to be increasing the willingness to achieve convergence, and generating practical programs for doing so.

The growing trend is now toward promoting EU-US convergence on the legal and ethical infrastructures of the marketplace (e.g., company law, corporate governance, and accounting) as well as the regulation and supervision of financial markets. Two significant initiatives began in 2002. The conclusions of the EU-US Summit in May 2002 called for a transatlantic dialogue for financial services to form part of a "Positive Economic Agenda", which has resulted in a number of exchanges between the Treasury, SEC and Federal Reserve, on the US side, and the European Commission's DG Internal Market for the EU. The Transatlantic Business Dialogue launched a Financial Markets Dialogue focused on the Sarbanes-Oxley Act, accounting standards and trading screens.

At the Oviedo Informal Ecofin Council in April 2002, the European Commission presented a paper on "a first EU response to Enron related policy issues", which essentially demonstrated that most relevant actions were already in the pipeline, and required only some review in the light of the new developments, plus the addition of a few agenda items. These items include: CESR Report on impact of complexity of derivatives trading and hedge funds; cross-sectoral policy assessment on rating agencies; and a look at the role of financial analysts.

Nevertheless, the European Commission, at the request of the Council, presented in May 2003 an Action Plan on Modernizing Company Law and Enhancing Corporate Governance in the EU. This is the first attempt at pan-EU legislation on corporate governance, which has been addressed to date mainly via voluntary codes. The Action Plan draws on the conclusions of the report of the Winter group on corporate governance and company law. It aims to strengthen shareholders rights, reinforce protection for employees and creditors, while increasing the efficiency and competitiveness of business. It contains a set of proposals for action, covering short, medium and long-term priorities and devotes particular attention to a series of corporate governance initiatives aimed at boosting confidence on capital markets. An encouraging feature of the Action Plan is that the European reference framework for this work has in general been explicitly focused on contributing to regulatory convergence, or at least avoiding the opposite.

Simultaneously with the Corporate Governance Action Plan, the Commission published ten priorities for improving and harmonizing the quality of statutory audit throughout the EU -- to prevent conflicts of interest and to ensure that investors and other interested parties can rely fully on the accuracy of audited accounts. Public consultation for both sets of proposals concluded in August 2003 and the Commission expects to bring forward some of the constituent initiatives by early 2004 at the latest.

This paper reviews six key aspects of regulatory convergence between the US and EU that would have significant impact on the transatlantic capital markets. Three of these aspects involve areas where actions or potential actions by the US are impacting the EU. One is the possible accommodation of US GAAP to international accounting standards (IAS); the second is the extra-territorial reach of the Sarbanes-Oxley Act ("SOX"); the third is direct access of US investors to European trading screens. The other three aspects of US-EU regulatory convergence involve situations where the EU may move toward or accommodate US norms. One is the proposed liberalization of the EU rules on investing pension assets; the second is the proposed revision of EU rules on takeover defenses; the third is the EU's new directive on supervision of financial conglomerates.

In each of these six areas, the paper will outline the background on the relevant issues and suggest a preferred set of policy alternatives for the Bertelsmann Group (the "Group") to advocate.

## 1. Global Accounting Standards

For most European companies, conversion to US GAAP is the single biggest barrier to making a public securities offering in the US or registering securities to trade on a US stock exchange. The SEC has already accommodated European issuers by allowing them to use home country disclosure requirements on management compensation and affiliated transactions. But the requirements of US GAAP in areas such as segment reporting are difficult to meet for many European companies, especially German companies that have historically relied on "hidden" reserves. This has been an inhibiting factor for companies based in continental Europe to register their shares with the SEC and list in the US.

Most multinational companies would agree on the need to establish a uniform set of accounting standards that could be utilized on a global basis. Such standards would substantially reduce accounting costs of multinational companies, and would allow them to more easily access capital markets throughout the world. In turn, such standards would allow investors to compare company performance more accurately, and to allocate capital more efficiently among competing claimants.

Although the SEC has historically taken the position that US GAAP is the best accounting system in the world, Enron and other corporate scandals in America have called into question this position. In a bid to unify fragmented standards across Europe, the EU announced earlier this year that all EU companies listed for trading on a European market must adopt International Accounting Standards (IAS) for consolidated accounts for financial years commencing after 1 January 2005. This announcement applies to approximately 7,000 companies currently using their home country GAAP. At present, only a few companies in the EU follow IAS on a consistent basis.

In the US, both the SEC and the Financial Accounting Standards Board (FASB) have recognized the importance of the EU's emphasis on accounting principles as well as detailed rules. At the same time, the International Standards Accounting Board (IASB) has been developing detailed rules in many areas to supplement the EU's traditional reliance on general accounting principles.

To provide support and impetus to these efforts, the group should advocate a total reconciliation of US GAAP and IAS as soon as practical. In 2002, however, there were at least fourteen significant accounting differences between US GAAP and IAS according to Deloitte

Touche Tohmatsu. In some areas, the International Accounting Standards Board ("IASB") is currently working on a project that is likely to lead to convergence with US GAAP. For example, the IASB is proposing to move from pooling to purchase accounting for business combinations as US GAAP recently did (though with stricter rules on restructuring charges). However, the IASB and the FASB are moving in different directions in other important areas of accounting. In addition, there is internal disagreement, within the US and within the EU, on important accounting issues.

One of the most controversial areas is IAS 39. This standard is of enormous significance for financial services firms and any other companies which use financial instruments, especially derivatives, to hedge risks in their business. The key elements of this standard are

- a more extensive use of fair value
- marking all derivatives to fair value
- strict rules on the use of hedge accounting
- macro hedging and internal hedging are no longer allowed
- first day profits on derivatives are not allowed
- valuation of OTC derivative portfolios on a transaction by transaction basis
- discounts on block transactions are no longer allowed

Another controversial area is the proposed requirement to pass the estimated expenses associated with stock options through a company's income statement. Under a new draft rule, the IASB has proposed the mandatory expensing of all stock options at the date of grant. So far some US companies have voluntarily decided to expense stock options, while others have not (especially high tech companies). Despite political opposition from high tech companies, the FASB intends to propose by the end of 2003 mandatory expensing of stock options. In the process, the FASB expects to establish a uniform valuation methodology for companies to expense stock options on their income statements.

Since IAS and US GAAP are both currently in a state of flux, but all EU companies must adopt IAS by 2005, it would be useful to identify and analyze the significant remaining differences between the two accounting systems at the start of 2004. Such an analysis, especially if it included suggestions for compromises on the key issues, would facilitate regulatory efforts to harmonize IAS and US GAAP. Such an analysis would also help EU companies estimate the costs involved in reconciling IAS accounts to US GAAP — a requirement for listing on the NYSE or NASDAQ. Therefore, the Group should authorize the retention of an accounting firm to delineate the significant remaining differences between IAS and US GAAP at the start of 2004.

2. Extra-Territorial Application of SOX

The enactment by the US Congress in the summer of 2002 of the Sarbanes Oxley Act of 2002 (the "SOX Act") resulted in the application of many provisions of the new statute to foreign companies as well as the auditors and lawyers who provide services to those foreign companies that are "reporting companies" (Reporting Companies) in the United States.[2]

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[2] *A "reporting company" is one that is required to make periodic filings with the US Securities and Exchange Commission (the "SEC"). According to the US Chamber of Commerce, there are 185 companies based in the EU*

Most significantly, the SOX Act requires a personal certification by both the CEO and CFO (or their equivalents) to be included with each filing by a Reporting Company of its annual report on Form 20-F. This certification includes a verification that the report complies with the requirements of US law (*i.e.,* the report does not contain any material misstatement or omission and that the financial statements of the company fairly present in all material respects the financial condition of the issuer.) To make these certifications, Reporting Companies are required to have in place internal controls and procedures effective for generating complete and accurate financial information. The officers must have both evaluated the effectiveness of such systems and reported any deficiency therein. The SOX Act also mandates similar certifications in another section, which involves criminal penalties for knowing or willful violations.

Other provisions of the SOX Act address specific relationships between the Reporting Company and its management. These include the repayment to the company by CEOs and CFOs of certain bonuses and share trading profits following an accounting restatement due to material non-compliance resulting from misconduct; prohibitions on most loans from companies to their officers and directors; and permanent bars against "unfit" individuals from serving on any boards of publicly traded companies.

Additional requirements of the SOX Act in the corporate governance area may be inconsistent with home country practice for many foreign issuers. For example, the SOX Act mandates disclosure of whether Reporting Companies have adopted a Code of Ethics and, if so, whether there have been changes in or waivers granted from the Code. However, unlike US issuers, non-US Reporting Companies need not immediately disclose waivers, as long as all waivers are disclosed in the annual report. Similarly, the SOX Act mandates that a Reporting Company releasing any non-GAAP financial measure reconcile it to the most comparable measure under GAAP. However, there is an exception if: (1) the measure is required or expressly permitted by the standard setter for financial statements in the company's primary financial statements; and (2) the measure is actually included in the non-US Reporting Company's annual report filed in its home country.

While the SOX Act mandates a regime for audit committees that is inconsistent with the normal governance procedures of many non-US Reporting Companies, the SEC has addressed these inconsistencies through exemptive rules. The SOX Act requires that an audit committee composed entirely of independent directors be responsible for the appointment, compensation and oversight of the company's external auditors. The external auditors may not provide any of nine enumerated non-audit services to the company, and may provide other types of non-audit services to the company only if approved by the audit committee. In the rulemaking process, however, the SEC has granted exemptions for non-US Reporting Companies from the requirement that audit committees be composed entirely of independent directors. For example,

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*listed on the NYSE, and 149 companies based on the EU listed on NASDAQ. All listed companies, as well as companies that voluntarily become registrants without listing their securities (e.g., issuers of high yield bonds who later register those bonds for trading purposes only), are subject to all of the provisions of the SOX Act, absent a specific exemption. The terms of the SOX Act do not apply to foreign companies that merely furnish information to the SEC under Rule 12g3-2(b).*

the SEC allows non-executive employees to serve on an audit committee of a non-US Reporting Company if the employee is appointed under a collective bargaining agreement or co-determination statute. Similarly, if a non-US Reporting Company has a two-tiered board system, the SEC applies its audit committee requirements only to the audit committee of the supervisory board.

The SOX Act imposes particularly onerous requirements on non-US accounting firms that are engaged to provide audit services for non-US Reporting Companies, or that play a substantial role in audits. Non-US auditing firms will be required to register with the newly formed Public Company Accounting Oversight Board (PCAOB), and become subject to inspections, investigations and potentially disciplinary actions by the PCAOB. On the other hand, the SEC has made some accommodations to foreign auditing firms subject to the SOX Act. For example, the rotation requirement is limited to partners serving the parent or subsidiaries with 20% or more of the parent's assets or revenues. Similarly, the "cooling off" periods for employment of audit firm members by an audit client will be limited to key positions in a non-US Reporting Company.

Thus, although the enactment of the SOX Act had the potential of dramatic and severe exterritorial application of US law outside the United States, which may very well contravene recognised principles of comity in international law, the SEC has shown sympathy for arguments of conflicts of law and has tried to create specific exemptions in the rulemaking process to deal with those conflicts. The Group also should recognize that it would be extremely difficult to obtain any legislative amendments to the SOX Act, as there is widespread public support for its underlying principles -- transparency and accountability. Therefore, it would be best for the Group to argue that the SEC should more broadly and flexibly exercise its interpretive discretion and exemptive authority under the SOX Act in relation to a limited number of important issues. In particular, the Group should urge the SEC to adopt reasonable and precise guidance on financial certifications by CEOs and CFOs of Non-Reporting Companies, especially with respect to financial controls. The Group should also ask the PCAOB to find a pragmatic solution to the current requirement for inspection and discipline of foreign auditors of Non-Reporting Companies if those auditors do not have offices in the US.

3. <u>Trading Screens</u>

Near the top of the list of official European complaints about the US regulatory environment in the capital markets context is the demand for access by European exchanges directly to US investors by placing trading screens on the desks of US broker-dealers.

European securities exchanges are effectively prohibited by the SEC from directly accessing the US market without first registering as a US exchange. The Federation of European Stock Exchanges (FESE) has been quite successful in raising awareness of this perceived barrier – at one stage the EU planned to bring the issue to the World Trade Organization (WTO). But the US successfully argued the issue was not suited to the WTO, because it is not a national treatment issue. Foreign exchanges in the US are accorded national treatment, since the requirement to register as a US exchange is no more onerous for EU exchanges than for exchanges located in the US.

One SEC concern, related to investor protection, focuses on the fragmentation and varying quality of regulation of European markets (their differing trading systems, supervision, disclosure, etc.). The second SEC concern, related to the range of entities underlying the securities products that would be offered, focuses on differing accounting and corporate governance standards within the EU. The Europeans argue that a new Investment Services Directive and updated Standards for Regulated Markets in the EU should largely overcome the first concern. The second appears less easily resolved until the IAS is widely adopted and corporate governance reforms are instituted throughout the EU.

Following numerous discussions between the European Commission and the SEC, the SEC has indicated a willingness to contemplate open access for products that have their "primary listing and area of offering" outside the US. Though the SEC's willingness to discuss the matter pleases the Europeans, the EU feels that the SEC has not taken sufficient steps toward proposing a satisfactory solution. Moreover, the SEC seems reluctant to liberalize its standards on trading screens because it fears that then foreign companies would have little incentive to access US capital markets by listing on a US market. In the view of many Europeans, however, the SEC appears to give too much weight to the implications of EU trading screens for US listings. Even if EU trading screens were allowed in the US, an EU company would continue to have many of the historic reasons for seeking a US listing, such as creation of a stock currency for acquisitions of US companies and the establishment of stock incentive plans for US employees of the EU company.

The Group should recommend both of two approaches to accommodate the EU's interest in trading screens. One approach would be to limit the use of European trading screens to institutional clients. This has been a successful approach to expanding the breadth of quasi-public offering by foreign companies under SEC Rule 144A. A second approach would be to qualify specific products listed primarily on specific EU markets for direct access to US broker-dealers. A possible start would be common stocks trading on the London Stock Exchange.

4. Open Entry to EU Pension Management

In the EU, the provision of retirement benefits has operated under various national laws and practices. With a few exceptions, these national laws and practices have created barriers to entry for other global financial firms skilled in the management of pension funds. In particular, it is currently not possible for companies operating across borders to offer a single, pan-European occupational pension plan to employees. Many countries do not permit funding of state pensions, or maintain quantitative investment restrictions and currency matching requirements on funding. This area is particularly significant because many of the EU's largest countries (e.g., Italy, France and Germany) are facing an imminent pension crisis. In response, most are considering a shift in their emphasis from defined benefit (DB) plans to defined contribution (DC) plans as well as permitting funding.

US firms are particularly interested in offering investment services to DC plans because of the extensive American experience with 401(k) plans and individual retirement accounts. The assets of DC plans now constitute a majority of pension assets in the US, although DB plans still hold over 40% of pension assets. US firms offer DC plan managers not only a broad choice of pooled products, but also an extensive array of record-keeping and educational services.

However, the general principles underlying the EU's policy of free trade in financial services have not been well implemented by certain EU countries. Indeed, many US executives believe that certain EU countries have used the implementation of pension reform policies to reassert nationalistic approaches to financial services. For instance, German pension plans must be managed by a specialized institution incorporated and located in Germany. It bears emphasis that US executives are focused on the investment of EU pension assets, rather than on the contribution, distribution or taxation of pension assets – areas which have more impact on local budget issues.

Some of these issues are addressed in the EU Institutions for Occupational Retirement Provision ("Pension Directive") passed by the Council in May 2003. The Pension Directive establishes a common prudential framework for occupational pension schemes across Europe. It is modestly helpful legislation, but its main value is in the signal it sends to member states to make pension reform a priority, and in establishing a solid legislative foundation for further work on policy reforms.

The Directive has a long and somewhat tortured history – having been through the European Commission, the European Parliament and the Council as three separate proposals over a period of 12 years before passing. The original Commission proposal included the prudent person principle but gave member states the ability, within prescribed limits, to impose some quantitative restrictions, including a cap on investments in non-matching currencies. In its first reading, Parliament went further than the Commission in the direction of codifying the prudent person rule and would have required that exceptions be removed after a period of years. However, the final version does not include such a sunset provision.

The final Pension Directive takes a few steps backwards by allowing some quantitative restrictions. Member states can impose more detailed rules than the prudent person rule for plans in their countries, including quantitative restrictions, if they are prudentially justified. In addition, to the extent member states impose these rules on plans within their own country, they can require institutions conducting cross-border activities in their country to comply with the following restrictions on their activities in the host state: a 30% cap on investments in unregulated markets, a 5% cap on investment in a single issuer and 10% cap on investment in issuers in the same group, and a 30% cap on investment in assets denominated in currencies other than those in which liabilities are expressed.

Moreover, the Pension Directive now incorporates the issue of biometric risks (risks of longevity, disability and premature death). The original Commission proposal did not cover biometric risks, because the Commission strongly opposed inclusion of product specifications in a prudential directive. In its first reading, Parliament added a provision requiring that plans offer the option of coverage for biometric risks through a lifelong pension, disability coverage, and provision for survivors. The final Pension Directive merely allows member states to mandate coverage of biometric risks and insurance of the principal if employers and employees agree. Mandating coverage of biometric risks or providing insurance will significantly increase administrative costs, — thus, reducing overall returns at the end of the life of the pension, and building in a competitive advantage for insurance providers.

The Pension Directive provides a further advantage to insurance companies over other service providers by allowing them to invest occupational retirement plans (as an IORP) by creating segregated accounts for their pension assets and liabilities. However, it would not allow other types of regulated financial institutions to qualify automatically under the favorable provisions applicable to IORPs. Instead, the final version directs the Commission to monitor the market for occupational pensions and consider extending the IORP provisions to other regulated financial institutions at a future date.

The Group should generally support the implementation of a consistent European approach to the investment of EU pension assets. The key focus is now implementation of the Pension Directive. In particular, the Group should recommend that legislation implementing the investment aspects of the Pension Directive in every EU country consistently incorporate the following key requirements:

a) Prudent person rule – No EU country should quantitatively restrict how pension assets can be invested, but rather should rely on principles of diversification and prudence. Research has demonstrated that pension plans experience higher returns under these principles than categorical asset allocations imposed by a national government.

b) Level playing field for providers – All types of authorized financial services firm, including EU subsidiaries of US securities firms and asset managers, should be allowed to offer services and products to EU pension plans. The competition among providers and products will help maximize returns to plan participants and beneficiaries.

c) Cross-border flexibility – Financial institutions that qualify to manage pension funds should be free to provide service or products from any location within the EU. Allowing managers such locational freedom will achieve efficiencies that reduce the cost of plan management to the benefit of plan participants and beneficiaries.

## 5. Takeover Rules

In the US, most publicly traded companies are owned by a widely dispersed group of shareholders, even though a few institutions may hold blocks of shares as large as 10% of the outstanding. One of the key checks on inferior company performance in the US is the potential for non-negotiated changes in control. While the SEC rules on corporate takeovers are neutral, some state statutes and state case law have allowed poison pills to be implemented. Availability of such measures has not had the effect of preventing hostile takeovers, but may have resulted in achieving higher prices for target shareholders.

In continental Europe, by contrast, ownership structures of publicly traded companies are more heavily concentrated, with the dominant block of shares frequently held by the national government, local families or commercial banks. These dominant shareholders control the board of directors, which often have legal duties to labor and community interests as well as to shareholders. The board (or supervisory board in Germany's two-tier board structure) may appoint a CEO who is more responsive to the interests of the dominant shareholder than to minority shareholder concerns. In turn, the dominant shareholder or primary bank serves as an effective check on the CEO, as hostile takeovers are relatively rare in the EU (outside of the UK).

The attitudes and rules toward hostile takeovers in the EU have been slowly converging toward those in the US, although substantial differences remain. One significant barrier to hostile acquisitions are the "golden shares" retained by EU member state governments in partially privatized companies. These "golden shares" take different forms, but typically provide for special intervention rights or veto rights for the government, particularly in change of control situations. There have been several recent significant European Court of Justice decisions limiting the scope for government golden share schemes. In June of 2002, the ECJ ruled that all golden shares constitute per se restrictions on the principle of free movement of capital and therefore also on freedom of establishment, and can therefore only be justified in limited circumstances, provided that the objective falls within a "general or strategic interest" and cannot be attained by other less restrictive measures, and that the measures are based on precise criteria known in advance and open to court review. However, the Court left open an exception for national security defense – which allowed the Court to uphold Belgium's golden share in two energy companies and may apply to other industries. In May 2003, the ECJ struck down additional golden share schemes in the UK and Spain, and further narrowed the permissible parameters, stating that the objective must fall within the Treaty of Rome's exceptions such as defense or national security, or fall within the broader EU legal definition of "overriding requirements in the general interest".

At the same time, the European Commission – led by Commissioner Bolkestein – has been drafting the first pan-European takeover code. In 2001, a highly negotiated version of the Takeover Directive failed to pass on a tie vote in the European Parliament. The opposition was led by Germany, which objected to the Code's provisions that would have required advance shareholder approval for certain takeover defenses, including the poison pill, arguing that this would raise a level playing field issue with the US and other jurisdictions that permit defensive mechanisms without prior shareholder approval. (It should be noted that, unlike much of Europe, boards in the US have a court-sanctioned fiduciary responsibility to shareholders.)

Chancellor Gerhard Schroeder has been particularly supportive of a special German law limiting any single shareholder to 20% of Volkswagen's total voting rights. However, the European Commission has begun legal proceedings to challenge the validity of the so-called Volkswagen Law. More recently, in May 2003, Commissioner Bolkestein has once again met with resistance to his efforts to obtain majority support for a revised pan-European takeover bill. This time his bill was delayed by the Germans, the Scandinavians (who dislike the one-share, one-vote principle in the proposal), and Great Britain (which reportedly supports German opposition to this proposal in exchange for German support of Britain's position on another proposed EU directive concerning the rights of temporary workers). The failure to adopt an EU Takeover Code represents a substantial barrier to the creation of a single EU capital market, with potentially adverse effects on the EU's general competitive position and the need for consolidation in specific sectors.

Yet Germany does not currently allow the use of golden shares or multi-class arrangements as anti-takeover devices. Moreover, in 2002, Germany put into effect its own Takeover Code with a general requirement that the Management Board refrain from taking any action to frustrate a takeover offer, subject to five exceptions:

1. The Management Board may take any action that it prudently could take if there were no takeover bid.

2. In any event, the Management Board may search for a competing bid from a "White Knight."

3. The Management Board may take any action to frustrate a takeover bid if such action is approved by the Supervisory Board within its legal authority.

4. The Management Board may take any action to frustrate a takeover bid if such action is approved at a shareholder's meeting after the takeover bid is announced.

5. The Management Board may take any action to frustrate a takeover bid if such action has been approved in advance of a shareholders' meeting. (Note that the Management Board may not invoke a poison pill to thwart a hostile takeover unless in advance shareholders have approved both the authorization of sufficient shares and the abolition of pre-emptive rights.)

Given the adoption of the new German Takeover Code and the current delay in agreeing on an EU Takeover Code, the Group should recommend the retention of legal experts to compare the various aspects of these two legal regimes. Further, the legal experts should compare the anti-takeover elements of Delaware corporate law to the relevant provisions of German and EU Codes. These comparative analyses would be very useful to EU leaders trying to evaluate whether or not the adoption of the proposed EU Anti-Takeover Code would put European companies, facing hostile takeover bids, at a competitive disadvantage vis a vis US companies.

6. <u>Financial Conglomerates Directive</u>

The EU's new directive on the enhanced supervision of financial conglomerates and its extraterritorial application to financial groups with a parent based outside the EU is high on the list of issues under discussion between the EU and the US. US securities firms argue that this new directive places them at an unfair disadvantage relative to European universal banks, because US securities firms are regulated by the SEC, rather than by the Federal Reserve.

The new directive has also brought to the fore perceptions by the US and EU of the faults of the other's supervisory structures and practices. For US securities firms operating in Europe, the key issue is the directive's requirement of verification by the EU competent authority of "equivalent supervision" by third-country authorities. There is concern among US authorities and the financial services industry that if the EU were to consider US supervision as not equivalent, it would raise the cost to US firms of doing business in the EU and thus place them at a significant disadvantage to their EU-parented competitors.

Under the proposal that has now been adopted, the EU competent authority (i.e. the lead EU regulator of the non-EU parented group) must consult with the new Financial Conglomerates Committee, comprised of Member State officials, before taking a decision. The Committee may provide guidance as to whether a third-country's supervision achieves the objectives of the directive. A negative opinion by the Committee, if endorsed by the Commission, would be binding. The Committee has yet to draw up its rules of procedure, so it is not known how it will address the issue, but it is likely that it will form an opinion on a country-by-country basis.

The Commission is convinced that a common EU position on key countries, such as the US, must be reached to avoid confusion (one Member State's authorities approving a third-country's supervision and another one not) and to ensure there is no regulatory arbitrage. The EU authorities have used meetings with the SEC and the Federal Reserve Bank to explain the reasoning behind the directive, and in particular third-country equivalence.

However, US financial firms are suspicious that the need for a common EU position could simply be a thinly veiled means of putting pressure on the US to fall in line with the EU's approach to consolidated supervision, which is largely based on the premise that banks play the central role in financial markets. In the US the situation is quite different, with much higher levels of disintermediation outside of commercial banking, and a bigger role for investment firms and asset managers. The Commission has privately acknowledged that Fed supervision might be deemed equivalent but that SEC supervision might be argued to fall short. In this situation, US parented groups supervised by the SEC would be disadvantaged vis-à-vis their competitor banks supervised by the Fed.

Since the debate on the supervision of financial conglomerates is very much up in the air, the Group should suggest that the European regulators accept the SEC as well as the Fed as the primary regulator for US financial conglomerates. If necessary, the European regulators could ask the SEC to consult with the Fed on specific issues such as money laundering or capital requirements.

## **Conclusions**

The US and EU are generally moving closer together in many aspects of financial services. This relationship is based on a significant flow of primary and secondary offerings across the Atlantic, and has grown as both the US and the EU have struggled to respond to the recent wave of accounting and corporate scandals. Yet the convergence between the US and the EU is far from complete. The regulatory structure in areas like pensions and financial conglomerates is quite different, and so are the approaches to corporate governance and accounting.

Therefore, financial services present an excellent opportunity to bolster the relationship between the US and the EU by building on an existing, but incomplete, foundation for common ground. Given the erosion in the US-EU relationship in the foreign policy area, it is particularly important for the Group to use this opportunity to strengthen Transatlantic ties in financial services.

In choosing specific aspects of financial services on which to proceed, the Group must be careful. On the one hand, we cannot attempt to make major changes in aspects that have recently been shown to be relatively intractable. On the other hand, we should be reluctant to concentrate on areas in which global standards have already been promulgated without the Group's intervention. In addition, the overall set of recommendations should be roughly balanced — calling on both the US and the EU to make appropriate accommodations to each other.

The Group should therefore focus on a few selected areas where there is a significant potential for change, but the field has not yet been totally occupied. In our view, these dual criteria suggest four areas for specific efforts by the Group — two mainly on the US side and two mainly on the EU side. The Group should also authorize further expert analysis of particular aspects of accounting and legal frameworks in order to help facilitate the resolution of a difficult set of issues — one on each side of the Atlantic.

On the US side, the Group might fruitfully encourage the SEC to take a modest step toward allowing EU trading screens to be shown directly to US investors by adopting the approach of Rule 144A, where the rules on transatlantic offerings have been loosened for offerings limited to institutional investors. In addition, the Group might identify a few subjects under the SOX Act — perhaps involving certification standards for financial controls of non-US Reporting Companies, or local supervision of foreign accounting firms serving such Companies — and ask the SEC to take a more flexible approach to these subjects. The Group might also help both regulators and companies by authorizing a paper identifying the key remaining differences between IAS and US GAAP, together with suggestions for resolving these issues.

On the EU side, the Group should support the adoption of truly pan-European principles by each EU country in implementing the new pension directive; in this area, the devil is in the details and the details are subject to a broad range of discretionary judgments in each country. The Group should also provide political impetus to ongoing efforts to persuade EU institutions and regulatory bodies that they should accept the SEC as the primary global regulator of US securities firms, drawing on the provisions of Gramm-Leach-Bliley, perhaps with a proviso that the SEC consult the Federal Reserve on topics like capital adequacy. The Group might also help

EU leaders think through the difficult issues involving anti-takeover laws by authorizing an expert analysis of the current legal regimes in Germany and Delaware as compared to the proposed EU Takeover Code.

Transatlantic leadership toward financial regulatory convergence would illustrate several of the basic elements of the "G-2" concept. Europe and the United States could operate as a very informal steering committee, reaching agreements on how to proceed as a kind of "G-2 caucus" and then promulgating their concurrence through formal and multilateral structures like the International Accounting Standards Board. Such informal steering efforts at this point in history would be especially valuable, in light of the acute tensions in overall Europe-United States relations and the recent tensions even in the traditional areas of G-2 success like competition policy.

Effective cooperation in financial services would indicate a willingness on the part of the "G-2" to exercise leadership in an area where global responsibility clearly lies on its shoulders. Such leadership would demonstrate the practicability of the "bottom up" approach to overall G-2 activity (as opposed to a "top down" directive from political leaders to carry out G-2 coordination on a large number of topics). Such leadership on financial issues would also meet the basic G-2 criteria of both improving relations between Europe and the United States themselves, while contributing to a more effective global economic order with tangible benefits for the rest of the world.

Hence we believe that adoption of the recommendations in this paper would convey two major sets of advantages. Most importantly, they would help resolve a series of issues that are significantly hindering international finance and thus international commerce. At the same time, the process of implementing the recommendations in this paper would further demonstrate that the "G-2 strategy" of effective collaboration between Europe and the United States constitutes a viable way of providing needed leadership for the world economy.