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# THE US-EU REGULATORY DIALOGUE AND ITS FUTURE

## HEARING

BEFORE THE

## COMMITTEE ON FINANCIAL SERVICES
## U.S. HOUSE OF REPRESENTATIVES

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# THE US-EU REGULATORY DIALOGUE AND ITS FUTURE

**Thursday, May 13, 2004**

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.*

The committee met, pursuant to call, at 10:06 a.m., in Room 2128, Rayburn House Office Building, Hon. Michael Oxley [chairman of the committee] presiding.

Present: Representatives Oxley, Biggert, Hart, Hensarling, Garrett, Watt, Ackerman, Sherman, Inslee, Moore, Lucas of Kentucky, Emanuel, and Bell.

The CHAIRMAN. [Presiding.] The committee will come to order.

Two years ago, this committee convened a hearing to address "The European Union's Financial Services Action Plan and its Implications for America's Financial Services Industry." Today's hearing explores how the US-EU Dialogue has worked over the last 2 years and how participants expect it to evolve in the context of a united Europe consisting of 25 countries with a wide range of economic strength and development.

We welcome back witnesses from the SEC, the Treasury, and the Federal Reserve to discuss this issue. I look forward to seeing whether their expectations 2 years ago were met and what they think the future might hold. We welcome for the first time on this topic our PCAOB witness who will provide a perspective on how innovative and productive a variety of informal processes can be in resolving difficult transatlantic regulatory issues.

I am particularly pleased to welcome for the first time before this committee the European Commission. It is not often that a foreign authority testifies before Congress. I understand that Director-General Alexander Schaub will use the opportunity of this hearing to present significant new ideas on how the US-EU regulatory relationship might evolve. We look forward to this testimony.

Two years after our first hearing on this issue, many of the same issues remain on the forefront of the transatlantic regulatory debate: The supervision of financial conglomerates, international accounting standards, convergence in accounting standards, transparency in prospectuses, and making consolidated supervision function on both sides of the Atlantic.

And yet, much has changed. We convene today shortly after the historic accession of 10 Eastern European countries into the European Union. This fulfills the dreams of many, including myself, that Europe after World War II could one day be united, whole, and free. Much of the European financial services agenda, espe-

cially after the fall of the Berlin Wall, has aimed to create a financial services marketplace to serve a European market nearly equivalent in size to ours.

The financial markets have also changed. The end of the Cold War and a revolution in risk management and telecommunications together have created opportunities and enthusiasm for global capital markets to integrate across borders. I believe that transatlantic trade in both goods and services benefits consumers and businesses on both sides of the Atlantic and helps create a vibrant job market here in the U.S.. It generates competition in both markets and forces firms to be more efficient, innovative and effective in serving customers. These trends place pressure on financial regulators to find better ways of working together.

Following our hearing 2 years ago, the US-EU Financial Markets Dialogue was created. It fosters regulatory discussion on emerging transatlantic issues and attempts to avoid conflicts. I understand that the Dialogue has been extremely successful. In fact, it has been so successful that some have suggested it needs to grow and become more formalized. Others have suggested that the Dialogue should seek to accelerate financial market integration and foster convergence of regulatory standards across the Atlantic. Our witnesses today will provide insight into the innovative tools used today to increase transatlantic mutual understanding and cooperation.

This is a very important initiative. Financial firms operating in multiple states must comply with multiple, sometimes conflicting, regulatory requirements. These requirements reflect government efforts to protect consumers and to foster financial system stability, safety, and soundness. The Financial Services Committee seeks to strengthen the U.S. regulatory framework, permitting it to adapt to a world where significant changes in capital market behavior and the world around us require new approaches to accounting, auditor oversight, consolidated supervision and protection from abuse from terrorists and money launderers.

This committee also seeks to reduce regulatory burdens. Last fall, we enacted major banking regulation relief legislation, and we are right now working on an insurance regulatory package. I am committed to reducing inefficient regulatory burdens for all financial institutions doing business in the U.S. subject, of course, to security and financial stability considerations.

Relieving regulatory burdens in the U.S., however, is only part of the picture. America's largest financial institutions are major players in the European capital markets. Major European firms are a significant and growing presence in all three sectors of the United States financial services market: banking, securities and insurance. The choices one country makes for how best to protect its investors and depositors may not always coincide with the choices other countries make.

Different policies can be driven by differences in market structure. Such differences are legitimate and do not easily lend themselves to calls for convergence. I believe that convergence and equivalence in regulatory structures can only make sense where convergence is already underway in the markets and where differences in regulation can have a detrimental impact. To endorse

convergence as a goal without considering the needs and views of the voters that brought us to Washington to represent their interests would be irresponsible.

I hope this hearing will help us understand which differences in regulatory standards are needed to address different market structures and which differences are inefficient. I am skeptical that transatlantic regulatory convergence will occur quickly in all areas. While the financial markets continue integrating, national regulators will need authority and a legislative mandate to protect consumers and markets at home. I note that it took Europe almost 40 years to achieve a legal framework based on mutual recognition, and this framework is still under construction.

Some might question whether the mutual recognition concept can operate outside the EU. In addition, the EU's new framework has not yet been fully tested. The Financial Services Action Plan will not be implemented until next year, and concerns have already been expressed that full implementation may impose unnecessary costs or create unnecessary conflicts. Questions also exist concerning how the new regulatory structures in Europe will interface with the rest of the world, putting pressure on the execution of consolidated home country supervision.

Here in the U.S., we have our own regulatory burdens to consider and address. The specter of listed firms needing to provide financial statements using two different accounting standards and the prospect of having two different regulatory capital frameworks for financial institutions are two examples of areas where regulators on both sides of the Atlantic face common challenges. I believe that practical working relationships such as those created through the US-EU Dialogue and other transatlantic discussions can help generate a process for differences to be discussed and understood better.

We will not all agree today on the right solutions for any of the issues before this transatlantic regulatory Dialogue. In the future, we cannot expect disagreements will disappear regarding how best to regulate the very fluid and innovative financial sector. But I firmly believe that increased dialogue can lower the temperature of our disagreements and can lower the odds that serious misunderstandings can develop. The capital markets will not stop integrating, and it is our responsibility as policymakers to ensure that the rules generated to protect consumers and enhance market discipline do not generate excessive and inefficient compliance costs.

Are there other members seeking for an opening statement?

[The prepared statement of Hon. Michael G. Oxley can be found on page 28 in the appendix.]

The gentleman from California, Mr. Sherman?

Mr. SHERMAN. Thank you, Mr. Chairman. No discussion of our trade and international economic relationships can be complete without a mention of the one-half trillion dollar trade deficit of the United States. The world is building a house of cards. It is a beautiful house of cards. They are happy living in the house of cards. But every year we add another half trillion dollars of debt of the United States to the rest of the world, we build another story on the house of cards.

And in a perfect world we could hope that somehow that trade flow would be not only—the negative would be slowed but even reversed. We can dream of a world in which the second half of this decade involves us sending a Cadillac to Europe for every Mercedes they sent us in the first half of this decade. I know of no one in the automotive industry planning for that as an eventuality. The world is addicted to the United States as importer and as borrower.

And so in perhaps a decade, individual actors in the economic system, whether they be countries, banks or individual investors, will probably and unfortunately in a very short period of time suddenly lose faith in the dollar, wonder why the world has lent so much to a country that has done so little to repay.

Now, I would like to think that we can avoid this catastrophe, but that would involve a weak dollar. Instead, our Asian governmental friends and trading partners are deliberately and I would say illegally or at least wrongfully weakening their own currencies. That would involve a U.S. budget surplus. I don't know of anyone who dreams of that at any time in the near future.

So since we are unlikely to avoid the disaster, the question is whether we are building our financial institutional system to prepare for the disaster, to make sure that the panic does not become a depression.

We have, I believe, in our stock markets circuit breakers to deal with sudden drops. I hope that our witnesses today will discuss with us here or supplement the record with a discussion of what we can do to have equivalent circuit breakers for sudden declines in the U.S. dollar, for sudden and multi-trillion dollar outflows of capital from the United States, and from all the things that you would expect will eventually happen, and you can wonder whether it happens in 5 years or 15 years, but what eventually happens to a country that is almost force-fed like a European goose, import after import, consumption after consumption until suddenly it breaks.

I would hope that this international financial system is not just the most efficient way to deal with how to live in a house of cards, but also that we build in mechanisms to deal for what happens when the house of cards falls over. I yield back.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from Illinois seeks recognition.

Mrs. BIGGERT. Thank you, Mr. Chairman, and thank you for calling this important hearing today. As you noted in your opening statement, the financial services markets in the U.S. and Europe are increasingly intertwined.

I think this hearing is well-timed, coming as it does just 2 weeks after the historic accession of 10 Eastern European states to the Union. I would like to congratulate you for organizing a hearing that includes our key partner in the Dialogue—the Commission of the European Union. This is an excellent opportunity for the Financial Services Committee to hear both American and European perspectives on the key transatlantic regulatory issues of our day.

The relationship between the American and European capital markets is of keen importance to the U.S., generally, and of particular importance to those of us who come from Chicago. Last year, there was a great deal of controversy associated with the pro-

posal for a European options exchange to establish itself as a competitor to the traditional options exchanges in Chicago. The resolution was that the exchange submitted to the jurisdiction of the CFTC and established a subsidiary. Along the way, many people in my home state began to think in very concrete terms about what it means to have such integrated capital markets.

I am a firm believer in the adage that political friendships follow the trade lanes. Free and fair trade fosters competition and communication, benefiting workers and consumers on both sides of the relationship. My impression from the testimony submitted is that the regulatory Dialogue underway right now between the U.S. and the EU contributes to these goals.

While I support these goals and the accomplishments achieved to date within the Dialogue, I think it is important to sound a note of caution as well. We must be careful that in our zeal to find new and better ways for our regulators to work together internationally, we do not lose sight of our own very important domestic policy goals.

In this country, we have over the last century built the deepest, most transparent and most liquid capital market in the world. This capital market and the economy that it supports are the engines of global growth and innovation. One critically important component of that market is the framework of laws and regulations that protect investor access to information and provide for rigorous oversight of financial institutions.

Financial innovation and economic growth in the U.S. have thrived under this framework. Growth and innovation have been slower in Europe, but are accelerating with a number of reforms. On this side of the Atlantic, we must be sensitive to the views of the financial markets and ensure that the EU package of reforms does not stifle growth and innovation through imposition of significant compliance costs.

I also believe that policymakers on both sides of the Atlantic must consider more carefully the nuts and bolts of how consolidated home country supervision will in fact work. This is especially important for the highly complex financial institutions that are at the heart of both the American and European financial systems.

I agree that we can and must work more closely together. I am just not so sure that agreeing up front to wholesale harmonization of legislative frameworks or treating all regulations as equal is wise. I think that a case-by-case determination of where convergence might be necessary to achieve increased market efficiency and stability is more appropriate. It is for these reasons that I support the US-EU Dialogue and look forward to hearing testimony about it today.

Thank you very much and yield back.

[The prepared statement of Hon. Judy Biggert can be found on page 31 in the appendix.]

The CHAIRMAN. The gentlelady yields back. Are there further opening statements?

The gentleman from Washington State.

Mr. INSLEE. Thank you. I look forward to your discussion about coordination in regulatory affairs, because I think we have seen some good successes in coordination with the American and EU

regulators, but we have seen some different approaches, temporarily at least, taken by the EU and American regulatory structure, particularly an anti-trust issue that provokes my concern from the 1st district of the State of Washington.

And we think there are problems that can happen when there are obviously inconsistent approaches by the two regulatory branches that can force American companies to undergo different treatments, has wide implications in privacy issues and piracy issues and the like.

So we obviously are very interested in anything we can do to promote a true coordination, and I just hope that the panel will address the prospects of working on the issues at the upcoming US-EU Summit or the G7 meetings in the hopes that we can really reach that happy day when we have got total coordination between these two regulatory bodies. Thank you.

The CHAIRMAN. I Thank the gentleman.

We now turn to our distinguished panel. The Honorable Randal Quarles, Assistant Secretary for International Affairs at the United States Department of the Treasury; the Honorable Susan Bies, Governor, United States Federal Reserve Board; Ms. Samantha Ross, Chief of Staff of the Public Company Accounting Oversight Board and Mr. Ethiopis Tafara, Director of the Office of International Affairs, United States Securities And Exchange Commission.

Welcome to all of you folks, particularly Ms. Ross who makes her first appearance before our committee as a representative of the PCAOB.

Mr. Quarles, we will begin with you.

**STATEMENT OF HON. RANDAL QUARLES, ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, UNITED STATES DEPARTMENT OF THE TREASURY**

Mr. QUARLES. Thank you, Mr. Chairman.

The CHAIRMAN. Get your mike on there, Mr. Quarles.

Mr. QUARLES. Thank you, Mr. Chairman and members of the committee. With your permission, Mr. Chairman, I would like to submit my written remarks for inclusion in the record.

The CHAIRMAN. Without objection, all of the prepared remarks will be made part of the record.

Mr. QUARLES. Thank you, sir. And I want to begin by thanking this committee for its support for the US-EU Financial Markets Dialogue, which I, at least, think has been really integral to the progress that we have been able to make over the last couple of years, having that support.

As you mentioned at the outset, sir, the US-EU Dialogue began in March of 2002, and since then we have had technical meetings that have been led jointly by the Treasury and the European Commission. That includes active participation of the U.S. regulators, principally the Federal Reserve and the Securities Exchange Commission. Those have taken place on roughly a quarterly basis, and in addition to Dialogue it is supplemented by substantial interaction of senior policy officials.

The United States has a keen interest, a self-interest in the success of Europe's Financial Services Action Plan, because a central

aim of our foreign economic policy is to promote a strong and growing global economy. And we know that strong and efficiency capital markets support robust growth.

Also, U.S. financial institutions are a vital and leading part of the European financial landscape, and we want our firms to be able to compete globally on fair terms that reward their competitiveness. And so just as the United States is interested in the evolution of European capital markets, so Europe is interested in the evolution of U.S. capital markets and some of the recent steps that we have taken here.

Both the U.S. and the EU recognize that our financial, legal, historical and cultural traditional are different. The challenge of the Dialogue is to see through these differences and work to achieve our common objectives and substance and manage the spillovers of these differences into each other jurisdiction. If we are successful in this effort, then both sides will win.

So against this background, the United States strongly supports Europe's Financial Services Action Plan. And in fact we commend Europe for the ambition and the progress that they have made to date.

In my written remarks, I cover a broad range of issues, but let me mention two of the many key issues that we are discussing with Brussels. The Financial Conglomerates Directive requires a foreign supervisor regime to be deemed equivalent by Europe for firms from that country to operate within Europe without making costly changes to their method of operation. While there is always room for refinement and improvement, of course, it goes without question that the U.S. supervisor regime is a gold standard for the world's capital markets, and all U.S. regulators have cooperated closely with Europe in explaining their approaches to consolidated supervision. We are confident that a positive equivalence finding will soon be made.

Second, the Prospectus and Transparency Directives initially suggested that U.S. firms that would be listing new U.S. securities in Europe should prepare financial statements on the basis of international accounting standards by 2005, rather than US GAAP or they would have to cease issuing in Europe.

Moreover, the draft directives didn't make any provision for grandfathering previously listed issues. We discussed these matters with Brussels for the last year, and the final text of these directives provide for grandfathering of existing issues, and we fully expect that U.S. firms that will be listing new securities in Europe will be permitted to continue preparing their statements in US GAAP.

In addition to these specific matters, we applied the increased transparency of European rulemaking, growing consultations of regulators with market participants. These have improved European rulemaking in the same way that they improve our own rulemaking here in the U.S.. They have created a greater consensus and buy-in for proposed regulations, and they have strengthened European financial markets.

I think it is inevitable that there will be compromises in building an integrated capital market in light of different European country practices. That will be part of the FSAP process. But Brussels, the

parliament, the member states and the commission, in our view, are working to instill as liberal a vision as possible for the European capital market.

The FSAP's implementation is a work in progress. It will continue to evolve, but it represents an important step forward and the extension of this vision at the European-wide level to the so-called passport, and that will contribute to the growth in global capital markets.

Following the selection of a new commission and European parliament later this year, the Dialogue will need to tackle new challenges in promoting a more vibrant transatlantic capital market. Among these are promoting convergent accounting standards, improving corporate governance, strengthening investor protection and reducing the cost of clearance and settlement in Europe.

In conclusion, the Dialogue has increased the transparency of rulemaking and it is been part of the momentum to European financial market reform. I think that it is rightly credited as having helped diffuse transatlantic tensions in an important area that is vital to the functioning of the world economy.

And, finally, if those of us on both sides of the Atlantic can agree on financial regulatory standards, then others around the globe will follow. I think the potential benefits of this effort are enormous and that it is important that the Dialogue succeeds, and I believe it will.

Thank you, sir, very much.

[The prepared statement of Hon. Randal Quarles can be found on page 47 in the appendix.]

The CHAIRMAN. I thank you for your testimony, Mr. Quarles.

And, Ms. Bies—it is Bies, right? I am sorry, I had it wrong, but we will correct the record.

**STATEMENT OF HON. SUSAN BIES, GOVERNOR, UNITED STATES FEDERAL RESERVE BOARD**

Ms. BIES. My husband will appreciate that very much. Thank you, Mr. Chairman. I appreciate the opportunity to speak today on matters relating to the US-EU Financial Markets Regulatory Dialogue. I am going to comment briefly on the Dialogue's role in helping us to monitor European-wide regulatory developments in financial services and understand the effects on U.S. banking organizations operating in the EU.

At the time the Treasury Department initiated the Dialogue in 2002, the European Union was continuing with efforts to establish a single market in financial services by implementing measures comprising the Financial Services Action Plan. U.S. regulators were continuing to implement provisions of the Gramm-Leach-Bliley Act, and Congress was considering reforms that led to the adoption of Sarbanes-Oxley.

U.S. and EU financial services firms were and remain major participants in each other's markets. These regulatory developments will impact those firm's operations for years to come. In the United States and internationally, it is generally accepted that a foreign firm conducting business in a local market should receive national treatment; that is, the foreign firm should be treated no less favorably than a domestic firm operating in like circumstances.

Implementing national treatment can be challenging, as local rules must be adapted to foreign organizations that operate under different legal and regulatory structures. It is therefore critical that supervisors have timely and full information in order to have a good understanding of the supervisory and regulatory environments in which global firms operate.

The Dialogue has served as a useful forum for information sharing among regulatory experts who are responsible for implementing rules embodying national treatment. It helps to foster a better mutual understanding of U.S. and EU regulatory approaches, developments and time tables and to identify potential substantive conflicts in approach as early as possible in the regulatory process.

Although the Federal Reserve has an established program of working with foreign supervisors, both bilaterally and multilaterally, the Dialogue is the only venue specifically dedicated to US-EU regulatory issues. It complements the Federal Reserve's ongoing relationships and discussions with EU national regulators.

The Dialogue provides an efficient and effective forum for discussion of issues across a spectrum of financial services. As such, it has great utility for supervisors of large, complex financial services organizations. We have been able through the Dialogue to advance our views on the application of the EU's Financial Conglomerates Directive to U.S. bank holding companies.

Under EU rules, foreign financial firms must be subject to supervision at the holding company level by competent home country authority which is equivalent to the supervision provided for by the provisions in the directive. In the absence of an equivalence determination, U.S. financial firms with EU operations could be subject to higher capital and risk control requirements or be required to create an EU subholding company.

The Federal Reserve and the Comptroller of the Currency have provided information regarding the supervision of U.S. banking organizations. We anticipate that the commission will keep us informed of member states' progress in this regard, and we expect that U.S. banking organizations will be found to be in compliance with the supervision standards of the directives.

I would like to comment briefly on the relationship between the Dialogue and international developments in the areas of capital, accounting, and auditing standards. As you know, the Basel Committee on Banking Supervision is in the process of revising the Basel Capital Accord. Dialogue participants have discussed application, implementation, and timing concerns regarding Basel II. It has not focused on technical issues that have been under discussion within the Basel Committee. Technical issues have been left for the experts to work through.

The Dialogue has served as a useful venue for participants to gain a better understanding of implementation procedures that are anticipated. This discussion has helped both sides to achieve a better sense of the implementation challenges we all face and the commitment to see the process through.

The Federal Reserve and U.S. banking agencies are actively involved in the efforts of the Basel Committee to promote enhanced international accounting and disclosure standards and practices for global banking organizations. For example, an official of the Fed-

eral Reserve Board is a member of the Standards Advisory Council that advises the IASB and its trustees. Federal Reserve also has been active in supporting the Basel Committee's project with the International Federation of Accountants and other international regulatory organizations, such as IOSCO.

Although we have been actively involved in addressing international accounting and auditing issues primarily through our involvement in the Basel Committee's projects, the Securities and Exchange Commission has had the primary role in discussing these matters with the EU representatives in the Dialogue.

In summary, the Federal Reserve has found the Dialogue to be a useful vehicle in monitoring the rapid regulatory developments in the EU and exchanging information. At the Federal Reserve, we have an obligation to keep apprised of these developments on a timely basis in order to fulfill our supervisory functions and ensure a level playing field for U.S. banking organizations operating in the European Union. We are confident that continuing the Dialogue in its present informal form will facilitate these objectives. Thank you.

[The prepared statement of Hon. Susan Bies can be found on page 34 in the appendix.]

The CHAIRMAN. Thank you, Ms. Bies.

Ms. Ross?

**STATEMENT OF SAMANTHA ROSS, CHIEF OF STAFF, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD**

Ms. ROSS. Thank you, Chairman. Good morning. I am pleased to appear before you today on behalf of the Public Company Accounting Oversight Board to discuss the regulatory Dialogue between the Board and the European Union.

While we are not part of the official Financial Markets Regulatory Dialogue, under the leadership of our chairman, Bill McDonough, we have established a very effective working relationship with the EU related to oversight of the auditing profession. Both we and Europe have learned from experience that no borders can contain the losses and uncertainty that occur with large corporate failures.

Beginning with the work of this committee, Congress took steps to restore the public's confidence in our markets with the Sarbanes-Oxley Act. The act created the Board to oversee the auditors of public companies and gave it significant powers.

Among these powers, the Board has the authority to register public accounting firms that prepare audit reports for issuers as well as to conduct inspections of those firms. The board also has the authority to conduct investigations and disciplinary proceedings concerning public company audit work. Further, the Board has the authority to establish the standards governing the preparation of audit reports.

One of the Board's first steps was to establish a registration system for accounting firms that audit public companies, including non-U.S. firms that issue audit reports for companies that have registered securities in the U.S.. This includes the auditors of U.S. multinational companies that have significant operations abroad and the auditors of foreign companies that have elected to access the U.S. capital markets.

Today, 840 accounting firms have been registered by the Board, including 35 non-U.S. firms from countries such as the United Kingdom, Germany and Hungary. More than 145 additional non-U.S. firms have applied for registration, and we expect that as many as 300 may register in the near future. Registration is only the beginning of our oversight, however.

As we prepared for our oversight of non-U.S. firms, we began exploring with international auditing regulators ways to enhance the effectiveness of our oversight and minimize duplicative regulations. Based in large part on these discussions, the Board has developed a cooperative framework that would allow it to gain insight from and rely on the inspection by a firm's home country regulator.

This approach would permit varying degrees of reliance on the home country system of inspections, depending on the independence and rigor of that system. The board would place the greatest reliance on those systems that maintain the highest level of rigor and independence from the accounting profession. Conversely, the Board would participate more directly and rely less on those systems that are less independent or rigorous.

The European Commission is facing the same issues relating to audit quality that we face. The Parmalat scandal, which came to light last December, galvanized investors in European securities to demand more reliable financial reporting and auditing. With the proposed 8th Company Law Directive, European Commissioner Frits Bolkestein and Director-General Alexander Schaub have taken important steps to restore confidence in European markets.

Shortly after the 8th Directive was proposed this past March, Commissioner Bolkestein and our Chairman held an unprecedented roundtable discussion in Brussels with EU member state representatives. Our primary discussion focused on the key objectives of auditor oversight upon which we are all building our new regulatory systems.

The oversight system required by the 8th Directive appears to mesh quite well with the oversight system we are putting in place here in the U.S.. The 8th Directive would require external independent oversight of auditors in a manner that is transparent, well-funded and free from undo influence by auditors or audit firms. It would also provide for cooperation with other regulators. These provisions should substantially enhance our ability to coordinate with our European counterparts.

While the assistance of non-U.S. regulators will help us achieve our objectives under the Sarbanes-Oxley Act, true collaboration is a two-way street. The board has previously stated it is willing to assist non-U.S. regulators in their oversight of accounting firms. Because the needs of every regulator are different, we plan to work out the details of our assistance through direct discussions.

In conclusion, we still have much work ahead of us to establish lasting relationships and working protocols with other regulators, and the Board is optimistic. Cooperation among regulators requires good will and flexibility. Our experience with the European Commission has demonstrated that European regulators share this view. We are confident that with the continuation of our open and constructive Dialogue with both the EU and its member states, we

will be able to work together to fulfill our important missions to protect investors. Thank you.

[The prepared statement of Samantha Ross can be found on page 52 in the appendix.]

The CHAIRMAN. Thank you.

Mr. Tafara?

**STATEMENT OF ETHIOPIS TAFARA, DIRECTOR, OFFICE OF INTERNATIONAL AFFAIRS, UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

Mr. TAFARA. Thank you. Chairman Oxley and distinguished members of the committee, I am delighted to have been invited to testify about the US-EU Regulatory Dialogue on capital markets. The Dialogue is the result of historic changes in the way capital markets function and our likely to develop. Today, almost all developed markets and even a considerable number of developing markets have adopted forms of security regulation similar to our own. At the same time, capital markets have become global. The result is something unique—a truly global capital market but operating in a world of expensive domestic capital market regulation.

At this point, I should say that I firmly believe that the U.S. securities laws and SEC market oversight are two of the principal reasons why our markets are as efficient and effective as they are at fueling the capital needs of our economy. These laws focus on investor protection and have created in investors a certain bedrock confidence in the integrity of our securities markets that even sizable financial scandals have not been able to diminish entirely.

In Europe, the union has promised to create an EU-wide capital market and a rationalized coordinated European securities regulatory structure. These initiatives will improve the efficiency and liquidity of Europe's securities markets, developments that will benefit both U.S. investors and issuers in the long run by providing the former with greater investment opportunities and benefiting issuers by possibly lowering their cost of capital.

The U.S. and EU securities markets are too large to be ignored, and potential conflicts between the regulatory requirements of these markets can have an adverse impact on cross-border flow of capital. Some of these conflicts may prove difficult to avoid, stemming, as they may, from differences in regulatory philosophy. Nonetheless, some duplicative or even contradictory regulation in this cross-border environment may offer little in the way of investor protection and merely place an unnecessary burden on issuers, firms and investors. The SEC is committed to avoiding such situations where possible.

The US-EU Dialogue was created as a form in which to discuss such conflicts and other regulatory matters and fulfill several functions. Most importantly, it has served to reinforce our common ground. With respect to financial services regulation, the U.S. and EU share the same fundamental goals: Protecting investors, maintaining the stability of our markets and allowing free and unfettered competition among all market participants.

The Dialogue is also proving useful in resolving potential problems by providing an opportunity for both sides to air concerns

about the possible impact of upcoming regulations and to explore adjustments.

Finally, the Dialogue has afforded an opportunity to learn from each other's experiences. The learning process allows us to consider possible new avenues of regulation for our own markets which ultimately enriches the regulatory rulemaking process and helps us each to better carry out our regulatory mandates.

We have made a connection with the Dialogue on a number of occasions and on these occasions we have discussed a number of key issues, including the implementation of the Sarbanes-Oxley Act, EU Financial Conglomerates Directive and international financial reporting standards. Although the US-EU Dialogue began before the Sarbanes-Oxley Act was signed into law, implementation of the act added new significance to the Dialogue.

As the SEC began to implement the Sarbanes-Oxley Act, it quickly became clear in some cases implementing the provisions in certain ways could conflict directly with laws and regulations in other jurisdictions. The SEC worked very hard to resolve these conflicts in a manner consistent with the spirit and intent of the act.

The Dialogue played a key role. Through our interactions with representatives of the European Commission, the SEC learned where potential conflicts lay, while the European Commission came to understand the objectives of our proposed rules. These discussions, in turn, led us to consider modifications to our proposed rules and avoided putting foreign market participants in the unenviable position of being asked to comply with conflicting laws while still ensuring that the objectives of the Sarbanes-Oxley Act were met.

The cross-border impact of securities regulation travels both ways, as the SEC also had to respond to legislative initiatives in the European Union. And one example we had to respond to was the EU legislation called the Financial Conglomerates Directive. This directive had cross-border implications given that it requires non-EU holding companies or financial firms operating in the EU to be subject to consolidated supervision.

Again, the Dialogue played a key role. As the EU went through the process of proposing, amending and finalizing the directive, we discussed as part of the Dialogue the implications of the directive for U.S. broker dealers with operations in Europe. Indeed, the SEC provided detailed explanations of the SEC's form of oversight to EU regulators and policymakers and at this juncture expects that the European Commission and EU member states will find our system of consolidated supervision to be equivalent to the Financial Conglomerates Directive.

Going forward, the SEC and the European Commission will be examining many of the same regulatory issues partly in response to very similar financial scandals in both our markets. The Dialogue is proving to be fertile ground for exploring new ideas and approaches, as both sides consider whether to introduce new regulation or to strengthen existing regulation to address regulatory concerns.

To complement our discussions with the European Commission, I expect that we will in the near future also develop a framework for cooperation between the SEC and the Committee of European

Securities Regulators, or CESR. The committee comprises securities regulators from all EU member states and is responsible for implementation of EU laws and day-to-day oversight.

In conclusion, I would note that the US-EU Dialogue is a key element in a web of connections between the U.S. and EU policymaking community. It serves the important function of providing a forum for developing greater understanding of each other's approaches, for airing concerns about actions that either the U.S. or EU has taken with respect to financial services and ultimately will help us achieve more converged regulations relating to financial services while ensuring the highest level of investor protection.

I believe the Dialogue will lead to better securities regulation in the U.S. and the European Union and in the long run better protection and choices for investors. Thank you.

[The prepared statement of Ethiopis Tafara can be found on page 82 in the appendix.]

The CHAIRMAN. Thank you, Mr. Tafara, and we now turn to our panel, and I will begin with a series of questions.

I would first like to ask Mr. Quarles, since the Treasury coordinates the views of the U.S. Federal regulators regarding the issues before the Dialogue, one of the most striking differences that I have noticed between the Federal regulators until recently has been that the SEC did not regulate holding companies and supervise holding companies. That appears to be changing. It would seem to the outside observer that the SEC is finally using the Gramm-Leach-Bliley authority in order to converge with the EUs legal standard.

I understand the equivalence determination in Europe regarding our state-based insurance regulators could be at least as thorny as the determinations in the securities industry. Having said that, what is the Treasury doing to help facilitate the equivalency determinations for all sectors of the U.S. financial services industry, and where do we go from here?

Mr. QUARLES. The question of equivalency has been one of the central ones that we have been discussing in the Dialogue, and we have—what the Treasury has been doing is attempting to deal with all of the aspects of that as it arises in the discussion. What the SEC is proposing has been helpful. We have been encouraging direct conversations between the commission and the regulators on the topic of equivalency and some of the technical issues that arise.

And on the insurance side, there is a direct Dialogue as well between the commission and the insurance regulators. It is an insurance regulatory Dialogue that is led by the NAIC, the National Association of Insurance Commissioners, which we are monitoring, and occasionally representatives of the NAIC will participate in our Dialogue on issues related to the Financial Conglomerates Directive and equivalency determination. So we have attempted to strengthen their separate Dialogue by including them in ours.

The CHAIRMAN. Does our system of insurance regulation at the State level complicate your efforts?

Mr. QUARLES. I don't know that I would use the word, "complicate." Obviously, because there isn't a Federal system of regulation for insurance, we have to approach that in a different way than we approach the regulation of other financial institutions. But that said, I think that the Dialogue that there has been between

the State insurance commissioners and the European Commission, which we have been monitoring, has been helpful in addressing some of the concerns about varying State regulations that the European institutions face when they come into the United States.

The CHAIRMAN. When you get into Dialogue sessions, do you have a coordinated approach going into those, and that is directed by the Treasury, you are kind of the quarterback? Is that how it works?

Mr. QUARLES. Yes.

The CHAIRMAN. In areas of competency and regulatory structure?

Mr. QUARLES. Yes. Generally, the technical group when they meet, for example, usually will meet in advance, not always, but usually will meet in advance to go over the issues that will be presented in the discussion, so that there is a unified view.

The CHAIRMAN. Thank you. Let me ask all of our witnesses, and I am kind of running short of time, so we will try to do our best to get some answers. The exercise of consolidated home country supervision in the world of modern finance is going to involve a lot of sharing of information across borders—sharing data, verifying models implemented properly, even on occasion sharing enforcement and investigative authority.

Let me start with Mr. Tafara and we will work that way. Do you believe that all of these things can be accomplished through the informal networks that exist, such as the Dialogue, or are we going to need at some point some more formal arrangements to accomplish our goal?

Mr. TAFARA. I am not sure that we need something more formal. Indeed, today, I mean as we have put into practice our risk assessment program, which involves gathering certain information from broker dealers and assessing their exposure and the capital that should be charged as a consequence of that exposure, we do meet regularly with our counterparts in Europe at the national level, particularly with respect to broker dealer groups that have a presence in the major countries, in Europe, Germany and the UK and indeed a country outside of the EU, the Swiss.

We meet with them one to two times a year to share information about what we see, concerns that we have identified and to hear from them about the same thing. And that process has worked extremely well over the course of the past several years that we have been meeting with them. And I expect that will continue going forward, that we would continue to meet on a rather informal basis but yet share information relevant to the risks and the risk exposure of these firms that we should be taking into account.

The CHAIRMAN. Thank you.

Ms. ROSS? Don't forget that mike.

Ms. ROSS. Yes. We do plan on establishing working protocols and procedures with the various auditor oversight bodies that we hope to be able to gain assistance from and rely on in our inspection work and our other oversight programs. That is one of the things that we are beginning now to get working on. The European Commission has been very helpful in establishing a framework for that kind of work through the ACE Directive.

In addition, the European Commission is now helping us establish relationships with the various member states which will be

forming these new auditor oversight bodies as we are forming now so that we can work together.

The CHAIRMAN. Thank you.

Ms. Bies?

Ms. BIES. Mr. Chairman, the Federal Reserve already has legal agreements that allow us to share information with all the major banking regulators across the world, and where we have specific cases of investigations, our experience has shown we work very well together under the period where you are sort of under stress and have a real problem situation.

So we are very comfortable we have the authorities that we need day-to-day coordinate the activity between the home and host regulators.

The CHAIRMAN. Mr. Quarles, specifically to you in terms of terrorist financing and anti-money laundering, do we need to go beyond the informal arrangements and look towards MOUs and other forms of agreements? I know that based on the PATRIOT Act that the Treasury has been quite busy and successful in many cases in implementing that law. Could you give us some details?

Mr. QUARLES. Sure. There obviously are a number of ways in which we would want Europe to, again, refine and improve the procedures it has in place for addressing anti-money laundering and counterterrorist financing. I don't know—at this point, I don't know that we would say that it requires something more formal than what we have been doing.

We have a regular interaction with the Europeans on these issues, and, for the most part, it is fruitful, and we have had some significant successes, for example, in September of 2003 when Europe moved to designate the entire Hamas organization rather than attempting to split it up from its charitable arm and its political military arm.

But, for example, in that same vein, they still don't designate all of Hezbollah, and that is something that we are working with them to improve. We think they need to streamline the clearinghouse process that they have for handling information related to preparing designations and for moving quickly to disseminate information about designations to banks in their jurisdiction. We think they need to develop a more flexible standard for designation. It is really more of an actual criminal standard as opposed to an administrative standard, and that isn't flexible enough to be able to act quickly enough, and speed is of the essence in this effort.

So there are clearly issues like that—I think those are the principal ones—there are issues like that we want them to move on and are continuing to work with them to move on. But the progress that we have had so far, while it is not complete, I think would not say that we need a thorough overhaul of the way that we are engaging with them.

The CHAIRMAN. My time has expired.

The gentleman from Washington?

Mr. INSLEE. I was so enthralled with your questioning that I was just momentarily rendered speechless, which doesn't happen very often.

[Laughter.]

The CHAIRMAN. That is true. I won't start your time running until you tell me when you want.

[Laughter.]

Mr. INSLEE. Okay. Maybe it goes without saying that U.S. businesses have a huge interest in having consistency between American and EU regulatory structures. And where we have consistency, we frequently have global kind of concurrence, other nations follow. And where we don't, it can give inconsistent results, not only in the EU but folks who feel free to start new regulatory schemes around the world.

This was brought home to me. Obviously, frankly, with the Microsoft case, it has two different at least potential, and there are some good signs, actually, that we may find more coordination in those policies, so that is—we have optimism about that.

But I just wondered what you could tell us, particularly, Mr. Quarles, about efforts at upcoming summits, EU-American summit, G7 and the effort to really emphasize our need and explore ways to improve our consistency across the pond knowing how important it is to U.S. business.

Mr. QUARLES. This Dialogue, for example, is something that forms an important part of the discussion at the summit, at the US-EU summit. And in the context of the G8 summit that will be coming up, a central theme is the agenda for growth, which is to say measures that all of the G8 economies need to take in order to—we call them supply side measures that improve the environment for economic growth in each of those economies. And an important part of that is the regulatory environment and ensuring that business climate is conducive to economic growth.

We have made that a constant and central theme of our engagement with the developed countries at the summit level, at the ministerial level and in various international forums, and I think you can see that it is beginning to bear some fruit, both from the support that the Dialogue has at the heads level because it is always, as I say, a central topic of the US-EU summit but also in some of the structural changes that European countries are making in their economies that are pro-business and pro-economic growth.

Mr. INSLEE. Well, we encourage those efforts, we hope you are successful, because this has enormous ramifications for companies that need predictability, need consistency, need to trust one judicial system instead of having to go through 100, and we hope you will be successful. Thank you.

The CHAIRMAN. I thank the gentleman.

Let me ask Ms. Bies and Mr. Tafara, and I am going to be asking a similar question to Dr. Schaub when he testifies. It is a complicated issue and it is one that really has enormous consequences going forward. Many U.S. institutions have been listing in the Euro markets on the basis of US GAAP standards.

The euro markets are obviously huge. I understand that the new EU directives imply that unless US GAAP is soon found equivalent for the purposes of listing in Europe, these firms may not be able to continue using the Euro markets. It would seem to me that such a development would mean lower liquidity and volume in the European capital markets, which would be contrary to the basic purpose of the FSAP.

In the meantime, uncertainty in the markets could inhibit issuances. Governor Bies and Mr. Tafara, there has been much debate and concern in Europe regarding the IASB's proposed fair value standard for derivatives. What is your impression of how that debate is likely to turn out? Do you agree that it could be a problem for the balance sheets in Europe and the United States to have different standards for evaluating and valuing derivatives?

Ms. Bies?

Ms. BIES. Mr. Chairman, the proposal that Europe is debating at the moment would bring the international standard closer to the U.S. Today, we have a very wide difference between the two accountings. In the United States, several years ago, the Financial Accounting Standards Board required all corporations, not just financial institutions, to recognize on their balance sheet financial derivatives of all types. Europeans still don't do that.

So one of the things in terms of a level playing field and transparency of these complex organizations, we think it is important that they do move forward and provide that transparency.

Now, the U.S. companies, to their advantage, had to adopt all these changes one by one because these are in different standards in the U.S. and so had more time to implement, and that is one of the issues I think the Europeans are struggling with to adopt all this at once. But the European firms who are already preparing under US GAAP will find that much of the work they are already doing will help them.

And, furthermore, some of the approaches that are in IASB proposals 39 and 32 actually provide some interesting alternatives to some of the areas in the US GAAP that we have found problematic and might provide an alternative. So I am hoping that we get to a closer consistency across the two standards, and I think the Dialogue that is going on now between the FASB and the IASB and our work with the other banking regulators in Europe to talk about how to look at financial standards in the two countries is very productive.

I would also add that even if we get comparable standards, the issue is going to be whether they are implemented and interpreted the same way, and that is going to require some work. We think some of the new standards, for example, on loan loss reserve accounting should move us closer than what we have in practice today. And, obviously, the work of the PCAOB is important because a lot of the issues that we struggle with that we call accounting issues, even in this country, are not accounting, they are audit failures.

The CHAIRMAN. Well, maybe we should ask Ms. Ross then to comment on that since you brought her into the equation here.

[Laughter.]

Ms. ROSS. Thank you, Chairman. Our board has not taken a position on accounting standards, and I don't really expect it to, because we really are in the audit area. But, of course, once the accounting standards are established, we do play a very big role in helping to ensure that these accounting standards are applied in a consistent manner, just as Governor Bies is saying.

So that will be critically important to us as we move forward in our inspections of accounting firms work on public companies, both

those public companies that are the sort of bread and butter companies we have here in the U.S. and then also the foreign private issuers that are listed and registered with the Securities and Exchange Commission. So this is something we are very mindful of.

The CHAIRMAN. Thank you.

Mr. Tafara?

Mr. TAFARA. Don't know that I have much to add to what Governor Bies had to say about IS 32 and 39. We have tried to stay outside of the debate that is raging in Europe with respect to whether or not they should use IS 32 and 39, as they have been currently proposed, other than to note that a financial instrument standard is pretty important to add and to note that the conceptual underpinnings to 32 and 39 are the ones that are in FASB 133 and our institutions have been able to adapt to use the standard.

With respect to convergence, I want to add on to what Governor Bies had to say and say that we have been strong supporters at the SEC, at least at the staff level, of the convergence project that is taking place between the IASB and the FASB, the exercise of identifying the principal differences and trying to eliminate them over a period of time, and we think that actually will increase the transparency and the comparability of financial statements as investors look to the choices they have for their capital.

But as Governor Bies pointed out, critical to the acceptance of IAS on a cross-border basis will be a robust infrastructure for consistent interpretation, application and enforcement of the standards. Without that, what is supposed to be one standard can quickly devolve into 15, 25, 30 different standards, and that is something we are working with our counterparts across the Atlantic on establishing.

The CHAIRMAN. I would assume that all of the witnesses would share the same concerns expressed by Mr. Tafara in terms of having numerous standards and trying to deal with all of those. I see everybody shaking their heads. And, of course, one of the purposes of the hearing was to get some of those issues out there, and that is been enormously helpful, and your testimony has been enormously helpful to the committee in making a record as we move forward.

I think the encouraging thing is that we have made significant progress already, and in many ways we are just probably in the first inning of this process, but it is quite encouraging, and for that we thank all of you and we are now—you can go back to work, and thank you for your testimony.

The committee is now pleased to welcome Mr. Alexander Schaub, Directorate General for the Internal Market of the European Commission.

Mr. Schaub, it is great to have you here to share your expertise. The committee is very familiar with your background and your reputation in the European Union, and we most appreciate your coming across the Atlantic to be with us this morning and testify, and you may begin whenever you feel comfortable.

**STATEMENT OF ALEXANDER SCHAUB, DIRECTOR GENERAL, DIRECTORATE GENERAL, INTERNAL MARKET, EUROPEAN COMMISSION**

Mr. SCHAUB. Good morning, Chairman Oxley and members of the committee. Thank you very much for inviting me to testify on behalf of the European Commission and in addition for the first time on the informal EU-US Financial Markets Regulatory Dialogue.

Cooperation in this area is not an option, an extra. It is an economic, political and regulatory necessity. We are economically interdependent. In the global markets, our regulations inevitably spill over on each other, not only in this area, it was already talked about, competition policy where you have exactly the same phenomenon.

The financial integration that we are undertaking in Europe offers huge opportunities for the U.S.. And we can cooperate. Within the EU, we have had to ensure that also in an enlarged union investors in one country can feel secure about the offer of service from intermediate in another. We have taken, and we continue to take, stringent steps to ensure that high regulatory standards prevail. Such cooperation, which we have been training and practicing over 4 decades now within the European Union, must also be possible with our friends in the U.S.

We have taken a fresh start in our cooperation. That has involved recognizing the need, not necessarily to take identical approaches, but to agree on equivalent approaches. That is, in our view, the only viable way forward, and it is based on our practical experience over the last 40 years. We have taken a fresh—excuse me.

The Financial Markets Regulatory Dialogue is key to this exercise. There is no magic to the term, it just refers to the fact that we are talking to each other frequently. It does not matter whether that takes place face to face or by telephone. What matters is that it does happen and in a constructive and effective way which removes hurdles and prevents the creation of new ones.

What makes it tick is its informality, meeting only as on as an as and when basis and concentrating on solutions. We are constantly looking at improvements by organizing our discussions better, delegating work to experts, encouraging parallel Dialogues, including that, by the way, between yourselves and the European parliament, and we were always pleased to see you in Brussels, and between industry, while keeping all stakeholders informed of progress achieved.

One of the key issues will be, as already mentioned, auditing. We welcome the excellent and extremely pleasant cooperation with the PCAOB, and we hope this will continue.

On conglomerates, we recognize the need for certainty, and we hope to be able to announce guidance shortly, European guidance to be applied by the national supervisors. It is vital that we work together on the reconciliation of international accounting standards with US GAAP, and there are indeed practical questions which have to be further clarified.

It is crucial that supervisors continue to work closely on the implementation of a new capital accord, and I think we can congratu-

late our negotiators from both sides of the Atlantic on the outcome of the latest meeting in Basel. Banks must not find the benefits of the new framework undermined by conflicting approaches to implementation and interpretation.

There are benefits to cooperating on the regulation of securities and exchanges and the possibilities of remote excess to trading screens of exchanges based in the jurisdictions of the other side. We also see benefits in the increased cooperation on the collateralization of reinsurance, allowing insurers on both sides to diversify risk.

Finally, there are issues such as credit rating agencies, financial analysts, mutual funds and hedge funds which offer real opportunities for more upstream convergence and practical cooperation.

Mr. Chairman, I welcome the support that you have brought to this process, and I ask this committee to support us as we proceed. Our citizens, intermediaries and companies all stand to benefit from it. Thank you for your attention.

[The prepared statement of Alexander Schaub can be found on page 68 in the appendix.]

The CHAIRMAN. Thank you, Mr. Schaub, again for—Dr. Schaub for appearing before us today and your very positive comments. And, indeed, what you say is correct, that our constituents on both sides of the Atlantic are depending on policymakers to work together to make certain that the free flow of services and their financial future is well in hand and that we do have the benefits of regulation that provide the kind of safety and protection for investors and for savers at the same time.

Let me begin. The EU's Financial Conglomerates Directive states that the U.S. securities firms operating in Europe must be subject to an equivalent consolidated global supervision system which would be determined by the relevant Member State regulator beginning in 2005, next year. As you know, the SEC and others have been working closely with the European Commission for over 2 years in order to ensure that the SEC's regime is determined to be equivalent. As a matter of fact, we had some discussions in Brussels about that, I guess, almost 2 years ago.

And I understand that the Commission will not issue its guidance to start the equivalency determination process until at least June of this year. This delay is causing some concern, as you might guess, within the U.S. financial services industry. Is there any reason for us to be concerned that the SEC's new regime will not be found equivalent in time for compliance?

Mr. SCHAUB. First of all, I should underline that this equivalence requirement is not a way of torturing unnecessary our friends and partners. It is a natural prerequisite before you enter into cooperation in such sensitive, important matters with important partners, and we find it perfectly natural that in cases where the U.S. is supposed to cooperate—U.S. supervisory structures are supposed to cooperate with us, that they would naturally first have a look whether the partner, their cooperation partner is at the equivalent quality level.

Now, on the concrete case, you will understand that I cannot prejudge the outcome of this process, but personally I am very much convinced that this exercise, which is a new experience, which has

taken more time also because American companies needed more time to present the practical details, I believe that at the end we will clearly come to a positive outcome.

That is my firm, personal expectation, and I can tell you that we in the commission, Mr. Bolkestein, in the first place, are following closely this process. And if there should be any problem in the further development, because, as it was said, the final decision on equivalence is taken by the national supervisors on the bias basis of community-wide guidance, on the application of uniform rules at community level. But the last word is delegated to the national supervisors, and we will be in very close contact to make sure that unnecessary accidents can be avoided.

The CHAIRMAN. Thank you. Do you think that the insurance issues will perhaps create the thorniest problem? What is your view just on the overall insurance issues within the scope of your jurisdiction?

Mr. SCHAUB. Well, I think it is not a secret that the insurance industry on both sides of the Atlantic is not in the most brilliant state of its history and that market participants rightly expect that this industry gets its act together. That is what is happening on the European side, what is happening certainly on the American side, and I believe that we have an interest on both sides to make sure that this process is closely followed and that it is pursued over time, because the scandals have already created enough doubt and hesitations in the marketplace, and it is vital for both sides that confidence comes back, and confidence is created in the first place by market players who visibly get their act together.

The CHAIRMAN. And you heard the testimony from our panel. Was there anything that the previous panel discussed that you would like to comment on? Are there any glaring omissions or differences that you may have noted during that testimony?

Mr. SCHAUB. I would say on the contrary, what is striking for me and what is at the same time very encouraging is that we are speaking more and more the same language and that your concerns on the U.S. side are our concerns in Europe.

Let me just take one particularly crucial example, that is the introduction of international accounting standards. We both agree that this would be a major step forward, because what is happening at present that big internationally active companies have to present their annual results in four, five and sometimes even more different techniques with the amazing result that exactly the same company in some countries presents losses of $2 billion and in other countries comes out with a positive result of a billion. That is very amazing and puzzling for the market participants, and it undermines, obviously, the credibility of the whole system.

Therefore, there is deep conviction on both sides of the Atlantic that this is certainly one point where we need to come to single rules. We don't need single rules for everybody and for everything, but this is a key element where do need, like on capital requirements for companies, we need common single rules. And I share the expectation and the strong wish of the U.S. authorities and of Congress that this crucial step is done soon.

As you know, these activities of the International Accounting Standards Board is entering now in a dramatic final phase. It

seems to us clear if there is no agreement by mid-June, it will practically be impossible to create the conditions for companies to apply the new international accounting standards as of January next year, which was foreseen, which was the target date for a long time.

So we are working very intensely with Mr. Bolkestein, personally involved with very intensive contacts with Paul Volcker and with David Tweedie, the chair of the IS Board, on how to solve the very few still open questions. And my conviction is, and I was very pleased to see that this is also Paul Volcker's conviction, that we can solve these one or two open points until mid-June in a pragmatic way, which means that we need not on every last detail come to solutions which would be considered as solutions for the next decade.

If we come to solutions which are as a provisional solution, acceptable on the condition that a credible process is immediately now launched with a target date to further improve the provisional results, which, as I see today, will, in any case, imply very significant improvement if such a pragmatic way could be followed, it should be possible to terminate mid-June and to assure that as of January next year companies will apply these new standards.

It would be an enormous breakthrough. It would give the signal to the world that this target of credibility and of reinsurance for the marketplace will be pursued and therefore it is worthwhile that all forces are concentrated on this final breakthrough.

If we would fail, we should have no illusions that this would be a major shock for the marketplace, because it would not just mean probably that the efforts to go forward are not concluded, it would open a major risk that the process could be brought backwards, because there are people in the marketplace who would not be unhappy to work on more regional standards, and the whole dynamic towards convergence risks to be undermined and destabilized, and we could lose a decade if we can't bring this now to a positive end. We really hope that it will be possible, and I am personally confident that it will be done.

The CHAIRMAN. And so we are really talking about a month. We are already in the middle of May, so we are talking a matter of 4 or 5 weeks; is that correct?

Mr. SCHAUB. That is exactly the case.

The CHAIRMAN. So as we would say over here, it is crunch time.

Mr. SCHAUB. Yes.

The CHAIRMAN. Is the likelihood of fair valuation for derivatives the key issue to be decided?

Mr. SCHAUB. This is certainly the most difficult remaining issue, and I believe it is crucial that on this point real significant progress is achieved, because I would understand that it is not acceptable that on such a key point simply nothing happens that would undermine the credibility.

From my point of view, what is absolutely essential is that at least clear transparency is created, that investors in the marketplace have a possibility to get an idea what this hedging exercise, which is so complicated that only very few people understand it and I don't belong to these people.

The CHAIRMAN. Nor do I.

Mr. SCHAUB. But I can understand that the simple human being participating in the marketplace wants to know what does this hedging exercise mean for my company in January, in June, in December, and the minimum is that such transparency is introduced as a compelling element of the future rules.

The CHAIRMAN. We have had some discussions with private sector folks on this side of the Atlantic that they are concerned about what appears to them to be lack of transparency in the EU process. To what extent do you take into account those views from private sector people that will be affected, obviously, by the rulings?

Mr. SCHAUB. We are deeply convinced that high quality rules cannot be produced without systematic implication of the private sector on both sides of the Atlantic, because we are talking about rules which should be applicable worldwide.

Now, it is not a surprise, certainly not for you, that private does not appear spontaneously with a common view. So we are systematically exposed to quite diverging views which are reflecting often the diverging position of the companies or the association of companies which appear. It is simply a fact that there are—some of them are much more affected, and others are much less or not at all affected. So they will not sing the same song when they come, but our task is to make a sound judgment what should be taken into account of their wishes and what cannot be taken into account without endangering the credibility of the new future rules.

The CHAIRMAN. Thank you. I think we have pretty well covered the IASB issues, and, by the way, we have had testimony from Mr. Volcker on a couple of occasions, and we could not be better represented than someone with his stature and ability, and we have certainly relied on him and leaned on him in many cases to help the committee better understand this transformation that is taking place across the Atlantic.

The home country supervision issue, the term, "home country," I just need to get this in my mind, home country supervision, from our perspective, means, of course, U.S. supervision. With the EU now, we are really talking about an expanded breadth of home country supervision, correct? In other words, the European Commission and European Union represent that home country supervision. I am correct, right? In other words, we are not talking about individual states here now, we are talking about the entire European Union when we define home country supervision.

Mr. SCHAUB. Well, in Europe, we do not have the same structure than the one you have since very recently. We don't have one single European supervisor. There is a lot of debate about this. We have at present a decentralized European supervisory system, and that means that there are common European rules, there is a European body for security, CESR, and corresponding bodies for banks and for insurances, which are closely following the application—together with the commission the application, the enforcement of the common European rules by the national supervisors.

So it is a bit more complicated than your system today, but the purpose is to assure, like on the U.S. side, convincing, efficient, credible results. And we agree with the Bill McDonough and your PCAOB that an intelligent work sharing between the two sides is

only possible if each side has convinced itself that the system on the other side offers comparable, equivalent guarantees.

Now, this is not done just because we like the Americans so much or because you like the Europeans so much, it is largely a question of efficiency, how are we from London or from Frankfurt able to assure the supervision of a Japanese company located in Kobi and having a Japanese auditor? That is very difficult. So the same is true if you want to supervise an Italian company located in Milan and Bill McDonough has certainly highly qualified staff, but it is not sure that he has enough Italian-speaking people who could really do the job on the spot.

So the idea is that there is work sharing to the point that it remains credible, that the guarantees of reliability of this joint effort is the same. And we believe that this work sharing is probably the only way to get out of the problem in an increasingly global system.

The CHAIRMAN. Dr. Schaub, what is the—just having gone through an enlargement now, what commitments do the new countries that have joined the EU, what kind of commitments do they make in terms of their regulatory structure and all of the negotiations that are going on currently?

Mr. SCHAUB. Well, you know, the fundamental requirements, preconditions for accession are for each of these 10 new members that they introduce as of the 1st of May fully—they introduce fully because there are no derogations accepted—the implementation of the so-called community acquis that is the totality of European Union rules on financial services. And it is the task of the European Commission to make sure that the community rules are effectively respected.

Now, it is not a secret that we have been working frantically until the end of April with some of these countries to make sure that they do the very few remaining elements of homework which had not been delivered yet.

So we are now in a situation where they have introduced the rules where they do have supervisory structures, and we will now be in a much better position than in the past via the multiple committees where the representatives of these supervisory authorities from all 25 member states are regularly meeting. It will be much easier to assure that all these 25 supervisors are effectively applying the same rules, that they are making the same interpretation of these rules, and that they deliver convincing results. That will be, of course, an important responsibility for the commission and for these Europe-wide committees, but it is an exercise which has been applied in many other areas before.

So it is not something totally new, and it is something which has successfully worked in other cases. Personally, I remember particularly the positive experience after the last accession exercise in the new member states at the time, and I remember very well in the competition area the remarkable efforts the 10 new member states have undertaken over the last years to get their own competition authorities now, their own financial supervisory authorities into the shape required to be part of a convincing European system.

The CHAIRMAN. Very good. Again, we thank you profusely for coming over and testifying before the committee. We know that your trip was a brief one here, and for that we are most appre-

ciative that you did take the time to come over and visit with us and impart some knowledge for the committee and make an excellent record.

So, again, Dr. Schaub, thank you, and the committee stands adjourned.

[Whereupon, at 11:40 a.m., the committee was adjourned.]

# A P P E N D I X

May 13, 2004

**Opening Statement**

# Chairman Michael G. Oxley

## Committee on Financial Services

**"The U.S.-EU Regulatory Dialogue and its Future"**
**May 13, 2004**

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Good morning. Two years ago, this Committee convened a hearing to address "The European Union's Financial Services Action Plan and its Implications for America's Financial Services Industry." Today's hearing explores how the Dialogue has worked over the last two years and how participants expect it to evolve in the context of a united Europe consisting of 25 countries with a wide range of economic strength and development.

We welcome back witnesses from the SEC, the Treasury, and the Federal Reserve to discuss this issue. I look forward to seeing whether their expectations two years ago were met and what they think the future might hold. We welcome for the first time on this topic our PCAOB witness, who will provide a perspective on how innovative and productive a variety informal processes can be in resolving difficult transatlantic regulatory issues.

I am particularly pleased to welcome for the first time before this Committee the European Commission. It is not often that a foreign authority testifies before Congress. I understand that Director General Alexander Schaub will use the opportunity of this hearing to present significant new ideas on how the U.S.-EU regulatory relationship might evolve. We look forward to this testimony.

Two years after our first hearing on this issue, many of the same issues remain on the forefront of the transatlantic regulatory debate: the supervision of financial conglomerates, international accounting standards, convergence in accounting standards, transparency in prospectuses, and making consolidated supervision function on both sides of the Atlantic.

And yet, much has changed. We convene today shortly after the historic accession of 10 Eastern European countries into the European Union. This fulfills the dreams of many (including myself) that Europe after World War II could one day be united, whole, and free. Much of the European financial services agenda, especially after the fall of the Berlin Wall, has aimed to create a financial services marketplace to serve a European market nearly equivalent in size to ours.

The financial markets have also changed. The end of the Cold War and a revolution in risk management and telecommunications together have created opportunities and enthusiasm for global capital markets to integrate across borders. I believe that transatlantic trade in both goods and services benefits consumers and businesses on both sides of the Atlantic and helps create a vibrant job market here in the United States. It generates competition in both markets and forces firms to be more efficient, innovative, and effective in serving customers.

These trends place pressure on financial regulators to find better ways of working together. Following our hearing two years ago, the "U.S.-EU Financial Markets Dialogue" was created. It fosters regulatory discussion on emerging transatlantic issues and attempts to avoid conflicts. I understand that the dialogue has been extremely successful. In fact, it has been so successful that some have suggested it needs to grow and become more formalized.

Others have suggested that the dialogue should seek to accelerate financial market integration and foster convergence of regulatory standards across the Atlantic. Our witnesses today will provide insight into the innovative tools used today to increase transatlantic mutual understanding and cooperation.

This is a very important initiative. Financial firms operating in multiple states must comply with multiple, sometimes conflicting, regulatory requirements. These requirements reflect government efforts to protect consumers and to foster financial system stability, safety, and soundness. The Financial Services Committee seeks to strengthen the U.S. regulatory framework, permitting it to adapt to a world where significant changes in capital market behavior and the world around us require new approaches to accounting, auditor oversight, consolidated supervision, and protection from abuse from terrorists and money launderers.

This Committee also seeks to reduce regulatory burdens. Last fall, we enacted major banking regulation relief legislation and we are right now working on an insurance regulatory reform package. I am committed to reducing inefficient regulatory burdens for all financial institutions doing business in the United States subject, of course, to security and financial stability considerations. Relieving regulatory burdens in the United States, however, is only part of the picture. America's largest financial institutions are major players in the European capital markets. Major European firms are a significant and growing presence in all three sectors of the United States financial services market: banking, securities, and insurance.

The choices one country makes for how best to protect its investors and depositors may not always coincide with the choices other countries make. Different policies can be driven by differences in market structure. Such differences are legitimate and do not easily lend themselves to calls for convergence. I believe that convergence and equivalence in regulatory structures can only make sense where convergence is already underway in the markets and where differences in regulation can have a detrimental impact. To endorse convergence as a goal without considering the needs and views of the voters that brought us to Washington to represent their interests would be irresponsible.

I hope this hearing will help us understand which differences in regulatory standards are needed to address different market structures and which differences are inefficient. I am skeptical that transatlantic regulatory convergence will occur quickly in all areas. While the financial markets continue integrating, national regulators will need authority (and a legislative mandate) to protect consumers and markets at home. I note that it took Europe almost 40 years to achieve a legal framework based on "mutual recognition" and this framework is still under construction. Some might question whether the "mutual recognition" concept can operate outside the EU.

In addition, the EU's new framework has not yet been fully tested. The Financial Services Action Plan will not be implemented until next year and concerns have been expressed that full implementation may impose unnecessary costs or create unnecessary conflicts. Questions also exist concerning how the new regulatory structures in Europe will interface with the rest of the world, putting pressure on the execution of consolidated home-country supervision. In the United States, we have our own regulatory burdens to consider and address.
The specter of listed firms needing to provide financial statements using two different accounting standards and the prospect of having two different regulatory capital frameworks for financial institutions are two examples of areas where regulators on both sides of the Atlantic face common challenges.

I believe that practical working relationships such as those created through the US-EU Dialogue and other transatlantic discussion for a can help generate a process for differences to be discussed and understood better. We will not all agree today on the right solutions for any of the issues before this transatlantic regulatory dialogue. In the future, we cannot expect disagreements will disappear regarding how best to regulate the very fluid and innovative financial sector. But I firmly believe that increased dialogue can lower the temperature of our disagreements and can lower the odds that serious misunderstandings can develop. The capital markets will not stop integrating and it is our responsibility as policymakers to ensure that the rules generated to protect consumers and enhance market discipline do not generate excessive and inefficient compliance costs.

**Opening Statement**
**Congresswoman Judy Biggert**
**Committee on Financial Services**
**Full Committee**
**"The US-EU Regulatory Dialogue and its Future"**
**May 13, 2004**

Mr. Chairman, thank you for calling this important hearing today. As you noted in your opening statement, the financial services markets in the United States and Europe are increasingly intertwined.

This hearing is well-timed, coming as it does just two weeks after the historic accession of 10 Eastern European states to the Union. I would like to congratulate you for organizing a hearing that includes our key partner in the Dialogue – the Commission of the European Union. This is an excellent opportunity for the Financial Services Committee to hear both American and European perspectives on the key transatlantic regulatory issues of our day.

The relationship between the American and European capital markets is of keen importance to the United States generally, and of particular importance to those of us who come from Chicago. Last year, there was a great deal of controversy associated with the proposal for a European options exchange to establish itself as a competitor to the traditional options exchanges in Chicago. The resolution was that the exchange submitted to the jurisdiction of the CFTC and established a subsidiary. Along the way, many people in my home state began to think in very concrete terms about what it means to have such integrated capital markets.

I am a firm believer in the adage that political friendships follow the trade lanes. Free and fair trade fosters competition and communication, benefiting workers and consumers on both sides to the relationship. My impression from the testimony submitted is that the regulatory Dialogue underway right now between the US and the EU contributes to these goals. While I support these goals and the accomplishments achieved to date within the Dialogue, I think it is important to sound a note of caution as well.

We must be careful that in our zeal to find new and better ways for our regulators to work together internationally, we do not lose sight of our own very important domestic policy goals. In this country, we have over the last century built the deepest, most transparent, and most liquid capital market in the world. This capital market and the economy that it supports are the engines of global growth and innovation. One critically important component of that market is the framework of laws and regulations that protect investor access to information and provide for rigorous oversight of financial institutions.

Financial innovation and economic growth in the United States have thrived under this framework. Growth and innovation have been slower in Europe, but are accelerating with a number of reforms. On this side of the Atlantic, we must be sensitive to the views of the financial markets and ensure that the EU package of reforms does not stifle growth and innovation through imposition of significant compliance costs.

I also believe that policymakers on both sides of the Atlantic must consider more carefully the nuts and bolts of how consolidated home country supervision will in fact work. This is especially important for the highly complex financial institutions that are at the heart of both the American and European financial systems.

I agree that we can and must work more closely together. I am just not so sure that agreeing up front to wholesale harmonization of legislative frameworks or treating all regulations as equal is wise. Instead, I think that a case-by-case determination of where convergence might be necessary to achieve increased market efficiency and stability is more appropriate. It is for these reasons that I support the US-EU Dialogue and look forward to hearing testimony about it today.

May 13, 2004

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Full Committee Hearing Entitled, "The US-EU Regulatory Dialogue and Its Future"

I would like to thank you, Mr. Chairman, for calling this important hearing and allowing us the opportunity to highlight the US-EU Regulatory Dialogue and its important role as a strong vehicle for transatlantic cooperation.

As Chairman of the North Atlantic Treaty Organization Parliamentary Assembly (NATOPA) Economic and Security Committee, I experience first hand the invaluable discussions enabled when North American and European parliamentarians are brought together to discuss their concerns, issues and differences and remain strongly supportive of opportunities for international financial regulators to interact and discuss issues directly with their counterparts.

On May 1, the European Union (EU) expanded its borders to include ten new nations bringing its total membership to 25 and solidifying its standing as the second-largest economy in the world behind the United States. As the EU continues its capital market integration through their Financial Services Action Plan (FSAP) it has become increasingly important that the transatlantic regulatory dialogue continue.

In recent years, we here in Congress have enacted some major changes to our financial system impacting our European neighbors including the Gramm-Leach-Bliley Act in 1999 (GLB), Title III of the PATRIOT Act in 2001, and the Sarbanes-Oxley Act in 2002. The US-EU Financial Markets Regulatory Dialogue provides regulators with an important forum to identify and address existing and potential differences in financial standards and the impact of our domestic laws on our economic partners.

I look forward to hearing from today's witnesses on anything we in Congress can do to improve or further our support of the program.

Thank you again, Mr. Chairman, for calling this important hearing and I look forward to an informative session.

For release on delivery
10:00 a.m. EDT
May 13, 2004

Statement of

Susan S. Bies

Member

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

House of Representatives

May 13, 2004

Thank you, Mr. Chairman, for the opportunity to speak today on matters relating to the informal U.S.-EU Financial Markets Regulatory Dialogue. I would like to focus my remarks on the Dialogue's role in helping us to monitor European-wide regulatory developments in financial services and understand the effects on U.S. banking organizations operating in the European Union.

Background to the Dialogue

As has been noted, the Dialogue was initiated by the Treasury Department in 2002, at a time of significant regulatory developments in both the European Union and in the United States. At that time, the European Union was continuing its efforts, begun in 1999, to establish a single market in financial services by implementing the "Financial Services Action Plan" (FSAP). The FSAP consists of a number of regulatory and legislative measures designed to achieve, among other things, a single wholesale European market; open and secure retail markets; and state-of-the-art prudential rules and supervision. On our side of the Atlantic, U.S. regulators were continuing to implement provisions of the Gramm-Leach-Bliley Act and Congress was considering reforms that led to the adoption of the Sarbanes-Oxley Act. These developments, which affected European financial services firms with U.S. operations, naturally were of interest to staff of the European Commission.

From the outset, the Dialogue's purpose has been to foster a better mutual understanding of U.S. and EU regulatory approaches and to identify potential substantive conflicts in approach as early in the regulatory process as possible. The Dialogue consists of an informal discussion or explanation of regulatory approaches, developments, and timetables, conducted at an experts level. This format has served us well during the past two years. Although the Federal Reserve

has regular contact with staff of the European Commission in other groups on a range of issues, the Dialogue is the only venue dedicated specifically to U.S.-EU regulatory issues.

Federal Reserve's Interest in Monitoring Foreign Regulatory Developments

As the umbrella supervisor of U.S. bank holding companies and financial holding companies, the Federal Reserve has a strong interest in the regulatory environments in which these firms operate outside the United States. We have an established program of working with foreign supervisors at both bilateral and multilateral levels. Through regular contact, we track changes to foreign bank regulatory and supervisory systems and seek to understand how these systems affect the banking institutions we supervise.

This is especially important in the European Union, where U.S. banking organizations have substantial operations. As of September 30, 2003, thirty-four U.S. banking organizations operated in the European Union with aggregate EU assets of more than $747 billion. As of December 31, 2003, sixty-eight EU banking organizations maintained active banking operations in the United States, with total third-party banking assets in their U.S. offices of $937 billion. As these figures suggest, institutions from the United States and the EU are major participants in each other's markets.

The Dialogue as an Additional Forum for Monitoring EU Regulatory Developments

As the EU seeks increasingly to harmonize financial services rules across its internal market, the regulatory role of the European Commission has grown correspondingly. In this environment, the Dialogue complements the Federal Reserve's ongoing relationships and discussions with EU national regulators.

The Dialogue, moreover, fills a role not presently served by any one of those ongoing relationships and discussions. As the market for financial services becomes increasingly

integrated, the interests of banking, securities, and insurance regulators correspondingly are becoming more common and intertwined. The Dialogue provides a forum for discussion of issues in each of these areas. The regulatory discussions benefit from this sharing of different substantive perspectives. For this reason, too, the Dialogue is an efficient forum for information exchange, which has great utility for supervisors of large complex financial services organizations.

Global companies operate across many countries and must adapt their business and strategy to local regulatory and supervisory requirements. It is now generally accepted in the U.S. and internationally that a foreign firm that conducts business in a local market should receive national treatment, that is, the foreign firm should be treated no less favorably than a domestic firm operating in like circumstances. The United States adopted a specific policy of national treatment for foreign banks operating in this country with the enactment of the International Banking Act of 1978.

As we have previously testified, implementing a policy of national treatment can be challenging. Although large financial services companies operate in a globalized world, each is based in a specific country whose economic regulation or supervisory approach will differ from those in other countries. The challenge of providing national treatment arises as we seek to adapt our own regulatory system to a foreign banking organization that operates under a different legal and regulatory structure. We believe the Federal Reserve has successfully met the challenge in its treatment of foreign banking organizations operating in this country. Part of that success can be attributed to our work with foreign regulators and supervisors in seeking to understand the operating environment of the foreign banks we regulate. The Dialogue contributes to that knowledge.

We are equally concerned that U.S. banking organizations receive national treatment in their foreign operations. The Dialogue provides us the best opportunity to understand EU directives that affect those operations and provides us with the ability to raise concerns directly with the staff that has responsibility for the preparation and presentation of such directives.

The Dialogue provides a useful forum for information exchange between U.S. regulators and the European Union over Europe-wide matters that have the potential to affect the application of national treatment in particular situations. In implementing the FSAP in the European Union, the European Union has an obligation to ensure that the rules adopted are consistent with the principle of national treatment. It is our expectation that the European Commission and the member states will continue to seek to do so.

Select Issues Discussed During the Dialogue

The Dialogue has touched on a variety of issues in the past two years. Of particular interest to the Federal Reserve and to U.S. banking organizations operating in the EU is the issue of the application of the EU's Financial Conglomerates Directive to U.S. financial firms. This Directive, and others that have been amended in connection with its adoption, establishes various supervisory requirements for EU firms. Among other matters, it requires that the consolidated group be subject to supervision and minimum capital standards by a member state authority. For firms that are headquartered outside the EU, such as U.S. banking organizations, the directives require that the foreign financial firm operating in EU markets must be subject to supervision at the holding company level by a competent home country authority, which supervision is equivalent to that provided for by the provisions of the Directive.

The EU's national supervisors will be responsible for making equivalency determinations on a group-by-group basis, in accordance with guidance issued by the European Commission. In

the absence of an equivalence determination, U.S. financial firms with EU operations could be subject to higher capital and risk control requirements or be required to create an EU sub-holding company.

The European Commission is preparing guidance on what might constitute equivalent supervision by third countries. In preparing this guidance, committees working under the auspices of the Commission convened a technical group comprised of member state supervisors to provide input on issues to be taken into account in verifying equivalence. The group sent questionnaires to home country supervisors of financial organizations having operations in the EU, inquiring about the measures those supervisors take to ensure that the entities they supervise are subject to consolidated supervision at the top-tier level. The Federal Reserve and the Office of the Comptroller of the Currency prepared a joint response on supervision of U.S. banking organizations with EU operations. We understand that the EC's guidance is expected to be issued in the summer.

Member state lead regulators are expected to rely on the European Commission's guidance in verifying equivalent supervision with respect to individual institutions. We anticipate that the European Commission will keep us informed of member states' progress in this regard during the Dialogue and also will alert us to the existence of and procedures for addressing any disparities in member states' approaches. We fully expect that U.S. banking organizations will be found to meet the supervision standard of the directive.

Another topic of discussion relating to banks has been the status of work on revisions to the Basel Capital Accord (Basel II). The discussions within the Dialogue have not focused on technical issues that have been under consideration within the Basel Committee on Banking Supervision (Basel Committee), but rather have addressed the scope of application and

implementation and timing concerns. Specifically, the Dialogue has served as a useful venue for both the EU representatives and the Federal Reserve participants to gain a better understanding of the implementation procedures that are anticipated to be applicable in each jurisdiction. Staff has been able to ask questions about the EU legislative process, and to explain in detail how the U.S. regulatory process functions. Understanding the requirements and limitations of each others' legislative and regulatory processes has helped both sides achieve, in my view, a better sense of the implementation challenges we all face and of the commitment to see the process through.

With regard to the scope of application of the proposed new Accord, the Federal Reserve representatives were able to provide information for the EU participants about the reasons the U.S. banking agencies proposed to require only a core set of banks to apply the advanced approaches for both credit risk and operational risk. As you know, one of the primary drivers behind this decision was the U.S. banking agencies' collective view that complex, sophisticated organizations should be using the most advanced risk measurement and management practices available and those techniques and practices are recognized in the Basel II advanced approaches. The U.S. agencies also proposed permitting other institutions to move voluntarily to the advanced approaches subject to the same rigorous risk measurement and management requirements as core banks. Through the Dialogue, the participants were able to discuss the U.S. approach and to compare it with the EU proposal to apply Basel II to all of its banks and investment companies. These different implementation strategies will raise some issues, and that is why the Basel Committee has created the Accord Implementation Group to coordinate implementation across jurisdictions and work through home-host issues.

As noted, issues are not resolved during Dialogue discussions; that is not the purpose of the Dialogue. But open communication that fosters understanding can feed back into the decision-making discussions when they are held in other appropriate forums. With respect to Basel II implementation and the Dialogue, in my view, the current structure will continue to serve a useful purpose--as implementation issues are identified, the Dialogue can be a venue for candid, informal communication. Participants can take back to their constituents the results of those discussions and the subject matter experts can determine how best to address issues that are raised or respond to particular questions or concerns.

The Dialogue has been useful in diffusing tensions over matters that have a direct impact on global firms. This has been especially true with respect to issues under the Sarbanes-Oxley Act, a discussion of which I shall leave to my SEC colleague. The Dialogue has also been helpful on less high profile matters. Through discussions at Dialogue meetings, we were able to keep EC staff apprised of developments relating to asset pledge requirements applicable to foreign banking organizations having U.S. offices.

For more than forty years, federal and state bank licensing authorities have imposed an asset pledge or capital equivalency deposit requirement on U.S. branches and agencies of international banks, primarily for safety and soundness reasons. This requirement obligated such institutions to hold certain negotiable securities at American custodian banks. In recent years, foreign banks were of the view that such requirements were more onerous than necessary and sought a reduction in the level of assets to be pledged. The matter was brought to the attention of European Commission staff who raised it at the Dialogue. We were able to inform Commission staff of progress being made on this front by state authorities in New York and elsewhere over a two-year period. New York changed its asset pledge requirement in 2003, generally satisfying

the concerns of foreign banks. The Dialogue was a useful forum to keep Commission staff apprised of developments during this period.

International Accounting

The FSAP also contemplates mandating adherence to international accounting standards. Currently, banking organizations in the European Union may prepare their annual financial statements in accordance with the accounting standards of the International Accounting Standards Board (IASB), U.S. generally accepted accounting principles (U.S. GAAP), and/or national standards. The use of U.S. GAAP is usually limited to those banking organizations or other companies whose securities are publicly traded on U.S. stock exchanges and are registered with the Securities and Exchange Commission. In many cases, these companies will also provide separate financial statements based on their national accounting standards and disclosure rules. The European Union will require all EU companies listed on EU exchanges that are currently following national standards to follow IASB standards by 2005 and will require those EU companies that currently follow U.S. GAAP to adopt IASB standards by 2007. The EU is also working to adopt international auditing standards for external audits of EU companies, including banks.

The IASB is now independent of the international accounting profession and independently funded. It has adopted many of the structural elements of the FASB in the United States, which are intended to promote an independent, objective standards-setting environment. Many senior American accounting experts serve on the IASB and its staff. IASB GAAP has many similarities with U.S. GAAP and the IASB issued extensive enhancements to its standards last year and this year, with additional improvements also issued as a proposal this year. For example, in recent months the IASB issued major revisions to its standards for financial

instruments, which are similar to U.S. GAAP and cover many areas of banking activities. One aspect of these revisions by the IASB significantly improved the guidance on loan loss allowances in ways that could lead to better bank reserving practices around the world.

The Federal Reserve has long supported sound accounting policies and meaningful public disclosure by banking and financial organizations with the objective of improving market discipline and fostering stable financial markets. The concept of market discipline is assuming greater importance among international banking supervisors as well. Basel II seeks to strengthen the market's ability to aid bank supervisors in evaluating banking organizations' risks and assessing capital adequacy. It consists of three pillars, or tools: a minimum risk-based capital requirement (pillar I), risk-based supervision (pillar II), and disclosure of risks and capital adequacy to enhance market discipline (pillar III). This approach to capital regulation, with its market-discipline component, signals that sound accounting and disclosure will continue to be important aspects of our supervisory approach.

The Federal Reserve and the other U.S. banking agencies are also actively involved in the efforts of the Basel Committee to promote sound international accounting, auditing, and disclosure standards and practices for global banking organizations and other companies. For example, an official of the Federal Reserve Board is a member of the Standards Advisory Council that advises the IASB and its trustees on IASB projects, proposals and standards. The U.S. banking agencies have been active in supporting the Basel Committee in its work with the IASB's technical advisory groups to enhance the IASB's standards for financial instruments and bank disclosures. The Federal Reserve Board has also been active in supporting the Basel Committee's projects with the International Federation of Accountants (IFAC) and other international regulatory organizations, such as International Organization of Securities

Commissions (IOSCO), to promote substantial enhancements to global standards and practices for audits of banks and other companies.

Although the Federal Reserve Board has been actively involved in addressing international accounting and auditing issues primarily through our involvement in the Basel Committee's projects, the Securities and Exchange Commission has had the primary role in discussing these matters with the EU representatives as part of the Dialogue.

Cooperation on Anti-Money Laundering and Counter-Terrorist Financing Issues

While not historically part of the U.S.-EU Dialogue, recent anti-money laundering and counter-terrorist financing regulatory initiatives on both sides of the Atlantic have had a significant impact on banking organizations, many of which operate globally. Because of the potential consequences of differences in regulatory approaches in this area, governments have been in frequent contact. In the end, the anti-money laundering provisions set forth in the USA PATRIOT Act and those contained in the EU Anti-Money Laundering Directive are generally in harmony.

Part of this can be attributed to the Federal Reserve's and other U.S. and EU regulatory authorities' mutual involvement in multilateral policy efforts to improve regulatory systems so to prevent these crimes, such as the Financial Action Task Force and the Basel Committee's cross-border banking group. On a practical level, supervisory dialogue and cooperation on anti-money laundering and counter-terrorist financing also has been necessary due to the role the Federal Reserve frequently shares with its EU counterparts as "home/host" supervisors of global banking organizations. However, this cooperation is typically focused on providing assistance in order to fulfill supervisory mandates, not to conduct money laundering or terrorist financing investigations, the authority for which typically falls with law enforcement authorities.

While Bank Secrecy Act requirements, including the provisions added by the USA PATRIOT Act, generally do not extend to foreign operations of U.S. banking organizations, the Federal Reserve is interested in understanding the global operations of the banking organizations under Federal Reserve supervision as a matter of safety and soundness. In this regard, the Federal Reserve relies upon communication with supervisors from foreign jurisdictions, including EU member states, in which banking organizations subject to Federal Reserve supervision have material operations.

Critical information obtained in the course of an examination, which may impact a banking organization's operations in the foreign jurisdiction, is typically exchanged among relevant supervisors. For example, when a Federal Reserve Bank conducts an on-site examination of a foreign banking organization in the United States, and significant problems are identified with regard to its anti-money laundering program, the Federal Reserve contacts the home country supervisor to discuss the findings and to develop corrective action plans.

Moreover, the Federal Reserve may provide information to European Union member bank supervisors when administrative penalties have been imposed or any other formal enforcement action has been taken against a U.S. banking organization (whether or not it is related to anti-money laundering requirements) if the Federal Reserve believes such information will be important to the host country supervisor. The Federal Reserve expects the same from its counterparts.

Future of the Dialogue

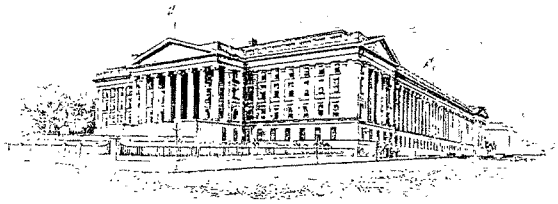
As is evident from the tenor of my remarks, the Federal Reserve has found the Dialogue to be a useful vehicle for monitoring the rapid regulatory developments in the European Union and exchanging information. We are committed to continuing discussions with the Commission

on matters of mutual interest, both bilaterally and as part of the financial markets regulatory discussions led by the Treasury Department. The regulatory landscape in the European Union is certain to continue to develop rapidly in the coming years, particularly with expansion of the European Union, member states' implementation of the numerous FSAP measures needed to create a single market for financial services, and the growing integration of our capital markets.

We at the Federal Reserve have an obligation to keep apprised of these developments on a timely basis in order to fulfill our supervisory function and to ensure a level playing field for U.S. banking organizations operating in the European Union. We are confident that continuing the Dialogue in its present form would facilitate these objectives.

We are equally confident that other existing multilateral and bilateral exchange mechanisms are appropriate venues for discussing policies and attempting to resolve disputes. In our view, formalizing the Dialogue--for example, by elevating it to the principals level or expanding its mandate to include policy-setting or dispute resolution functions--would be unnecessary and may impair the Dialogue's utility.

The Federal Reserve believes that U.S. banks are second to none in their ability to compete when they are given the opportunity of operating on a level playing field. Providing strong supervision at home and participating in international regulatory and supervisory groups such as the Dialogue helps assure that our banking organizations will continue to have such opportunities.



# DEPARTMENT OF THE TREASURY
## OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10:00 AM
May 13, 2004

Contact: Public Affairs
(202) 622-2960

**Testimony of**
**Randal K. Quarles, Assistant Secretary for International Affairs**
**U.S. Department of the Treasury**

**Before the House Financial Services Committee**

**Introduction**

Thank you, Mr. Chairman. It is a great pleasure to testify on the U.S.-EU Financial Market Dialogue. Indeed, the Treasury Department thanks the Committee for its continued attention to transatlantic financial market and regulatory relations and its support for the Dialogue. This backing has been integral to the progress made.

To be sure, there have been longstanding financial market discussions between the United States and Europe. But the US-EU Financial Market Dialogue, for all intents and purposes, began in March 2002. Since then, technical meetings of the Dialogue, which is led jointly by the Treasury Department and the European Commission Internal Market Directorate and includes the active participation of U.S. regulators, have taken place on more or less a quarterly basis. In addition, the Dialogue is supplemented by substantial interaction of senior policy officials.

Both the United States and the EU have increasingly viewed the Dialogue with satisfaction. At the last two US-EU Summits both sides provided favorable press statements about the Dialogue. For the upcoming Summit in Dublin, Ireland on June 27, we anticipate that Dialogue participants will provide a short joint report to Leaders. In my remarks, I will outline some key factors underpinning the Dialogue, recent achievements, and issues in which the Dialogue will likely play a role going forward.

**The Dialogue's Objectives**

The Dialogue from the start has been a two-way street reflecting mutual self-interest. A central aim of U.S. foreign economic policy is to promote a strong global economy. The United States is doing its part, but in Europe growth has lagged and needs to become more broad-based. Last September, G-7 Finance Ministers committed to an Agenda for Growth. This Agenda focuses on structural measures that countries can take to boost productivity and raise economic potential.

U.S. history shows that a strong, efficient capital market is a critical pillar for robust growth. Several studies have concluded that the creation of a truly liberal and integrated European capital market through Europe's Financial Services Action Program (FSAP) could raise EU growth by more than one percent per annum in a decade's time. Building on the successful introduction of the euro, progress on both the Agenda for Growth and the development of an integrated European financial market could be a lasting benefit not only for Europe, but also for the United States, emerging markets and developing countries throughout the world.

Our economies are part of a globalized economic and financial system. Hence, in observing the building of the European capital market, the United States has an interest in an FSAP that successfully anchors the European financial system in an integrated, state-of-the-art, open and soundly supervised global financial marketplace.

Also, U.S. financial institutions have long been global leaders and they are a vital part of the European financial landscape. We are clearly interested in seeing that our firms are able to compete globally on fair terms, which reward their competitiveness and demonstrated capacity to innovate. Indeed, we believe that US firms can help contribute to the European economy and financial system. For example, US firms have been leaders in the development of mutual fund products, which are critical for pension plans. Many analysts believe that greater use in Europe of such products under defined contribution plans is essential for addressing Europe's demographic challenges.

Just as the United States is interested in the evolution of the European capital market, so is Europe interested in the evolution of the US capital market. As the Chairman knows from the promulgation of the law informally bearing his name, US financial market legislation can have implications for market participants outside the United States. European firms are understandably interested in access to US capital markets.

Both parties to the Dialogue share an interest in promoting the common objective of strong capital markets that are soundly regulated. But in achieving these objectives, we both recognize that the United States and Europe have different financial, legal, historical and cultural traditions. Because of these differences, actions by one of us may have unintended spillover effects into the other's jurisdiction.

Before us are the paths of cooperation or confrontation. Together, we have decided that our challenge is to see through these different traditions, to work to achieve our common objectives in substance and to manage these spillovers. That is why the United States and Europe have a mutual self-interest in closely cooperating on financial markets through the Dialogue. That is why we meet often to promote understanding between us, to discuss emerging issues and the

implications of these issues for each other, and to anticipate problems and work them out if possible. Managing the Dialogue successfully, we believe, will produce a win-win outcome for the US, Europe and the world.

**The Agenda**

The United States strongly supports the Financial Services Action Plan and we commend Europe for its ambitious goal of unifying its capital markets and for the progress made to date. At the present juncture, the European Parliament has approved all but three of the 42 FSAP measures, which are now in varying stages of implementation. Because thorny issues lay buried in the details of these measures, it was important for the U.S. to actively engage with the EU on their ramifications for U.S. interests.

It is perhaps axiomatic that financial markets will always be a step ahead of the regulators and that regulation should ensure soundness while not stifling dynamism. Thus, effective rule-making requires close cooperation with market participants. We have been particularly pleased by the more transparent processes in Europe for financial rule-making that have emerged over the last two years and the increased consultations with market participants, including US financial institutions operating in Europe. We are also pleased that Brussels and the European Parliament appreciate that working with market participants can improve European rule-making, create a greater consensus and buy-in for proposed regulations, and strengthen European financial markets.

Some of the key issues we have been discussing with Brussels are the following.

- Financial Conglomerates Directive. We have been discussing the Financial Conglomerates Directive for two years. It requires a foreign supervisory regime to be deemed "equivalent" by the EU for firms based in that country to operate within the single EU market without costly legal and financial changes that could prove harmful to the European market. Our supervisory regime is top flight and world class. But to help Europe reach a finding of equivalence, all U.S. regulators (FRB, SEC, OTS, NAIC) have cooperated closely with Brussels and with member state regulators in explaining their approaches to consolidated supervision. We are confident that this process, albeit slow, will be brought to a successful conclusion.

- Prospectus and Transparency Directives. These directives initially suggested that US firms listing new securities in Europe should prepare financial statements on the basis of International Accounting Standards by 2005, rather than US GAAP, or cease issuing in Europe. Further, the draft directives made no provision for grandfathering previously listed issues. We have discussed these matters with Brussels for the last year, and final texts provide for grandfathering of existing issues. Also, to enable continued new listings by US firms in Europe using financial statements prepared under US GAAP, criteria are being crafted to allow European countries to make an affirmative determination later this year that US GAAP is "equivalent" to IAS.

- Investment Services Directive. This directive sets conditions for European share trading and raised the question of whether firms needed to put all trades through stock exchanges or

could match orders internally, which is a common market practice in the UK. In the end, Brussels softened features of the draft bill so as to permit internal order matching and price improvement for transactions greater than "retail" size.

- Takeover Directive. When drafted, this directive sought to build an integrated European market for M&A activity to help attract capital and rationalize inefficient firms. In the end, it allows member states to maintain national protections for some firms against takeovers. Brussels has assured the United States that any discrimination against third country firms would be inconsistent with Europe's international obligations.

Thus far, Europe is making progress under the FSAP in building an integrated capital market. Compromises reflecting different European country practices are an inevitable part of the FSAP process. But Brussels, the Parliament and the member states are working to instill as liberal a vision as possible for the European capital market. While this vision may not be identical to the perspectives of the New York or London markets, its implementation is a work in progress, it represents an important step forward and the extension of this vision to the EU internal market will contribute to the growth of global capital markets.

For its part, the EU cares deeply about financial market developments in the United States. Though the start of the Dialogue predated corporate malfeasance disclosures with respect to Enron and WorldCom, rapid enactment of the Sarbanes-Oxley Act in mid-2002 gave Europe more reason to accelerate talks with us on corporate governance issues. As many of these issues are in the domain of my colleague from the Securities and Exchange Commission, I will not comment on them other than to note that both the letter and spirit of Sarbanes-Oxley were fully observed, and EU concerns were substantially accommodated.

In terms of the near-term agenda, both sides have also discussed a range of other issues, including the Basel II Accord, foreign trading screens and the Capital Equivalency Deposit Requirement (CED).

**Looking Ahead**

The quest to build a European capital market will not end with the 42 measures. Following the selection of a new Commission and European Parliament, the EU and the United States will need to tackle new challenges together in promoting a stronger and more vibrant transatlantic capital market.

Among these challenges are the promotion of convergent accounting standards on both sides of the Atlantic, improving corporate governance and strengthening investor protections and confidence, and reducing costs of investment in Europe by creating a European-wide system of clearance and settlements. The effort to promote convergent standards -- consistently applied, implemented and enforced -- is particularly critical. By effectively tackling these challenges, a truly vibrant and integrated transatlantic capital market may come into being.

**Conclusion**

In conclusion, Mr. Chairman, the Dialogue has been making good progress. But many challenges remain. Already, the Dialogue has increased the transparency of rule-making and imparted momentum to financial market reform in Europe. Furthermore, the Dialogue is rightly credited as having helped defuse transatlantic tensions in an important area vital to the functioning of the world economy. The goals of the Dialogue support the Agenda for Growth, which is a key theme for this year's G-7 process. Finally, there is the expectation on both sides of the Atlantic that if the US and EU can agree on financial regulatory standards, then others around the world will follow. As you can see, the potential benefits are enormous, and not just for the U.S. and EU. It is important that the Dialogue succeeds, and I believe it will.

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# Testimony Concerning The Regulatory Dialogue Between the Public Company Accounting Oversight Board And the European Commission

Samantha Ross
*Chief of Staff*
*Public Company Accounting Oversight Board*

Before the Committee on Financial Services
United States House of Representatives

May 13, 2004

Chairman Oxley, Ranking Member Frank, and Members of the Committee:

I am pleased to appear before the House Financial Services Committee today on behalf of the Public Company Accounting Oversight Board ("PCAOB" or the "Board") to discuss the regulatory dialogue between the PCAOB and the European Union ("EU").

Two years ago the financial reporting scandals relating to Enron, Adelphia, WorldCom, and others, rocked the U.S. capital markets. As these problems were emerging publicly, the House Financial Services and Senate Banking Committees acted swiftly and decisively to restore public confidence in U.S. markets with the Sarbanes-Oxley Act of 2002 ("the Act").[1] Title I of the Act established the PCAOB to oversee the auditors of public companies that have registered securities with, or file reports with, the Securities and Exchange Commission ("SEC" or the "Commission") in order to access the U.S. capital markets. When President Bush signed the law, he acknowledged the importance of the creation of the PCAOB by declaring that, "For the first time, the accounting profession will be regulated by an independent board. This board will set clear standards to uphold the integrity of public audits . . . ." [2]

Both we and Europe have learned from experience that no borders can contain the losses and uncertainty that occur with large corporate failures, such as those of Enron, WorldCom, Royal Ahold and Parmalat. In the same way that our Congress took steps to restore the public's confidence in our markets, Commissioner Frits Bolkestein

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[1] P.L. No. 107-204 (2002).

[2] President's Remarks on Signing the Sarbanes-Oxley Act of 2002, 38 Weekly Comp. Pres. Doc. 1283 (July 30, 2003).

of the European Commission ("EC") and Director-General Alexander Schaub of the European Commission's Internal Market Directorate-General have taken important steps to help restore confidence in European markets. As I will explain further in my testimony, we see ourselves as partners with EU regulators in restoring investor confidence, and we have developed a constructive working relationship with the EC to further our mutual objectives.

**Introduction**

Today, the PCAOB is well on its way to maintaining, as required in the Act, a continuous program of auditor oversight "in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."[3/]

To carry out this charge, the Act gives the Board significant powers. Specifically, the Board's powers include authority –

- to register public accounting firms that prepare or participate in the preparation of audit reports for issuers;[4/]
- to conduct inspections of registered public accounting firms;

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[3/] Sarbanes-Oxley Act, Section 101(a).

[4/] Under Section 2(a)(7) of the Act, the term "issuer" includes domestic public companies, whether listed on an exchange or not, and foreign private issuers that have either registered, or are in the process of registering, a class of securities with the Securities and Exchange Commission or are otherwise subject to Commission reporting requirements.

- to conduct investigations and disciplinary proceedings concerning, and to impose appropriate sanctions upon, registered public accounting firms and associated persons of such firms;
- to enforce compliance by registered public accounting firms and their associated persons with the Act, the Board's rules, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants; and
- to establish auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for U.S. issuers.[5/]

Many U.S. public companies, of course, have subsidiaries and branches outside the United States. While these off-shore operations often play a significant role in the financial picture of the U.S. company, they are usually audited by local accountants in the countries where the subsidiaries or branches are located. In addition, companies headquartered outside of the United States often access the U.S. capital markets to sell their securities to those who invest in our markets. Approximately 1,400 foreign private issuers cause their securities to trade in U.S. markets and are required to file audited financial statements with the SEC. Most of these companies are audited by local accounting firms in their home countries.[6/]

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[5/] Sarbanes-Oxley Act, Section 101(c).

[6/] See: http://www.sec.gov/divisions/corpfin/internatl/companies.shtml.

Our capital markets, and the securities that trade in them, have a particularly strong link to Europe. Next to Canada, Europe has the most public companies that have registered securities, and file reports, with the SEC. As of December 31, 2002, there were 333 such European companies. In 2002, those 333 companies were audited by 58 E.U.-based auditors.[7] Forty-nine of those auditors are affiliated with large U.S. accounting firms.

**Registration of Public Accounting Firms that Audit U.S. Public Companies**

As required by the Act, in April of 2003, the Board adopted rules on the registration of public accounting firms that audit public companies that register securities, or file reports, with the SEC. The SEC approved these rules in July of 2003.[8] These rules require public accounting firms that prepare or issue, or play a substantial role in the preparation or issuance of, an audit report on the financial statements of such an issuer to register, irrespective of where those firms are located.[9] The Board's decision to require the registration of non-U.S. firms that audit such issuers was consistent with the Act. Specifically, Section 106(a) of the Act provides that non-U.S. firms are subject to the Act and to the rules of the Board "to the same extent as a public accounting firm that is organized and operates under the laws of the United States."

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[7] Id.

[8] Order Approving Proposed Rules Relating to Registration System, SEC Rel. No. 34-48180 (Jul. 16, 2003).

[9] PCAOB Rule 2100.

The Act does, however, give the Board certain flexibility with regard to how it satisfies the requirements of the Act in respect to non-U.S. firms. Accordingly, while the Act prescribed a date – October 22, 2003[10/] – after which public accounting firms could not lawfully audit a U.S. public company without being registered, the Board used its authority under the Act to delay the effective date of the registration requirement for non-U.S. firms to July 19, 2004, in order to provide those firms additional time to prepare for registration.[11/]

The Board's registration system will, for the first time, require non-U.S. public accounting firms to register with the Board as a condition of preparing, issuing, or playing a substantial role in the preparation or issuance of, audit reports on U.S. public companies. However, non-U.S. accountants that participate in the audit of U.S. issuers have long been subject to various U.S. requirements. For example –

- All financial statements filed with the Commission must be audited in accordance with U.S. auditing standards. This applies whether the report is filed by a domestic issuer or a foreign private issuer.[12/]

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[10/] Section 101(d) of the Act provided that the registration requirement should take effect 180 days after the Commission determined the Board capable of carrying out the requirements of Title I of the Act. Accordingly, the registration requirement took effect October 22, 2003.

[11/] PCAOB Rule 2100. The PCAOB has established resources, including a helpline and a dedicated e-mail account, for applicants to obtain answers to questions about the registration process.

[12/] Rule 2-02(b) of Regulation S-X, 17 C.F.R. 210.2-02(b).

- All firms that audit financial statements filed with the Commission must satisfy the SEC's independence requirements, whether the audit relates to a domestic issuer or a foreign private issuer.[13/]
- Non-U.S. public accounting firms that participate in audits of domestic or foreign private issuers are subject to Commission enforcement action for any violation of the U.S. federal securities laws.
- Before the Act replaced the profession's system of self-regulation with independent regulation by the Board, the SEC Practice Section of the American Institute of Certified Public Accountants required that its "member firms that are members of, correspondents with, or similarly associated with international firms or international associations of firms" provide the names of those associated firms and seek adoption by those associated firms of certain policies and procedures, including "inspection procedures" that provide for an expert in U.S. accounting, auditing, and independence requirements to review a sample of the associated firm's audit engagements relating to reports filed with the SEC.[14/]

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[13/] Rule 2-01 of Regulation S-X, 17 C.F.R. 210.2-01. The Commission has modified its auditor independence rules in some relatively minor respects to account for conflicts with foreign laws or to account for different conditions in non-U.S. jurisdictions.

[14/] See AICPA SEC Practice Section Manual ("SECPS") § 1000.08(n); SECPS § 1000.45, App. K.01(b).

- With respect to non-U.S. firms that are not affiliated with U.S. accounting firms, and thus are not subject to the SEC Practice Section requirements, the Commission staff has typically required such a firm to –
  - provide information on its size, location(s), practice and policies, and
  - engage an accounting firm that regularly practices before the Commission to review the firm's policies and represent to the Commission staff that the audit was properly planned and conducted in accordance with U.S. auditing standards.

While non-U.S. accounting firms that audit U.S. issuers have long been subject to U.S. securities laws and U.S. auditing standards, the Board has recognized that registration of those firms raises additional issues and entails additional administrative burdens. The Board therefore gave careful consideration to the impact of its rules on non-U.S. firms and crafted certain variances from its rules to accommodate conflicts in law and differences in approaches and custom.[15] I will discuss some of those accommodations below. In part because of these accommodations, and in part because non-U.S. firms typically audit only a small number of U.S. public companies (limiting, in most instances, the amount of data the registration system requires), the

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[15] Those variances are summarized in the Board's release accompanying its final rules on registration, PCAOB Rel. No. 2003-07, at 17-20 (April 24, 2003) (available at http://www.pcaobus.org/rules/Release2003-007.pdf).

registration applications of non-U.S. firms are relatively straightforward and ought not impose an undue burden.[16]

Today, 840 firms are registered with the Board, including 35 non-U.S. firms from countries such as the United Kingdom, Germany and Hungary. More than 145 additional non-U.S. firms have applied for registration. As required by the Act and the Board's rules, the Board will act upon those applications within 45 days of when they were submitted.[17] At this point, we expect that as many as 300 non-U.S. firms may register with the Board.

**International Initiatives and the Dialogue with the EU**

As we prepared for registration of non-U.S. firms that audit issuers that have registered securities, and file reports, with the SEC, we also began to develop our approaches to our continuing oversight of those firms. Specifically, we commenced an ongoing dialogue with international regulators involved in auditor oversight to find ways to enhance the effectiveness of our oversight and also, where possible, minimize duplicative regulation by coordinating our programs with those regulators. We also embarked on several initiatives, based in large part on the development of ideas in this dialogue. These initiatives include adopting certain accommodations in our registration system to address the special issues that face non-U.S. firms and developing a

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[16] The average number of issuer clients reported by non-U.S. firms that have submitted registration applications is 7.3; European firms that have submitted applications report an average of 4.3 issuer clients.

[17] Sarbanes-Oxley Act, Section 102(c)(1); PCAOB Rule 2106(b).

cooperative framework for our oversight of non-U.S. firms that takes advantage of the assistance and expertise of local regulators.

The European Commission is facing the same issues relating to audit quality that we face. The Parmalat scandal, which came to light last December, galvanized investors in European securities to demand more reliable financial reporting and auditing. Given Commissioner Bolkestein's and Director-General Schaub's foresight to develop a European model for independent auditor oversight, it is not surprising that they proposed a model in the proposed 8th Company Law Directive that should fit well with our hopes to coordinate our oversight with other regulators.

Shortly after assuming his position as Chairman of the PCAOB, Chairman Bill McDonough initiated our dialogue with government representatives of a number of foreign countries to explore ways to accomplish the goals of the Sarbanes-Oxley Act with the cooperation of other regulators, in order to establish a robust system of international regulation and, at the same time, minimize unnecessarily duplicative regulation. Chairman McDonough's first step in this effort was to travel to Brussels, in September 2003, to meet with Commissioner Bolkestein and Director-General Schaub.[18/] In those early meetings, we confirmed that we and the EC share the objectives of protecting investors and restoring public confidence in our markets by improving the quality of audits and the reliability of financial reporting. Given how inter-related our markets are, this convergence of objectives is no surprise.

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18/ We also had discussions with regulators in Canada, Australia, Japan and Switzerland.

Since September, our Chairman has met several times with Commissioner Bolkestein and Director-General Schaub, and our respective staffs have had numerous, productive meetings. Also, on March 25 of this year, Commissioner Bolkestein and our Chairman held, in Brussels, an unprecedented roundtable discussion with Member State representatives and others responsible for auditor oversight, from all current and acceding EU countries. We discussed, among other things, the key objectives of auditor oversight upon which we are all building our oversight systems.

**Oversight of Non-U.S. Firms that Audit U.S. Public Companies**

As I mentioned earlier, our dialogue has already led to certain policy initiatives. The Board recognizes that registration, inspection, and as necessary, investigation, of non-U.S. firms present special issues. To better understand these issues, the Board held a roundtable in the spring of 2003 for an open discussion about the challenges the Board and non-U.S. firms will face.[19]

Most of the concerns raised during the March 2003 roundtable, and in later conversations with the EC and others, related to the potential for duplicative oversight and conflicts in laws. For example, we have been told that in some countries privacy and other laws restrict auditors from providing some information that we require in registration applications. The Board's oversight of non-U.S. firms also raises practical

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[19] The following governments, firms and organizations participated in the public roundtable meeting: European Commission; U.K. Department of Trade and Industry; Embassy of Switzerland; Embassy of Australia; Financial Services Agency (Japan); Canadian Public Accountability Board; Wirtschaftspruferkammer (German Chamber of Accountants); Fédération des Experts Comptables (FEE); Ernst & Young (Brussels, Belgium); PricewaterhouseCoopers (Toronto, Canada); Deloitte Touche Tohmatsu (Santiago, Chile); KPMG (London); Pennsylvania Public Employees' Retirement System; and the State of Wisconsin Investment Board.

issues. For example, it may be difficult for the Board to implement an effective inspections program in other countries without assistance from local regulators, particularly when a firm maintains its records and conducts its audits in a language other than English.

The solution we fashioned to address these issues neither duplicates foreign regulation nor defers to it. Instead we sought to incorporate home-country regulation into a framework for our oversight of non-U.S. firms. As discussed above, the Board started by providing for some accommodations in our registration process for non-U.S. firms. First, the Board extended the deadline for registration of non-U.S. firms to July 19, 2004, in order to allow them additional time to gather the necessary information and further understand the Board's system of oversight.

Second, the Board adopted a rule that allows a firm to omit information from its application if disclosure would cause it to violate its home country law.[20/] An applicant that claims that submitting information as part of its application would cause it to violate non-U.S. laws may provide, instead, an exhibit to the application form that includes –

- a copy of the relevant portion of the conflicting non-U.S. law;
- a legal opinion that submitting the information would cause the applicant to violate the conflicting non-U.S. law; and
- an explanation of the applicant's efforts to seek consents or waivers to eliminate the conflict, if the withheld information could be provided to the

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[20/] PCAOB Rule 2105.

Board with a consent or a waiver, and a representation that the applicant was unable to obtain such consents or waivers.

Registration is only the beginning of our oversight of public accounting firms that audit U.S. issuers, however. In order to implement an effective program of continuing oversight of non-U.S. firms that audit such issuers, and based on our discussions with the EC and others, we have developed a cooperative framework that would allow the Board to gain insight from and rely on the inspection of a firm's home-country regulator based on a "sliding scale."[21/] Our goal is to provide the highest quality oversight while recognizing the differences in other countries' approaches toward auditor oversight. We believe that the sliding scale approach is both faithful to our statutory mandate and appropriately respectful of other regulatory systems.

The proposed approach would permit varying degrees of reliance on a firm's home-country system of inspections, depending upon the independence and rigor of that system. The Board may also, in appropriate circumstances, rely upon an investigation conducted, or a sanction imposed by, a non-U.S. authority. The Board would place the greatest reliance on those systems with the highest level of rigor and independence from the accounting profession. Conversely, the Board would participate more directly and rely less on those systems that are less independent of the accounting profession.

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[21/] Briefing Paper: Oversight of Non-U.S. Public Accounting Firms, PCAOB Rel. No. 2003-20 (Oct. 28, 2003) (See: http://www.pcaobus.org/rules/Release2003-020.pdf); Proposed Rules, PCAOB Rel. No. 2003-024 (Dec. 10, 2003) (See: http://www.pcaobus.org/rules/Release2003-024.pdf).

The Board's reliance would also depend on developing, with the home-country regulator, an inspection work program for non-U.S. firms selected for inspection. Under Section 104 of the Act, and the Board's rules, firms that audit fewer than 100 U.S. public companies must be inspected every three years. Most European firms that we expect to register audit significantly fewer than 100 U.S. public companies, and to our knowledge, none audit 100 or more. An inspection work program would prescribe procedures to evaluate a firm's quality controls and assess its compliance with U.S. laws and auditing standards in selected audit engagements relating to U.S. public companies. We recognize that the structure, size and mandate of other inspections systems vary and that not all jurisdictions have inspection programs that are independent of the auditing profession. We believe, however, that the cooperative approach the Board has proposed allows us an appropriate degree of flexibility.

In fact, the oversight system required by the EC's proposed 8th Company Law Directive appears to mesh quite well with the oversight system we are putting in place here in the United States. The 8th Directive would require external and independent oversight of auditors in a manner that is transparent, well-funded and "free from any possible undue influence by statutory auditors or audit firms."[22] The 8th Directive would also provide for cooperation with other regulators.[23] These provisions should substantially enhance our ability to coordinate with our European counterparts. We are

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[22] 8th Directive, Ch. VII, Art. 29, ¶ 1.(b); and 8th Directive, Ch. IX, Art. 31, ¶ 7.

[23] 8th Directive, Ch. XII, Art. 47.

engaging in discussions with oversight bodies of EU Member States to learn about those systems and facilitate the cooperation envisioned by the Board and the 8th Directive.

The 8th Directive would also require Member States to use the International Standards on Auditing as established by the International Auditing and Assurance Standards Board ("IAASB") for audits of EU financial statements.[24/] Both the PCAOB and the EC have been given observer positions with the IAASB, and we have offered the IAASB observer status on our standards-setting advisory group. Our mutual participation will enhance our dialogue on establishing high quality auditing and related professional practice standards.

Notwithstanding the cooperative framework I just described, non-U.S. accounting firms that wish to continue auditing companies whose securities trade on U.S. markets must comply with U.S. law, including by registering and cooperating with the PCAOB. In some jurisdictions, this may create a legal conflict. We expect, however, that the cooperative approach will go a long way toward resolving conflicts of law that may arise in connection with an inspection. In addition to consents and waivers, by working with the home-country regulator in the first instance to attempt to resolve any conflicts, it is our hope that most problems can be avoided.

While the assistance of non-U.S. regulators will help us achieve our specific objectives under the Act, true cooperation is a two-way street. The Board has previously stated that it is willing to assist non-U.S. regulators in their oversight of

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[24/] 8th Directive, Ch. VI, Art. 26.

accounting firms. Because the needs of every regulator are different, we plan to work out the details of our assistance through dialogue with individual regulators.

We still have much work ahead of us to establish lasting relationships and working protocols with other regulators, but the PCAOB is optimistic. Cooperation among regulators requires good will and flexibility. Our experience with the European Commission has demonstrated that European regulators share this view. We are confident that with the continuation of our open and constructive dialogue with the Member States of the European Union, we will be able to resolve issues so that together we can fulfill our important missions.

For release on delivery
10.00 a.m. ET
May 13, 2004

**Testimony of**

**Alexander Schaub,**

**Director–General, DG Internal Market of the European Commission**

**before the**

**Committee on Financial Services,**

**U.S. House of Representatives**

**May 13, 2004**

Chairman Oxley, members of the Committee on Financial Services, thank you for inviting me here this morning to testify on behalf of the European Commission on the informal EU-US Financial Markets Regulatory Dialogue and more generally on relations between the European Union and United States on financial services and markets.

I greatly appreciate the interest of the Committee in this matter, and in particular the very great personal commitment that you, Chairman, have brought to this area right from the start.

I have been able to observe these issues over the past two years as EU Director-General for the Internal Market and financial services, the senior official in this area under Commissioner Frits Bolkestein.

Economically we are by far the two biggest players, and with that comes a heavy responsibility for leadership and cooperation. It is therefore of particular importance if we can open up new areas of cooperation in mutual trust and understanding. Cooperation is not an optional extra, it is an economic, political and regulatory necessity.

If cooperation does not take place, all our businesses and consumers will suffer – 290 million in the US and 450 million in the EU.

## I. Why? Transatlantic Regulatory Cooperation is essential in a globalising capital market

### I. Economic interdependence

In the modern global **economy,** the EU and US are each other's biggest partner. Capital markets (bonds, equities, and bank assets) amount to over $50,000 billion in both the EU and US, equivalent to 6½ times and 5½ times GDP respectively. EU and US equity markets together represent 80% of global stock market capitalisation. 15% of the total capital raised by EU equity issuers through primary offers was raised in the US. This interdependence can only intensify as technology expands the possibilities for overseas trading and remote provision of services. In 2002, two-way cross-border trade in goods and services amounted to more than €650 billion (€412 billion in goods and €238 billion in services). Transatlantic trade represents 39% of EU and 35% of US total cross-border trade in services.

EU and US companies invest more in each other's economies than they do in any other area of the world. The EU and US accounted in 2001 for 49% and 46% respectively of each other's outward FDI flows. The EU accounted for 54% of US inward FDI and the US for 69% of EU inward FDI. These figures will expand even further now that the EU has enlarged from 15 Member States to 25. The fact is that a large number of EU and US jobs are dependent on developments in the other's economy and regulation.

This interdependence has been achieved despite regulatory differences and barriers. There is strong evidence that the removal of barriers would unlock many new economic benefits to both sides. Research published in 2003 by the British Treasury and Dutch Finance Ministry estimates that liberalisation of EU-US trade in goods and services would (permanently) boost EU GDP by 1-2% per annum and US GDP by up to 1% - significant potential improvements to growth and welfare on both sides of the Atlantic.

A further study estimates that true integration of financial markets has the potential to lower trading costs on both sides of the Atlantic by 60% with a consequent 50% increase in trading volumes, and a 9% decline in the cost of equity capital. It would make it far easier for US companies to raise money on European markets and for US investors to profit from investment opportunities in the EU and vice versa.

### ii. Regulatory spillover

In global high-tech capital markets, our regulations inevitably spill over on each other. The EU and US have to work together to handle this.

This is true of regulation on both sides.

Over the last five years, the European Union has been engaged in a process of integrating its financial markets, with a view to tackling the uncertainty, unnecessary bureaucracy, and excessive costs for European firms, intermediaries and investors looking to operate cross-border. It has been doing so on the basis of a Financial Services Action Plan with a framework for action of 42 measures.

Such an integrated financial market will be of huge potential benefit to the EU. Two recent studies have pointed to the benefits of integrating the capital markets of the current 15 members of the EU alone. The first estimates potential benefits from static improvements in the cost of capital alone of around one per cent of GDP and an increase in employment of half a per cent, whilst the second foresees a sustained 0.7 – 0.9% increase in manufacturing growth.

An integrated, deep and efficient single market also forms a major opportunity for US service providers. It offers more choice to investors, who could enhance their portfolio allocation and increase their returns. It would also be a major additional source of liquidity and financing for US companies, reducing their costs of borrowing and capital. In short: it is in the US' interest, as well as the EU that the FSAP succeeds. All US firms I talk to fully recognise this. I want to underline that we are building our capital market in a fully open way. There are no fortresses, castles, walls or frontiers to foreign competitors. On the contrary, we believe that increased competition leads to increased strength and depth.

Yet despite these good intentions, in implementing the plan, it has proved impossible to contain all the regulatory effects of the measures to the EU. In providing Single Market freedoms, legislation must make some provision for businesses, investors and intermediaries from third countries looking to operate in the EU: it cannot simply ignore them.

Equally on the US side, Members of the Committee will be only too aware how the Sarbanes-Oxley Act has had far-reaching consequences on auditors and listed companies outside the US, despite its laudable aims and provisions. This regulatory spillover is an inevitable part of finance in the 21st century and requires upstream cooperation, particularly by the two biggest players: the EU and the US. We have a duty to tackle issues together rather than trying to go it alone. We need to do this early rather than late. If we fail in this duty, we risk penalising investors and companies, with a consequent impact on jobs and economic growth.

**iii. Regulatory Best Practice**

Early cooperation can also have a positive effect, by promoting best practice and so benefiting businesses and investors.

Legislators and regulators on both sides of the Atlantic are constantly looking at how they can improve the regulatory environment for businesses and investors. The US clearly has a wealth of experience in financial regulation, and we have been keen to learn from that. In developing our Prospectus Directive for example, we were very mindful of the benefits to US investors from high levels of information on companies.

**iv. Politically Possible**

Some have suggested though that even if desirable, such cooperation is simply not possible or far too difficult. They have suggested that the regulatory and economic mindset on the two sides of the Atlantic is simply far too different: we have our way of doing things and you have yours and never the twain shall meet.

I feel that we can and do cooperate. Why do I say this?

We have proven within the EU that such cooperation is possible between countries. Some over here might underestimate the sheer difficulty of what we have been attempting in the EU. Sometimes we make it look too easy. Anyone who follows the internal debate will tell you that finding a way through is far from easy.

But we have had to find a way. The EU has spent the past forty years – and particularly the last five - developing approaches to resolve the access of service providers from one jurisdiction to potential customers in another across 25 different jurisdictions. The EU has had to find regulatory accommodations between independent countries to ensure that services can be offered

without regulatory friction but also without any lowering of regulatory standards. We have had to develop approaches that ensure complete confidence in high standards of regulation and supervision right across the Union, including in the ten new States that joined 12 days ago. Investors and governments in Member States with long established financial traditions would not have accepted the right of companies from new market economies to offer their services in their jurisdiction unless they had been absolutely convinced of that.

Secondly, I believe that regulatory cooperation in this area is possible because I have seen it at first hand in other areas. Some of you will know that I spent eight years as Director-General for our Competition DG. In that area, we developed an unspectacular but quietly efficient partnership between the EU and US on hundreds of competition cases, despite the very high potential difficulty of cases involved.

## II. So how can we cooperate together?

How do we cooperate in this area?

The first thing that we have had to do is to throw away the textbook and start from scratch. Whatever the merits of the concepts and their merits in other areas, my sense and that of my Commissioner has been that if we spend our time in discussions about terms such as "reciprocity", "national treatment" and "mutual recognition", we will not get anywhere. We have to make a fresh start and look at what will work in any particular case without getting obsessed by labels. We need to have the full tool kit and be flexible in the way that we treat each issue. They are very different.

### i. Mutual understanding

To do this, we need first to understand each other, each other's approaches, systems and legislation. It is not good enough to dismiss each other's systems as not being good enough: we have to sit down together and compare approaches, and see how they are different, but also how they are alike.

Let me add that this process is becoming considerably easier the more that the EU integrates its financial markets, because instead of having to look at 25 sets of rulebooks, US authorities are able to look at one broad set of rules and principles. As European regulators and supervisors cooperate with each other and converge their day to day approaches, as they are doing in the Committee of European Securities Regulators – CESR – and the two new committees that we have recently set up in banking and insurance, so even the comparison of the details of the rulebooks will become far more simple.

Let me add that if you look at the two areas of EU-US regulatory cooperation which are the most advanced, audit firm oversight and Financial

Conglomerates, you will see that there was no way in which we could have made progress without a deep study of each other's systems.

In some cases indeed, that mutual understanding can lead to an appreciation of where one system or the other has developed a more sophisticated approach and promote the regulatory best practice that I mentioned earlier. We should not be afraid to go back and amend our rules if that is the case.

**ii. Information Flow and Transparency**

Mutual understanding of existing rules is not enough, though. We also need to ensure that as we develop new rules or regulatory approaches, we consult each other upstream and ensure proper **information flow and transparency.** The more that we talk to each other at an early stage, the more that we can pick up any expertise or thoughts that the other might have, that we can avoid unpleasant surprises and critically that we can avoid the downstream problems or regulatory repair.

Can I mention in this context, the excellent agreement between the SEC and CESR to consult each other at an early stage on draft rules?

Even at later stages of regulation, we need to encourage each other and each other's businesses to comment on proposed regulations. In the past five years on financial services, the European Commission has moved to unprecedented levels of consultation and transparency as it draws up its proposals. The Internet offers a major opportunity for all sides to be consulted without having to do as we did in the past and targeting all parties who we thought might be interested by proposals. We have strongly encouraged comments from businesses, regulators and governments not just within the EU but beyond. Let me mention for instance, the very constructive role played by the US Securities Industry Association in this respect.

What we should absolutely aim to avoid from now on is intentionally trying to establish a type of first mover regulatory advantage: setting a standard and then compelling the other to match it. This is a recipe for uncertainty and many long term problems. Again cooperation on the basic principles is the name of the game.

**iii. Convergence**

Mutual understanding and information flow are two key elements, but they are no substitute for some degree of **convergence** of approach. We have to be sure that we are aiming at the same basic goals. Investors want to be clear that they are getting the same level of protection in another jurisdiction that they are getting in their own. If so, they will be more outward looking and trade across borders more. Intermediaries operating out of one jurisdiction want to be sure that they are on a level playing field with intermediaries in another. Businesses do not want to be faced with a

multitude of different approaches and aims. We both want to avoid regulatory arbitrage.

May I add though, that this issue is exactly the one that we have been grappling with at a European level over the past few years. What we have found is that ultimately the question is not whether you converge your approaches, but how high you set the bar. In negotiating the Financial Instruments and Markets Directive for instance, we were faced with fierce discussions between those on one side – notably from the United Kingdom - who said that we should establish basic principles, but leave the choice of systems to the market, and let investors decide for themselves which was the best, and those who wanted a much more harmonised or "one size fits all" approach.

The arguments of both sides have considerable merit and our experience has been that you need to take a case by case approach. Take, for example, the new **Basel** agreement on capital requirements for international banks, the European Commission is very supportive of this process. 'Basel 1' has been of major benefit to global financial stability, to fair competition and to the reduction of unnecessary burdens on internationally active banks. However, like others, I consider that the 1988 agreement is in the winter of its natural life and that the need for its replacement with something suitable for the 21st century has now become very pressing.

The process to develop the new framework has been at times a difficult one. But it has also been an important one with many benefits flowing from the process itself. These include enhancement of banks' risk awareness and management as they move towards implementation of the expected new framework, and further improvement in the understanding between and discussion amongst supervisors, something which is very important in the increasingly globalised market in financial services.

Concerning the product itself – the new Basel agreement – I consider that the unprecedented level of consultation and the very significant efforts and commitment of all concerned are now on course to deliver high quality results. I think that this agreement between supervisors as to what standards represent the appropriate minimum for international banks will form a very good basis for the regional and domestic processes that will now take place to establish modern capital requirements rules in the different jurisdictions.

In the EU, the Commission is in the final stages of completing its proposal for the new European framework. This will result in our implementation of the new framework by the end of 2006. Of course, in the EU and the US different approaches are being taken to implementation. In the EU, for example, we intend to apply the new framework to all institutions whatever their size or level of complexity. Moreover, given this wide application, we will not be applying the Basel framework unthinkingly, but with modifications where

necessary to reflect this wide application. Given the very flexible nature of the planned Basel framework, such modifications will be limited.

We have recently published a report into the likely effects on the economy of the new capital rules. This indicates that there will be beneficial long-run consequences for the European economy, no automatic disadvantage for smaller banks or indication that Basel II will force M&A's and consolidation in the banking sector, and no negative impact on the availability and cost of finance for SME's in most EU Member States.

In other areas, however, it is more appropriate to establish the core objectives to be achieved, but leave details to be fine-tuned at a later stage or allowing slight variations of approach.

Ideally if we are to remove regulatory barriers to each other, we should use such thinking on new issues or rules to move forwards at the same time and to converge our approaches as we do so. The parallel approach on audit firm oversight that PCAOB Chairman Bill McDonough and my Commissioner have been able to develop is a good example and I hope a useful precedent for the future.

I appreciate that this is not always possible: some issues become more salient for one party at a particular time than for another, so one side has to move forward while in the other there is no momentum for a change, but we should certainly do this whenever possible.

**iv. Equivalence**

But what all this comes down to in our view is that convergence alone is not the solution. In many cases convergence of details may not be practicable, not just between the EU and US, but even intra-EU and between States of the US. If we are to go forward, we will have to recognise that in some cases what is important is not that we take identical approaches, but that we agree that we have broadly **equivalent** approaches and that we share the same goal.

Before compelling service providers or businesses to comply with the full set of local rules – including ones which may even contradict those which they are asked to meet in their home jurisdiction – regulators and supervisors should follow a "rule of reason" approach. They should ask themselves whether the ways in which those companies are regulated in their home jurisdiction meet comparable or equivalent prudential and investor protection standards to those achieved by local rules. If there is indeed equivalence, it would not add to the quality of regulatory protection to insist on compliance with local rules; it would simply create an unnecessary hurdle to services being offered to those investors. That cannot be in the interests of either the EU or the US.

Working on the basis of equivalence is not an admission of defeat: it is a healthy recognition by both sides that there can be more than one way to

achieve a common objective. In many cases, there is no perfect solution to a regulatory problem. In some cases, the regulatory solution used in one jurisdiction might not work in the other. We need an organised and cooperative coexistence: a managed competition of equivalent systems based on common underpinnings.

What do we do if we are equivalent? How do we recognise that equivalence and manage a particular issue? These are early days in this sector, but it seems to us that no one solution will work for each and every issue. We have to take a case by case approach tailored to each situation. We need to use the full regulatory toolkit and ensure that there is enforcement.

In some cases, what we can do is to cooperate and work share on the basis of parallel approaches. This is the kind of approach that we have developed on auditing, where we have discussed our approaches, converged wherever possible, but got to a stage where the Commission has recently proposed a modernised Eighth Company Law Directive on auditing which will be flanked by a parallel forthcoming PCAOB rule on oversight of non-US accounting firms. The two proposals are broadly equivalent to each other's aims.

Under the co-operative approach, Member States may conclude co-operative working arrangements in relation to inspections, investigations and oversight of foreign audit firms, provided that the EU has recognised the other system as equivalent. In the case of equivalent third country authorities and where the third country authority is doing the same, Member States can exempt foreign audit firms from registration, inspection, investigations, etc.

That is one approach. Another is to say that companies headquartered in third countries can operate in the EU without further requirements provided that their supervision is deemed equivalent to that set out in a particular law. That is broadly speaking the approach that we have taken on Financial Conglomerates where the EU is in the process of adopting guidance on whether and to what extent regulation of these entities is equivalent.

This list is not exhaustive, and we will need to be ready to innovate on both sides, but it does at least give a flavour for some of the approaches that can be taken. Only by going down this route can we truly resolve the regulatory spillover and eliminate the regulatory frictions that I have referred to.

## III. What ar w doing and how should it go forward?

What are we doing in practice to take this approach forward?

### i. Regulatory Dialogue

The most obvious thing is talking to each other in the Financial Markets Regulatory Dialogue. I am sometimes asked what the Dialogue is, who it involves, how often it takes place. My response is quite simple: there is no magic to the term "Financial Markets Regulatory Dialogue", it just refers to the fact that the two sides are talking to each other frequently. It does not matter whether that takes place face to face, by telephone, or by videoconference. What matters is that it happens in a constructive and effective way which achieves the objectives that I have set out of removing hurdles from unnecessary duplication of regulation, converging where possible and preventing new ones from occurring. The term describes, it does not prescribe. It is solution driven.

The core of the Dialogue and what most people commonly associate with the term "Dialogue" is a regular meeting between Directors from the European Commission and their opposite numbers from the Treasury, SEC and Federal Reserve. This effectively acts as a "review group" to systematically go over all issues of interest to each side and check that progress is being made or that each side is properly informed.

This Dialogue has been going on for just over two years since March 2002. These review meetings take place roughly every four to six months, most recently in March this year.

The first thing that we agreed, and something that has in our view been critical to its success, was that we should meet informally, and on an "as and when" basis. We believe that that informality and discretion has been crucial, by allowing differences and concerns to be aired openly and directly. Both sides know that they can explain and discuss things honestly without being quoted in public the next day. This has been helped by growing familiarity with each other.

It has also been helped by a commitment on both sides, not to particular results, but to particular processes to discuss or resolve issues. Every year we sit down and agree what we are going to do, and how to do it. For instance, on Financial Conglomerates, the European Commission was able to set out the whole process by which the EU would reach its equivalence determination. This allows both sides to see that issues are being taken seriously. From our point of view in the EU, it has also enabled us to check with our Member States that we are tackling the issues of importance to them.

We are continually looking with our US counterparts at how we can improve the Dialogue still further.

A first observation is that the Dialogue has been a victim of its own success: as we have started to discuss issues together, so new issues have emerged or been suggested. This is testament to its perceived use, but if these issues are to be tackled properly, we believe that we will have to organise our work more effectively by grouping issues together and delegating work to more detailed meetings on specific subjects. We have done this to a certain extent on Conglomerates and insurance and are looking to extend it still further, by involving our regulators and supervisors to a greater degree. To keep costs down, videoconferences can help.

There is also scope for separate and more detailed cooperation between EU and US supervisors. We welcome the recent launch of a Dialogue between the SEC and CESR, and between the NAIC and the new Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

We are also continually looking to ensure that our Member States and the European Parliament are involved effectively in the process. The European Commission already makes strenuous efforts to keep them informed and consulted. We discuss relations with the US at nearly every meeting with Member States on financial services. Tomorrow for instance, I am seeing our Financial Services Committee, and will update them on my appearance here, and discuss how to go forward. With this in mind, we are keen that our Member States finance representatives should be able to meet US counterparts at least on an annual basis.

We have also encouraged contacts between our Parliament and this Congress, and in particular, contacts between the Economic and Monetary Affairs Committee and this Committee. We were very heartened at the videoconference which you held last year Mr Chairman and hope that this committee and the Senate Banking Committee will build on this with the new Parliament to be elected next month.

If we are to go forward though, it will need to be with the full support and involvement of industry, businesses and end-users. We recognise that it is not enough to be talking and resolving issues together; we have to communicate this more effectively, and ensure that we are resolving the right issues. We are currently looking at how we can best improve feedback to the private sector without jeopardising the informality of the Dialogue which has worked so well. There is also a valuable role to be played from industry on both sides sitting down together and defining together the problem areas and priorities. We are strongly supportive for instance of the relaunch of the Trans-Atlantic Business Dialogue (TABD), and of the recent roundtable between the FSR and EFR.

The Dialogue though, is only the vehicle for results and regulatory cooperation. We will need to show that using the methods that I listed earlier, we really are tackling specifics.

### ii. *Ex post* conflict r solution

Our first priority is to resolve those issues that are already of concern.

I have mentioned the cooperative approach that we are taking on **audit firm oversight.** Well ahead of Ahold and Parmalat, the European Commission was clear that what had happened in the US over Enron, Worldcom and others could have happened to us. We had already identified a number of areas that needed to be improved as part of our Financial Services Action Plan. In taking forward work on these areas, we tried to learn from Enron and Worldcom. The result was our Company Law and Corporate Governance Action Plan last year, and our draft Eighth Company Law Directive this year. We welcome the cooperation with the PCAOB. We also welcome the very constructive approach taken last year by the SEC in minimising some of the unintended effects of Sarbanes-Oxley on European companies and audit firms. We hope that this approach can continue.

Equally, I have referred to the equivalence issue for **Financial Conglomerat s**. It was never our intention to penalise American companies. In reaching guidance on equivalence, we have put the United States at the head of the queue, and hope to announce the results shortly. We welcome the increasingly constructive approach of US agencies on this issue.

A third issue on which we and our regulators need to working harmoniously with American counterparts is on the equivalence of regulation of exchanges and securities and the possibilities of remote access of investors to **trading screens** of exchanges based in the jurisdiction of the other. We recognise the difficulties in this, but believe that there are real potential benefits to investors and businesses on both sides from progress on this issue. We welcome the statement by SEC Chairman Donaldson that he will look at this issue later in the year.

In the **insurance** field, we have had fruitful regulatory cooperation with our American counterparts. The transatlantic insurance market is by far the world's most important. It is crucial that remaining obstacles to markets are removed. One important area where we could make more progress is the removal or lowering of collateral requirements on reinsurance companies. We hope that it will be possible to work together with the EU and US insurance industries to find a suitable solution that reduces the costs linked to the current collateralisation requirements. We are currently preparing an EU directive on reinsurance supervision that will further increase the regulatory standards of EU reinsurance companies. Furthermore we look forward to further international reinsurance cooperation with the US in the International Association of Insurance Supervisors (IAIS).

### iii. *Ex ante* upstr am cooperation

Equally however, we will need to cooperate upstream to prevent new conflicts emerging.

A priority here is on the implementation of any new Capital Accord. It is essential that supervisors continue to work closely together over the coming period. In general terms this is necessary to maximise the benefits and efficiencies flowing from the process and to address the further issues that will inevitably arise from the implementation process. More specifically, it is important that there is close co-operation to ensure that banks do not find the benefits of the new framework undermined by the different approaches to implementation being adopted in, for example, the US and the EU.

It is also extremely important that we cooperate effectively on the introduction of **International Accounting Standards** in the EU from next year. The more that there can be convergence in both directions between IAS and US GAAP, the better for all. We are therefore encouraged by the cooperation between the FASB and IASB. Nevertheless, we believe that such convergence can only go so far: ultimately the EU and US will have to cooperate on recognising the equivalence of each set of rules. This is an issue on which more progress is needed over the coming six months, but we are cautiously encouraged by some of the recent moves of the SEC. We hope that the SEC will draw up a road map towards recognition of IAS. The EU will be fully transparent about the equivalence recognition process in our Prospectus and Transparency Directives.

Beyond this, areas such as the ongoing work on both sides on Credit Rating Agencies, Financial Analysts, Mutual Funds and Hedge Funds offers an excellent opportunity for upstream cooperation and convergence.

## Conclusion

Mr Chairman, Members of the Committee, the Dialogue between the EU and the US is very much an evolving process. It is built on serious engagement by both sides to minimise the negative effects on our companies, intermediaries and investors from regulatory differences. It is built on recognition that we are living in a world where we either cooperate or damage each other needlessly. We have too much in common to be able to afford to do that.

The rewards to us in terms of jobs and growth if we can cooperate are significant. The benefits of cooperation will not just be felt by us, but by our other commercial partners such as Japan, China, Canada and Australia, with whom we also need to engage effectively.

Such cooperation will not be easy for either side. Our regulatory systems have grown in splendid isolation from each other and making accommodations to

different approaches will sometimes be politically difficult. But we have to recognise as mature economies that the blind exercise of regulatory autonomy will penalise us both, and undermine global capital markets.

I welcome the support that you have brought to this process and ask that this committee supports us as we proceed, providing a favourable political wind to blow through our sails and push us both forward in what we believe is a noble task.

Thank you.

# TESTIMONY
# OF

**ETHIOPIS TAFARA, DIRECTOR**
**OFFICE OF INTERNATIONAL AFFAIRS**
**U.S. SECURITIES AND EXCHANGE COMMISSION**

## CONCERNING
## GLOBAL MARKETS, NATIONAL REGULATION, AND COOPERATION

**BEFORE THE COMMITTEE ON FINANCIAL SERVICES**

**U.S. HOUSE OF REPRESENTATIVES**

**MAY 13, 2004**

**U.S. Securities and Exchange Commission**
**450 Fifth Street, N.W.**
**Washington, D.C. 20549**

# GLOBAL MARKETS, NATIONAL REGULATION, AND COOPERATION
## STATEMENT BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE

by Ethiopis Tafara
*Director, Office of International Affairs*
*U.S. Securities and Exchange Commission*

May 13, 2004

Chairman Oxley, Ranking Member Frank, and distinguished members of the Committee, thank you for inviting me to testify about the US-EU regulatory dialogue on capital markets.

### A SHORT BACKGROUND TO GLOBAL SECURITIES MARKETS

I've been asked to address the history of the US-EU regulatory dialogue and its importance to the Securities and Exchange Commission today and for the future. This dialogue is the result of historic changes in the ways capital markets function and are likely to develop.

Stock markets have existed in the United States and in Europe for centuries, and American and European investors, issuers, and markets have a relationship going back throughout most of this time. Much of the capital that traded on the London, Amsterdam, Paris, New York and Philadelphia stock exchanges over the years came from foreign investors. As an example, during the second half of the nineteenth century, British and other European investors provided much of the capital needed to construct the early American railroad system – to such an extent that populists of that era occasionally complained that the British were trying to "recolonize" America through direct investments. And, of course, the shape of the United States today owes something to the Mississippi Company, a French joint-stock company founded by a Scot and drawing on investors from England, France, Genoa, Germany, and Venice.

Yet, throughout most of this period, the regulation of securities markets varied considerably. English law prohibited unchartered "stock-jobbing" after the South Sea

Bubble financial crash in 1720. From the mid-nineteenth century on, various English Company Acts imposed national-level requirements on how shares in corporations could be marketed to the public and what information about these corporations had to be disclosed to potential investors. By contrast, throughout most of the existence of Wall Street, "securities regulation" in the United States was a combination of exchange self-regulation, common law, state corporation laws and, starting with Kansas in 1911, state "blue sky" statutes.

Despite the long history of stock markets, the United States was the first country to adopt a comprehensive national approach to securities market regulation with passage of the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act). These two statutes (along with the Public Utility Holding Company Act of 1935 and the Investment Advisers and Investment Company Acts of 1940) were passed the same time that the "international" dimension to our stock markets decreased dramatically, largely due to the Great Depression and the aftermath of the Second World War. While several other countries in the immediate post-War period followed the American example in creating their own national securities laws and in setting up their own securities markets, until relatively recently and with a few exceptions, the world's securities markets catered largely to domestic issuers. In 1986, for example, only 59 foreign issuers were listed on the New York Stock Exchange, compared with the 470 listed today. While the securities markets of a handful of countries were more "international," there was little regulatory overlap – at least from our perspective. In other words, for much of the SEC's existence, with some minor exceptions, regulation of our stock markets was mostly a local affair.

This situation is now changing. Almost all developed market jurisdictions – and even a considerable number of developing markets – have adopted forms of securities market regulation similar to our own. At the same time, capital markets are reverting to their earlier, more "global" form. The result is something unique in capital market history – a truly global capital market, such as we have had in the past, but operating in a world of extensive domestic capital market regulation.

At this point I should say that I firmly believe that the US securities laws and SEC market oversight are two of the principal reasons why our markets are as efficient and effective as they are at fueling the capital needs of our economy. These laws focus on investor protection and have created in investors a certain bedrock confidence in the integrity of our securities markets that even sizable financial scandals have not been able to entirely diminish. Of course, Congress' wisdom is evident, not just for passing the original securities laws in the 1930s, but also for rapidly reinforcing these laws and buttressing the SEC's oversight capabilities when scandals have erupted, such as with the Sarbanes-Oxley Act of 2002.

For these reasons, the US securities market remains by far the largest and most liquid in the world. And, as a practical matter, the size of our market means that rather than setting securities regulations in a vacuum, the agendas of Congress and the SEC have a worldwide impact. However, this situation is becoming more complicated.

Recent initiatives by the European Union promise to create an EU-wide capital market and a rationalized, coordinated European securities regulatory structure. These initiatives will improve the efficiency, liquidity and investor protection aspects of Europe's securities markets – developments that will benefit both US investors and issuers in the long run, by providing the former with greater investment opportunities and benefiting issuers by possibly lowering their cost of capital. However, the creation of a coordinated European securities regulatory structure also raises the possibility of real conflicts between regulatory requirements – conflicts with far-reaching extra-jurisdictional implications.

Today, both the US and the EU securities markets are too large to be ignored. Potential conflicts between the regulatory requirements of these markets can have an adverse impact on the cross-border flow of capital. Some of these conflicts may prove difficult to avoid, stemming, as they may, from differences in regulatory philosophy. Where investor protections or any other aspects of the SEC's statutory mandate are involved, the SEC has to be careful not to afford accommodations solely for a short-term improvement to efficiency in conducting cross-border investments – "short-term" because any

improvements to efficiency that undermine investor confidence are likely to prove short-lived. Nonetheless, some duplicative or even contradictory regulation in this cross-border environment offers nothing in the way of investor protection and merely places an unnecessary burden on issuers, firms and investors. The SEC is committed to avoiding such situations, where possible.

We must also keep in mind that, in a global capital market, where both investors and fraudsters can move funds across borders with ease, cross-border regulatory cooperation becomes vital for any securities regulator concerned about enforcing its own regulations. The old enemies to the integrity of the global capital market remain. The globe-trotting investors of the past – the British Victorians investing in the Erie and Northern Pacific Railroads, the Parisian nobles invested in the Mississippi Company, and the numerous international investors in the South Sea Company – frequently came to financial ruin because fraudsters "[drew investors] in by the reputation, falsely raised and artfully spread, concerning the thriving state of their stock."[1] Fraud today, just as 300 years ago, recognizes no borders.

### THE US AND EUROPEAN APPROACHES TO FOREIGN MARKET PARTICIPANTS

Despite the comparatively few foreign actors in our markets during the early part of the SEC's existence, the SEC has a long history of accommodating foreign issuers, investors and other market actors who wish to participate in our markets. From the very beginning, US securities laws drew few distinctions between domestic issuers, firms and investors and those based outside the United States. With that said, the SEC has also long been aware that, particularly for foreign issuers, home country laws and regulations may impose requirements that conflict with SEC rules. When this has happened in the past, and when we could do so without jeopardizing investor protection, the SEC frequently made accommodations for foreign participants in US markets to avoid direct conflicts of law. In this way, the SEC believes investors can be assured that their interactions with a foreign market participant are subject to the same regulatory oversight as those with a

[1] *Journals of the House of Commons*, 11:595 (Nov. 25, 1696), quoted in Stuart Banner's, *Anglo-American Securities Regulation: Cultural and Political Roots, 1690-1860*, 29 (Cambridge Univ. Press, 1998).

domestic market participant, and foreign and domestic issuers and firms alike can compete on a level regulatory playing field.

The EU generally has taken much the same approach to non-EU market participants – according them national treatment, for the most part, but taking into consideration home country regulations to make appropriate accommodations.

For a number of years, this approach to regulating foreign participants in our markets have served both the US and EU well. They have allowed us to make changes to our laws and regulations without creating significant conflicts between each other's laws. However, this situation changed quite suddenly when both the United States and the European Union undertook major regulatory reforms to strengthen the integrity of our markets.

**MOMENT OF CHANGE**

As you all well know, Congress overwhelmingly passed the Sarbanes-Oxley Act in 2002 – one of the most significant pieces of US securities legislation in the past seventy years. Sarbanes-Oxley arose out of the Enron, WorldCom and other financial scandals. The Act had a major impact on all participants in US markets, including those from abroad. In particular, foreign issuers found themselves subject to US rules that would directly impact their corporate governance – an area of regulation in which the SEC, in the past, accorded deference to home country rules.

Around the same time, the European Union began implementing its Financial Services Action Plan (FSAP), designed to create a single market in financial services throughout the EU. Forty-two legislative measures were contemplated as part of the action plan, many of which focused on securities regulation. Today, these measures are having a tremendous effect on the regulation of EU capital markets and, as with the Sarbanes-Oxley Act, have necessitated major adjustments on the part of issuers, accountants and lawyers, and regulators affected by the legislation.

It immediately became apparent to securities regulators on both sides of the Atlantic that some of these momentous changes were both extensive in their reach and not necessarily mutually compatible. It was also apparent that some of the objectives of these possibly contradictory requirements were not themselves at odds with each other. Putting aside the different legal traditions, in a few cases the substantive differences boiled down to the engineering equivalent of one side using nuts and bolts measured in English units and the other in metric units.

**RATIONALE FOR THE US-EU DIALOGUE**

The US-EU Dialogue was created as a forum in which to discuss these types of issues raised by the Sarbanes-Oxley Act, the EU's FSAP, and other regulatory matters since 2002. The Dialogue is led by the US Treasury Department and includes the SEC and the Federal Reserve Board on the US side, and representatives of the European Commission's Internal Market on the EU side.

The Dialogue fulfills several functions. One important function is that it has allowed us to reinforce our common ground. With respect to financial services regulation, the US and EU share the same fundamental goals – protecting investors, maintaining stability in our markets, and allowing free and unfettered competition among all market participants.

The Dialogue has also created the opportunity for the EU and US delegations to educate each other about existing laws and regulations and any changes thereto. This educative process allows us to eliminate misunderstandings that may exist or that may arise with regard to regulatory changes being considered. The discussions in the Dialogue also provide an opportunity for both sides to air any concerns about the possible impact of the changes, and to request certain adjustments to address these concerns. While such requests do not always result in action by the other side, the Dialogue allows us to explain our rationale for what we decide to do.

To date, the Dialogue has proven helpful in resolving potential problems, but it has also permitted us to learn from each other's experiences. This learning process allows us to

consider possible new avenues of regulation for our own markets, which ultimately enriches the regulatory rulemaking process and helps us each to better carry out our regulatory mandates.

**DIALOGUE DISCUSSIONS TO DATE**

We have met in connection with the Dialogue on a number of occasions. During each occasion, representatives from the United States and European Union have discussed a number of key issues, including implementation of the Sarbanes-Oxley Act, the EU Financial Conglomerates Directive, matters regarding the presence of foreign market trading screens in the United States, and International Financial Reporting Standards.

**1. Sarbanes-Oxley Act**

Although the US-EU Dialogue began before the Sarbanes-Oxley Act was signed into law, implementation of the Act added new significance to the Dialogue .

Notably, the Sarbanes-Oxley Act does not differ from other US federal securities laws in treating foreign and domestic market participants the same way. However, as mentioned earlier, the US securities laws of the 1930s predate the modern capital market system. International issuers and firms, as well as regulators in other jurisdictions, largely came into existence after the more global aspects of the US regulatory structure were already firmly in place. Any conflicts between US laws and foreign laws were not as apparent as now because most market participants did not operate globally. This situation, of course, has changed.

As the SEC began to implement the Sarbanes-Oxley Act, it quickly became clear that, in some cases, implementing the provisions of the Act in a certain way could conflict directly with laws and regulations in other jurisdictions. The SEC has worked very hard to develop ways to smooth out these conflicts, consistent with the spirit and letter of the Act. These efforts have required that the SEC learn more about how markets and market participants are regulated in other jurisdictions so that we can understand how the

objectives of the Act might be achieved in other jurisdictions using very different legal systems.

The Dialogue has played a key role in our developing this understanding. Through our interactions with representatives of the European Commission (EC), as well as through our contacts with representatives from other countries, the SEC learned where the potential conflicts lay while the EC learned the objectives of our proposed rules. These discussions, in turn, led us to consider modifications to our proposed rules that might avoid putting foreign market participants in the unenviable position of being asked to comply with conflicting laws, while still ensuring that our objectives were met.

One concrete example of this is the SEC's rule regarding the composition of audit committees of listed issuers. The Sarbanes-Oxley Act required the SEC to pass a rule mandating that all members of audit committees be directors who are independent of the issuer. However, we discovered that the corporate governance laws and regulations in countries such as Germany with a dual board structure require the supervisory board, which is charged with auditor oversight, to include a representative of the labor force, under the theory that non-management employees of a company have a deep interest in ensuring that the interests of corporate managers are aligned with those of the company and the employees. Yet SEC rules do not consider employees of an issuer "independent" for fear that employees appointed to the board would be beholden to the company's management.

The US-EU Dialogue helped inform the view at the SEC that in the dual board system, the mandatory labor representatives on the supervisory board are rank and file employees and are quite effectively independent of the company's management. Accordingly, at the end of the SEC's notice and comment period, the final rule relating to audit committees contained an exception that would allow employees who are not officers of a company to sit on the foreign issuer's audit committee. This allows German companies listed in the US to comply both with US and German law. In addition, the change preserved the intent of the Sarbanes-Oxley Act, which was to ensure that independent directors can communicate directly with auditors without interference by management.

I would note that, this past March, the European Commission issued a draft directive that, if enacted, would require the establishment of audit committees comprising non-executives on all EU-listed companies. This Directive echoes the concerns behind the audit committee requirements of the Sarbanes-Oxley Act and is a good example of how the United States and European Union may approach similar problems from different directions, but still agree about the substance of what needs to be accomplished.

**2. The EU Financial Conglomerates Directive**

Despite the accommodations made by the SEC in the implementation of the Sarbanes-Oxley Act, one of the criticisms made by the EU and individual countries has been that the Act has limited their flexibility with respect to their own future regulatory actions. These critics claim they may have to follow the US model to avoid creating new conflicts with Sarbanes-Oxley for their own issuers or investment firms accessing the US market. To a certain extent, of course, this may be true – as it has always been. But the cross-border impact of new securities regulation travels both ways, as the SEC has also had to respond to legislative initiatives in the European Union. When this happens, as it recently has, the Dialogue allows both sides to consider any future regulatory actions, and gives both sides advance warning to make any regulatory adjustments that are appropriate in light of actions about to be taken by the other side.

One such example, where the Dialogue has played an important role in coordinating such adjustments, has been the EU Financial Conglomerates Directive (FCD). This Directive already has had significant spillover effects on US securities regulations by requiring that non-EU holding companies of financial firms operating in the EU be subject to consolidated supervision – in other words, the domestic and foreign banking, insurance, securities and derivatives operations of a large financial conglomerate will have to be overseen by a single regulator to help ensure that financial difficulties of one function or subsidiary do not adversely impact the entire firm. The Directive states that consolidated supervision may be carried out by a regulator in the holding company's home country, but the supervision nonetheless must be "equivalent" to that carried out in the EU.

This Directive was of great concern to many US investment banks with operations in Europe. If the SEC's regulation of these banks were not considered equivalent to the requirements of the Financial Conglomerates Directive, US investment banks in the EU would face alternative and more expensive regulatory treatment. To remove any ambiguity about its regulations, the SEC recently finalized two rules to establish a consolidated supervision regime for investment bank holding companies. For years, the SEC has evaluated the activities and management of affiliates as part of our overall assessment of the financial health of investment banks. The new rules formalize and strengthen the SEC's role as a consolidated supervisor and allow certain investment banks to use state-of-the-art risk modeling tools to determine capital charges. The SEC had been considering such changes for quite some time, and the Dialogue helped enable us to make these regulatory reforms in ways more compatible with what the EU was itself contemplating.

As the EU went through the process of proposing, amending, and finalizing the Directive, we discussed its implications on US broker-dealers in the US-EU Dialogue. SEC staff also provided detailed explanations of the SEC's form of oversight to EU regulators and policymakers. We have every expectation that the European Commission and EU member states will find our regime to be equivalent to the FCD. We also have every expectation that the implementation of both the EU's Directive and the SEC's consolidated supervision rules will prove to be a step forward for prudential regulation of large, complex financial groups, to the benefit of markets and investors.

As a related matter, and as a result of the Directive and the new SEC rules, over the next several years several US investment banks likely will begin to perform capital calculations consistent with the New Basel Capital Accord. The US investment banking community has raised thoughtful comments with respect to the application of these standards to investment banks, pointing out that doing so might have unintended effects, given the differences between investment bank and commercial bank business models. A working group comprising members of the Basel Committee and the International Organization of Securities Commissions (IOSCO) has been formed to work through these

issues. We are also in complementary discussions with the European Commission as it considers amendments to its Capital Adequacy Directive.

### 3. Foreign Trading Screens

Another current topic of discussion in the US-EU Dialogue is the issue of locating foreign stock exchange trading screens in the United States without first registering with the SEC. Several EU stock exchanges have asked for an exemption from SEC registration requirements in order to place computer trading screens in the United States. Doing so would give these exchanges – and the issuers on these exchanges – direct access to US investors. Currently, US federal securities laws generally require all exchanges operating in the United States, and all securities traded on those exchanges, to be registered with the SEC. The EU exchanges argue that, because they are regulated elsewhere, these exchanges and issuers should not be subject to the regulation and disclosure requirements of the 1933 and 1934 Acts and the Sarbanes-Oxley Act.

The Dialogue has proven useful in improving our understanding of each other's points of view on this issue. The SEC has used the Dialogue to describe for our European colleagues the statutory basis of US registration requirements and the investor protection concerns that lay behind them. We have also noted that there are certain fairness concerns if foreign exchanges are not subject to the same registration requirements as are US stock exchanges. At the same time, we have sought to garner an understanding of the differences and similarities in the regulation of exchanges as practiced in the United States and the European Union.

Consideration of the issue of screen placement was deferred after Chairman Donaldson's announcement last year that the SEC was undertaking a comprehensive review of the US market structure. Depending on the results of the review, all exchanges operating in the United States, whether domestic or foreign, could be subject to a changed regulatory landscape. Accordingly, the review needs to be completed before the issue can be considered further. We will continue to update our European counterparts in the Dialogue about the progress of the market structure review.

**4. International Financial Reporting Standards**

As part of the Dialogue, the EU has also raised the question of whether the SEC will accept financial statements prepared according to International Financial Reporting Standards, or IFRS, without requiring their reconciliation to US Generally Accepted Accounting Principles (GAAP). This request arises because most EU public companies will be required to adopt IFRS beginning in 2005. The SEC requires that issuers using any body of accounting standards other than US GAAP, including IFRS, reconcile those figures to US GAAP so that investors in the United States can compare these figures to those of other US-listed companies. However, such reconciliation can be expensive.

As we have explained in the Dialogue and elsewhere, there are a number of issues to be resolved before the SEC would be willing to allow *all* IFRS to be used in US financial disclosure statements without reconciliation.[2] For example, we believe it is necessary to show IFRS can be consistently interpreted, applied and enforced by those jurisdictions requiring their use. This means that accountants and auditors must be trained to use the standards; companies must incorporate IFRS into their accounts; and regulators must learn to oversee the use of the standards. In addition, the standards themselves must address the full range of accounting issues. Currently, there remain serious disagreements within the European Union over how IFRS should account for such important financial products as derivatives. The SEC's Office of Chief Accountant is working hard with the EU as well as various multilateral bodies and standard setters to address these and other issues and lay the groundwork for a time when IFRS can be accepted without reconciliation.

Since this issue was first raised in the Dialogue, we have moved beyond discussions of accepting IFRS without reconciliation to an even more interesting prospect – the possibility of converging US GAAP and IFRS. True convergence would eliminate the need for reconciliation of accounting standards either in the US or the EU. This would greatly add to the transparency of financial reporting by global issuers in all markets that

[2] The SEC permits three IFRS to be used without reconciliation to US GAAP, although two of the IFRS generally are not used.

adopt IFRS. Upward convergence would enhance investor protection in the United States, Europe and all other jurisdictions that adopt IFRS, as investors would be able to make easy comparisons of companies in all of these markets. The increased transparency would also assist regulators in carrying out their oversight.

The work to converge US GAAP and IFRS is already underway. In October 2002, the Financial Accounting Standards Board (FASB), the US accounting standards-setter, and the International Accounting Standards Board (IASB), the IFRS standard setter, announced a project to eliminate the principal differences between US GAAP and IFRS. This project is supported by Commissioners as well as the SEC staff. The IASB and the FASB have already proposed changes to certain standards to bring them closer together.

As we have learned through the US-EU Dialogue, both the SEC and the European Commission believe that convergence of accounting standards would be valuable. I believe that we also agree that, in order for convergence to occur, the standard-setting bodies working on convergence must be independent and must have transparent processes for developing standards. Such processes would necessarily include a mechanism for collecting and taking into account the views of the users of the standards. The IASB, which was created in 2001, is working hard to live up to these requirements.

Although it is still early in the process, I am hopeful that the IASB-FASB convergence project will prove to be an example for future convergence discussions as part of the Dialogue. Indeed, the Dialogue may be able to produce the greatest good for both US and EU markets if our discussions lead to similar upwardly-converged approaches to other regulations. This would lower the transaction costs for market participants currently dealing with the varying regulatory requirements of all the jurisdictions in which they operate, while also promoting the highest standards for investor protection

**THE FUTURE OF THE US-EU DIALOGUES**

Through the Dialogue, we have discovered that the SEC and the European Commission are examining many of the same regulatory issues, in many cases highlighted by very

similar financial scandals in both our markets. As we consider whether to introduce regulation in new areas, or to strengthen existing regulation and enforcement, the Dialogue has proven to be an effective forum for exploring new ideas and approaches. It has also allowed us to avoid unnecessary regulatory conflicts when developing our respective policies.

Going forward, other areas of cooperation between the SEC and the European Union will also begin to play a prominent role in the overall regulatory discussion between the United States and EU. I expect that future discussions likely will address the development of a cooperative framework between the SEC and the Committee of European Securities Regulators (CESR) , which comprises securities regulators from all EU member states. In addition, I anticipate that we will work on ways to continue to cooperate on enforcement matters, both between the SEC and the national securities regulators within the EU and between the SEC and EU regulators and other financial authorities.

**1. SEC-CESR Cooperative Framework**

In addition to the US-EU Dialogue, which involves several US financial regulators and representatives of the European Commission, the SEC is working more closely with its direct counterparts in the EU. In January, Chairman Donaldson asked me to develop a framework for cooperation and collaboration with the Committee of European Securities Regulators. CESR provides the European Commission with technical advice as the EC develops new EU-wide securities regulation, and it plays a key role in implementing EC Directives. CESR also helps ensure consistent application of these directives throughout Europe. In terms of the nuts-and-bolts of day-to-day securities market oversight, the constituent members of CESR are the SEC's direct European counterparts.

The SEC-CESR dialogue will have two goals. The first will be to discuss emerging regulatory risks that we see developing in our markets, and thus create something of an early-warning system about potential problems on the horizon. Through these discussions, we hope to improve our ability to anticipate problems and take corrective

action before they occur, rather than only responding reactively by punishing wrongdoers and attempting to compensate the victims of financial fraud as far as possible.

The second purpose of the SEC-CESR framework will be to discuss emerging regulatory issues in order to achieve converged, or at least not incompatible, regulatory approaches. In this area, the SEC-CESR cooperative framework will complement the US-EU Dialogue by focusing on the technical details of securities regulation rather than on broader policies. As I mentioned earlier, the US-EU Dialogue has highlighted the fact that even where no substantive policy disagreements exist between us and our European counterparts, as is frequently the case, implementing these policies through written rules and regulations can lead to conflicting requirements. The SEC-CESR discussions will help avoid that problem.

The first SEC-EU meeting under the auspices of the new SEC-CESR cooperative framework took place last March between SEC staff and members of CESR-Fin, a sub-committee of CESR that works on accounting issues. A future topic of discussion under the framework may be the US market structure review and the EU's Investment Services Directive, now known as the Financial Instruments Markets Directive. Both the US and the EU are examining market regulation issues, such as how trades are routed to exchanges and the disclosure requirements for those trades. This could prove to be a fruitful area for future discussion for the purpose of achieving more converged approaches.

**2. Enforcement cooperation**

The SEC's mandate to protect investors requires that it vigorously enforce all US securities laws and regulations. In fulfilling this mandate, the SEC has a long history of cooperating extensively with foreign securities regulators and law enforcement agencies, including those from the EU. In just one recent example widely covered by the media, the SEC has worked closely with the Italian securities regulator (the Commissione Nazionale per le Società e la Borsa, or "CONSOB") and certain Italian prosecutors' offices in an investigation into matters surrounding the collapse of Parmalat SpA.

As this is an ongoing investigation, I cannot comment further on the case. I can, however, discuss more generally the SEC's approach to international cooperation in enforcement matters. In 1988, Congress strengthened the SEC's authority to obtain and share enforcement-related information with other securities regulators and law enforcement agencies. The SEC has worked diligently over the past 16 years to develop relationships with our foreign counterparts so that we could more effectively do just that. We have negotiated bilateral Memoranda of Understanding (MOUs) with more than 30 of our foreign counterparts, by which we have set forth the terms and conditions for sharing information with each other. In many SEC investigations that involve an overseas component – for example, investigations involving foreign entities, or where evidence or defrauded investors are located abroad – the Commission staff works hand-in-hand with securities regulators and law enforcement agencies in those other countries. Similarly, our foreign counterparts seek the assistance of the SEC on a regular basis to obtain evidence located in the United States.

More recently, we have also worked through multilateral organizations to strengthen cross-border assistance in investigations of securities law violations. Because of the existence and effectiveness of these other fora (in which the European Commission is also represented) enforcement cooperation has not yet needed to be a subject of discussion under the Dialogue. However, individual EU members continue to play a major role in encouraging and developing improved mechanisms by which securities regulators can assist each other in enforcement investigations. A significant milestone in multilateral cooperation occurred in 2002, when the members of the International Organization of Securities Commissions (IOSCO)[3] negotiated a Multilateral MOU on regulatory cooperation and information sharing. The IOSCO subcommittee that spearheaded the development of this agreement included the chairmen of most EU securities regulators and was led by Michel Prada, Chairman of the French securities authority.

[3] IOSCO, comprising over 100 securities regulators from around the world, is a body that sets principles and standards for international securities regulation and cooperation.

Through the Multilateral MOU, world securities regulators have reached broad consensus on what is required of regulators to be considered responsible members of the international regulatory community. In order to sign the Multilateral MOU, a country must be able to provide a certain level of assistance to its counterparts abroad, including bank account records and brokerage records. The IOSCO Multilateral MOU on enforcement cooperation and information sharing now has 24 signatories, including the US, with more added every few months. Several of the most recent signatories only just received the legal authority required by the MOU. Their legislatures granted such legal authority precisely because the Multilateral MOU is such a powerful statement of what the international community believes is needed of securities regulators in today's global environment. I believe that the Multilateral MOU will prove to benefit the SEC's enforcement program and those of all other signatories significantly.

Another multilateral organization in which SEC staff participates is the Financial Action Task Force, or FATF. FATF, founded in 1989, is an inter-governmental body comprising members from 31 countries dedicated to developing policies to combat money laundering and terrorist financing. In FATF, we work closely with EU and other counterparts to establish principles and standards for regulations to prevent money laundering and terrorist financing, taking into account cross-border business flows. The US delegation to FATF includes representatives from the US Treasury Department, the Department of Justice, and the State Department, as well as the Federal Reserve Board and the SEC. Delegations from other countries have a similar composition. This combination of different areas of expertise positions the FATF to address the multifaceted concerns that arise when preventing money laundering and terrorist access to financing. It also may make this organization best suited to address the anti-money laundering and anti-terrorist issues facing the United States and European Union.

**CONCLUSION**

The US-EU Dialogue is a key element in a web of connections between the US and EU policy-making community. It serves the important function of providing a forum for developing greater understanding of each other's approaches; for airing out concerns

about actions that either the US or EU has taken with respect to financial services regulation; and ultimately will help us achieve more converged regulations relating to financial services.

Of course, one point we should keep in mind in this brave new world of convergence and regulatory dialogue is that now, and in the future, different regulations and decisions made by the SEC, by the European Commission, and by securities regulators around the world, reflect not just different approaches to similar problems, but also deliberate policy choices. It may not always be feasible to harmonize or converge these differences away. Nonetheless, we should, where possible, work to minimize conflicts between them. I believe the US-EU Dialogue will lead to better securities regulation in the United States and the European Union and, in the long run, better protection and choices for investors.

Questions for A/S Quarles from Rep. Joseph Crowley, House Financial Services Committee Hearing, May 13, 2004 on US-EU Regulatory Dialogue

**Question 1:**
The Treasury Department… has a strong record of working with its European counterparts to ensure that regulators on both sides of the Atlantic do not impose inconsistent requirements on U.S. and European companies, including financial services firms. I know that similar efforts are underway in other Departments of this Administration… Yet we often see cases where a U.S. company will effectively get a "blessing" for its actions by U.S. regulators, and even by U.S. courts, only to see the very same conduct subsequently condemned by regulators in Europe. This divergence of approach…leaves U.S. firms in an impossible position. It also emphasizes the need for regulatory coordination – and I might add, for some measure of deference when U.S. authorities regulate a U.S. firm for conduct that takes primarily in the U.S. Could you tell us about the efforts that are underway to improve this situation, and whether this issue will be on the agenda of any upcoming meetings between your Department and the European Commission?

**Answer:**
The kind of divergent regulatory treatment you describe has not, to our knowledge, arisen in the financial services realm, and I think this is due in no small part to the informal and very active Financial Markets Dialogue that exists between Treasury, the European Commission and our financial regulators. Our discussions have enabled us to eliminate some misunderstandings. We also air concerns about the possible impact of changes being considered and where appropriate request adjustments to address such concerns. This discussion process has, I believe, been effective in controlling the temperature of transatlantic tensions in the financial/regulatory area.

Looking out further in time, one important way to address the more generic issue you raise is through regulatory convergence. Different regulations and decisions made by financial regulators in the U.S., by the European Commission, and by financial regulators in other jurisdictions, reflect not just different approaches to similar problems, but also deliberate policy choices made in the context of different cultural and legal systems. In some instances it may be feasible to eliminate these differences by harmonization or convergence; where that is not possible, we can work to minimize conflicts through better understanding and by accommodating each other's concerns within the scope of our laws.

**Question 2:**
I understand there is only one US Treasury Attaché in Europe, based in Frankfurt. Given the increased importance being attached to the US-EU regulatory dialogue, does the Treasury Department have any plans to restore Treasury attaches to European capitals, or at least to Brussels?

**Answer:**
There are actually two Treasury attachés in Europe: one based in Frankfurt at the US Consulate and the other at the OECD in Paris. While budgetary limitations and needs for Treasury attachés in other parts of the world preclude placing additional attaches in Europe at this time, we currently plan to redeploy our OECD attaché to Brussels in FY2005. Treasury has been and will continue to be fully engaged on Europe's "Financial Services Action Plan" and we intend to continue that engagement.

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