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US-EU Regulatory Convergence
Capital Markets Issues

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'Mutual acknowledgement of different, but equally effective systems, will also be necessary. We shall all have to compromise on something…..' (Commissioner Frits Bolkestein, 10 Oct 2002 in Brussels)

'Our final rules may not always address your concerns, but we do promise to listen, and carefully evaluate them, and do our best to harmonize the application of our rules with foreign sovereign requirements…' (SEC Chairman Harvey Pitt, 10 Oct 2002 in Brussels)

Overview

EU-US regulatory convergence has particular importance for global capital markets and global economic growth. As the interdependence of national economies grows, so too does the global capital raising and capital allocating process. The number of multiple tranche securities offerings has grown significantly during the 1990s. Most global multinationals have financing needs reaching beyond the capabilities of their local markets to handle alone, so they are frequently listed on multiple exchanges around the world. Access to local capital markets has helped them to eliminate exchange rate risk, broaden their shareholder base to include local markets where they operate, facilitate M&A outside their home market by using local currency stock as the acquisition currency, increase their visibility in non-home markets and generally concentrate exposure to the various local markets where they operate. From an investor perspective, global capital markets present attractive opportunities for portfolio diversification. US holdings of overseas securities have increased eight-fold in the last decade. The NYSE expects US investors to double the non-US component of their equity portfolios from 5% to 10%. European equities will form the majority of this increase. Flows in the other direction, holdings by foreign investors in US stocks and bonds are now four times the 1990 level.[1]

At the heart of interdependent capital markets is the relationship between US and European corporate issuers and investors. Looking at the figures puts this into context. The US and EU equity markets combined represent 80% of global financial markets.[2] Capital raising and trading flows between the EU and the US have grown enormously. The number of EU company listings in the US now totals 255, with 151 NYSE listings and a further 104 listings on NASDAQ. 82 US companies are listed in Germany, 69 on the London Stock Exchange, and seventeen in France. For a variety of reasons, all fairly obvious, the number of European (including non-EU) companies listed on NASDAQ fell significantly in 2002. However, there were 19 new European corporate listings on the NYSE in 2001, and 5 in 2002. In 2001, the 174 European listed companies had a combined market capitalisation of $3.4 trillion. This compares with 74 Asia Pacific companies at $0.9 trillion and 103 Latin American companies at $0.2 trillion.

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[1] *Speech by Don Cruickshank,"The Role of US and European Capital Markets in Global Consolidation"*, before the Securities Industry Association Annual Meeting, Nov 2001; New York Stock Exchange web site.
[2] *International Federation of Stock Exchanges: http://www.world-exchanges.org*

In 2002, European companies raised a total of €42 billion via primary equity public offerings. Of this, an estimated 15% was raised in the US, largely through Regulation 144A private placements. These figures do not take into account additional capital raised through secondary offerings. Comparative figures for Asia and Latin America are fractional.

In terms of secondary market trading, transactions in US equities between US investors and foreign individuals and institutions have ranged between $3-5 trillion per year in the past 3 years, while bond transactions ranged between $8-12 trillion per year. [3] In recent years, equity purchases of non-US stocks have increased to around $95 billion, and happen frequently through stock swaps in the context of mergers. Net purchases of non-US bonds declined during the mid-1990s. Net total sales by US investors of foreign securities totalled $27 billion in the first three quarters of 2002.[4]

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

How significant are EU-US regulatory divergences? From this context, it would appear that they have not been significant inhibitors of transatlantic capital market business development. There are relatively few issues, but given the significance of the interrelationship between the EU and US capital markets, they do merit putting significant resource into finding a solution.

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

Efforts at regulatory convergence between the EU and US are long-standing, but pride in legislative and regulatory prerogatives (e.g. EU financial conglomerates and data protection directives), or simply political *force majeure* (Sarbanes-Oxley), have tended to get in the way. However, recent events (Enron, WorldCom) have thrown the issues into sharper relief, in particular corporate governance and accounting standards. The steady interlocking of markets and an intensification of regulatory dialogue on dispute resolution and detailed policy questions do appear to be having an impact on willingness to achieve convergence, and generating practical programmes for doing so. The growing trend is now promoting EU-US convergence on the legal and ethical infrastructures of the marketplace (company law, corporate governance, and accounting) as well as the regulation and supervision of financial markets. Two significant initiatives arose in 2002. The conclusions of the EU-US Summit in May 2002 called for a transatlantic dialogue for financial services to form part of a "Positive Economic Agenda", which has resulted in a number of exchanges between the Treasury, SEC and Federal Reserve, on the US side, and the European Commission's DG Internal Market for the EU. The Transatlantic Business Dialogue launched a Financial Markets Dialogue focused on Sarbanes-Oxley, accounting standards and trading screens.

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[3] New York Stock Exchange website
[4] US Treasury Capital Movements Report 2002

At the Oviedo Informal Ecofin Council 12/13 April 2002 the Commission presented a paper on 'a first EU response to Enron related policy issues' which essentially demonstrated that most relevant actions were already in the pipeline, and required only some review in the light of the new developments, plus reviews on a couple of additional agenda items (CESR Report on impact of complexity of derivatives trading and hedge funds; cross-sectoral policy assessment on rating agencies; a look at the role of financial analysts). However the Council has since endorsed, after the report of the Winter group on corporate governance and company law, a call for a new Action Plan in this area. An encouraging feature is that the European reference framework for this work has in general been explicitly focused on contributing to regulatory convergence, or at least avoiding the opposite.

At the very least one can now say the frequency of bows in the direction of regulatory convergence establishes a more sound policy framework for US and EU work on these matters than was previously taken for granted. However, an examination of some of the specific areas of importance for the capital markets shows the challenges facing policy makers on both sides of the Atlantic.

Securities Regulatory Issues

Trading Screens

First on the list of official European complaints about the US regulatory environment in the capital markets context is the demand for access by European exchanges directly to US investors by placing trading screens directly onto US broker-dealers' desks. European securities exchanges are effectively prohibited by the US Securities Exchange Commission from directly accessing the US market without first registering as a US exchange. The Federation of European Stock Exchanges (FESE) has been quite successful in raising awareness of this perceived barrier - at one stage the EU planned to raise the issue in the World Trade Organisation. The US successfully argued the issue was not suited to the WTO, because it is not a national treatment issue. Foreign exchanges in the US are accorded national treatment, since the requirement to register as a US exchange is no more onerous than for US domestic originated exchanges.

The SEC's concerns are twofold, relating to (1) the quality of European markets (their trading systems, their supervision, disclosure, etc., and (2) the products that would be offered (because of fears over European accounting and European corporate governance). The Europeans argue that a new Investment Services Directive and updated Standards for Regulated Markets in the EU should largely overcome the first concern. The second concern appears less easily resolved.

Following numerous discussions between the European Commission and the SEC, the SEC indicated a willingness to contemplate open access for products that have their "primary listing and area of offering" outside the US. Though the SEC's willingness to discuss the matter pleased the Europeans, , the EU feels that it has not taken sufficient steps towards proposing a solution to the issue that would satisfy the Europeans.

EU Single Market for Financial Services

The US has no equivalent complaint to trading screens that has been openly lodged, but large financial firms operating in Europe (many of which are US parented) are disadvantaged by the failure to complete the single market in financial services. In the US, securities law is at federal level, with minimal scope for interference or divergence in the states. By contrast, in Europe, the member state divergences are the dominant feature, contributing to chronic market fragmentation. The failure of the Investment Services Directive and other 1992 single market legislation resulted in an increase in barriers to cross-border securities business in Europe, resulting in enormous compliance costs because of differences in implementation. In many respects, the large US/global players are more damaged by these barriers because they have a more pan-European outlook than many European parented firms, many of which seem to prefer preserving their home market advantages to the risks of liberalisation and market opening. Lack of consolidation in the financial services sector in Europe is to blame for this, fuelled by overtly protectionist stances by some European bank regulators to hostile bank acquisitions.

These issues came to the fore following introduction of the euro, which having achieved certain price comparability across markets for investors and jump started a European corporate bond market, starkly highlighted the lack of integrated capital markets. While the EU Financial Services Action Plan recognises this and attempts to remedy it, firms have become somewhat disillusioned with its lowest common denominator compromises, which market participants believe are achieving sub optimal regulatory results and will not solve the problems. The real issue is whether the European Commission will enforce consistent implementation of the new directives.

Clearance & Settlement

While US and EU trading systems are equally competitive, Europe lags the US in efficient, low cost, timely clearance & settlement, with average costs in Europe around 7 times those in the US. This would be a significant obstacle to direct trading screen access by European exchanges to US markets. There are two significant barriers to achieving reform. The current structure of European clearing and settlement is so fragmented as to make any vision of a truly European capital market daunting if the situation persists. Linking all the exchanges and Central Securities Depositaries in Europe would require over 600 separate bilateral connections. There is little incentive for CSD providers to act, because more often than not they are owned or part-owned by stock exchanges and provide a valuable source of revenue. A similar situation existed in the US before the SEC acted to create what is now the DTCC.

In Europe, a number of exchanges already own clearing and settlement businesses, and argue that the "vertical silo" approach of integrated exchange and clearing service provides efficiency benefits that outweigh concerns that exchanges could distort competition in exchange services by leveraging their ownership of, or other close relationship to, clearing and settlement systems. However, other market participants (companies, investors and broker dealers) believe that aligned ownership of exchange and CSD is an unstable structure that cannot possibly be relied upon to deliver an efficient market structure in Europe.

The US had this debate in 1975 when the SEC came down in favour of a well-governed utility, now the DTCC. This might be an option for Europe, but some competition among clearing agencies would help to reduce costs. There is much that Europe might learn from the US experience of integrating its clearance & settlement services.

Financial Conglomerates Directive

The EU's new directive on the enhanced supervision of financial conglomerates and its extraterritorial application to financial groups with a parent undertaking based outside the EU is high on the list of issues under discussion between the EU and the US, with US securities firms arguing that it places them at an unfair disadvantage due to their SEC regulated status. The directive has also brought to the fore perceptions by the US and EU of the faults of the other's supervisory structure and practice. For US securities firms operating in Europe, the key issue is the directive's requirement of verification by the EU competent authority of 'equivalent supervision' by third-country authorities. There is concern among US authorities and banks that if the EU were to consider US supervision as not equivalent, it would raise the cost to US firms doing business in the EU and thus place them at a competitive disadvantage.

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

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

However this leads on to another key US concern. There is a suspicion that the need for a common EU position could simply be a thinly veiled means of putting pressure on the US to fall in line with the EU's approach to consolidated supervision, which is largely based on the premise that banks play the central role in financial markets. In the US the situation is quite different, with much higher levels of disintermediation out of banking, and a bigger role for investment firms and asset managers. The Commission has privately acknowledged that the supervision of the Fed might be deemed equivalent but that the SEC's supervision might be argued to fall short. In this situation groups supervised by the SEC would be disadvantaged vis-à-vis their competitors supervised by the Fed. This could have serious ramifications for the future structure of supervision in the US. The issue is somewhat up in the air, pending the senior staff changes at the SEC. It is worth noting that during a visit to Brussels in October 2002, then SEC Chairman Harvey Pitt sought to treat the issue in a political context involving some trade-offs with EU demands on access for trading screens (see above).

Basel II/CAD III Regulatory Capital Requirements
Considerable progress was made by the Basel Committee over the summer to address the concerns of the US over the treatment of credit card business and those of the EU, in particular Germany (whose banks are highly exposed to the Mittelstand sector), over the treatment of exposures to small and medium sized enterprises ("SMEs"). From the European perspective there are still concerns that the treatment of SMEs remains too harsh and will cause economic and political problems in some Member States.

Moreover, EU banks are concerned that the US authorities will not apply the new Basel Accord to the same extent as in the EU. The European Parliament has raised this issue, citing the non-application of Basel to the activities of investment groups that are supervised by the SEC rather than the US Federal Reserve. This potential disparity arises because the EU chooses to apply the Basel capital rules to all banks, investment firms and asset managers, not just the internationally active banks for whom the rules are primarily written, while the SEC applies its own capital rules to firms under its supervision. If, as appears likely, the Fed but not the SEC applies the new Basel Accord then concerns about an uneven playing field could emerge between US and EU banks that have to apply the new operational risk charge to their activities outside the EU, and US investment firms that do not.

At the same time, US and EU investment firms and banks have concerns over the EU's application of the Basel rules to trading (as opposed to traditional bank lending) activities without due consideration being given to the different nature of risks attached to such activities. They argue that trading exposures have greater liquidity and typically lower maturity than traditional bank lending activities. Because this issue falls outside the remit of the Basel Committee, it is a matter that will have to be addressed in negotiations over the EU's implementing legislation, the Capital Adequacy Directive III. US investment firms have asserted that the proposals will have a disproportionate impact on investment firms compared to banks. While both types of entities will be subject to an operational risk charge, unlike banks, investment firms are unlikely to experience any decrease in credit risk charges for their (primarily) trading activities. In addition, operational risk proposals result in higher capital charges specifically for activities that are often undertaken by pure investment firms (corporate finance, trading and sales) compared to banking activities. In relation to trading book activities, Basel has made a number of amendments to take into account the greater liquidity and typically lower maturity of trading book exposures. These and other changes have resulted in a reduction in estimated credit risk capital requirements compared to the original proposals. Basel and the EU are working on a new proposal that is intended to further take these concerns into account, to be published in spring/summer 2003.

Corporate Governance/ Mergers & Acquisitions Related Issues
Sarbanes – Oxley Act: Impact on US Listings by European Companies
The EU has raised some sharp concerns regarding the Sarbanes-Oxley Act, both about process (lack of dialogue, inadequate examination of consequences), and substance. The latter have focused on: the requirement that foreign companies with secondary share listings in the US must reconcile their accounts to US accounting standards; audit committee requirements going beyond or conflicting with local requirements; and the requirement for CEOs to certify financial statements and requirements on independent board members (German industry, in particular, strongly opposes this measure as incompatible with its dual board structure and worker representation.

Commissioner Bolkestein has pursued talks with the US to achieve exemptions for European companies from the Sarbanes-Oxley Act. On 9 October 2002, Bolkestein held discussions with Harvey Pitt, and declared himself encouraged, though he has subsequently returned to the attack in some speeches. Convergence of US GAAP-IAS was also discussed, including the progress towards acceptance by the SEC of consolidated financial statements of European companies prepared on the basis of IAS.

At an open meeting on January 8, 2003, the Securities and Exchange Commission approved the issuance of a rule proposal aimed to alleviate some of the legal conflict issues raised by the Act. The proposed rules are expected to be issued in the near future. Although the SEC did not provide a broad exemption for non-U.S. companies from the board independence requirements, it has indicated that the proposed rules will contain the following important accommodations:
Shareholder Selection, Approval or Ratification of Auditors - Local law requirements that shareholders approve the selection of auditors would not conflict with the Act's requirement that the audit committee be solely responsible for the selection of auditors.
Employee Representation on Audit Committees - Where required by "co-determination" and other similar requirements of local law or listing requirements, the proposed rule would allow employees to serve as audit committee members provided that the employee is not an executive officer of the issuer.
Board Representation of Foreign Government Shareholders - To accommodate foreign issuers with controlling shareholders that are foreign governments, the proposed rule permits a foreign government representative to sit on the audit committee if that representative is not an executive officer of the issuer.
Board Representation of Controlling Shareholders - A representative of a 50% or more shareholder of the issuer may serve on the audit committee provided he is not an executive officer of the issuer and maintains only observer, not voting (or chairman) status on the committee.
Statutory Oversight of Auditors - The SEC acknowledged that in a number of jurisdictions, the oversight of outside auditors is the responsibility of a Board of Auditors or a group of Statutory Auditors rather than by an audit committee. The proposed rule would allow alternative structures provided in local law to perform the auditor oversight functions contemplated in Sarbanes Oxley.
This rule proposal is an important step toward accommodating foreign issuers under the Sarbanes Oxley Act, but reinforces the SEC's position that exemptions will be made only in cases of direct conflicts of law.
While recognising that the lack of consultation by the US has been counterproductive, it is also important to examine the actual commercial impact of the Act's provisions. Some European corporates and industry associations have predicted delisting by firms from US exchanges, or a disinclination on the part of firms to consider a future US listing. There are 255 EU companies with listings in the US (rising to 297 if one adds in non-EU European companies). A survey of 50 of these firms by Citigate Financial Intelligence found that threats of non-compliance by European companies have been somewhat overstated, and showed a broad intention among Europe's US-listed firms to comply with the new Sarbanes-Oxley Act. Of 11 companies citing serious compliance concerns, most were located in Germany, France, Switzerland and the Netherlands. It is important to

note that this study was conducted before the SEC open meeting and resulting proposals referenced above.

While the Act may have a marginal effect on future listing decisions, it is thought unlikely that it will lead to delisting by a significant number of companies. This is because (a) delisting is prohibited for companies with more than 300 US record holders, (b) the costs attached and potential PR issues are significant, and (c) delisting does not necessarily eliminate a non-US issuer's ongoing obligation to file reports with the SEC. Admittedly, companies whose primary motivation in seeking a US listing was prestige may look again at the rationale of seeking or maintaining a US listing. However, most large issuers that chose the US market on more concrete economic grounds will have reason to maintain a US listing, despite the additional compliance costs.

Given the unsettled SEC leadership, the US political climate on corporate governance issues and the limited amount of time that has elapsed since the Act's entry into force, more far-reaching action to amend or provide waivers from the Act is unlikely in the immediate future. A 'technical corrections bill' to amend the Act remains a distant possibility. However, the new Congress is not yet settled in and legal experts believe there is relatively limited scope for significant changes via this route. There are plans to hold hearings on the Act's impact sometime in the new Congress, but this would only be a first step toward a bill.

All of this leaves European companies in a difficult state of legal uncertainty, which is unlikely to be speedily resolved, but will have to be worked through with the SEC on a case-by-case basis, or by the use of additional non-compliance disclosures in corporate regulatory filings. Such disclosures for legitimate legal conflict reasons are unlikely to upset investors significantly.

Accounting

In the context of capital markets, common accounting standards would greatly enhance investors' ability to compare companies on a cross-border basis. The issue exists not only on a transatlantic basis, but also within the EU, where accounting variations persist at national level, and International Accounting Standards will only be required to be applied to all listed companies in 2005. Even then, national regulators will still have scope for variable interpretation and application of IAS rules.

Post-Enron the EU has been loud in its criticism of US GAAP as too detailed and too rules-based, and therefore easier for clever people to find ways round, in contrast to the 'principles-based' approach of International Accounting Standards (IAS), in particular the requirement to apply the "true and fair" overriding principle.

New accounting rules are still under development by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB). Following a meeting of the IASB and the FASB in September 2002, there has been a significant change in the position of the US. Previously the FASB had strongly defended its rule-based approach. Harvey Pitt took the opportunity of his Brussels visit in October 2002 to underline the SEC's strong support for the convergence of accounting standards. He went as far as to say that he saw the ultimate goal as the agreement of a single set of high quality accounting standards evenly applied worldwide. While noting the difficulties of ensuring consistent application country to country of principles-based standards, he conceded that they were desirable and that he expected to see US standards move towards a more principles-based approach.

These constructive comments of Harvey Pitt were followed by the signing of a memorandum of understanding in October 2002, establishing a long-term collaboration project on convergence of IAS and US GAAP. A number of thorny issues will have to be resolved before convergence can be said to have occurred. For example, the deduction of stock options from profits remains a controversial issue between the two sides now that the IASB has come out in favour of this. However, despite continuing opposition from many in the US technology industry, a significant number of key US institutions have now publicly stated they will account for stock options on a voluntary basis to shore up investor confidence, suggesting agreement o this issue will ultimately prove possible.

Merging into a new global standard or even full convergence between IAS and US GAAP are a long way off. However, in the interim, the EU and US should work to alleviate the major differences, by focusing on ensuring consistent application. The memorandum of understanding on IAS - US GAAP convergence constitutes a groundbreaking agreement, and could serve as a model for promoting regulatory convergence in other key areas.

Takeover Directive

The main sticking point on the takeover directive remains the debate on its failure to tackle the issue of multiple voting rights. European Parliamentarian Klaus Lehne asserts that this will create a level playing field issue, because such rights are banned in Germany and vary across other member states, as well as being permitted in the US. He also argues that elimination of the right to takeover defences will leave Europe's companies vulnerable to bids by US companies, because US companies have poison pill defences. The reality is that while much attention has been focused on this directive, even if passed in its current form, M&A experts do not expect it to trigger wave acquisitions by US corporates in Europe. Labour costs and regulations, tax issues and other market fragmentation issues continue to operate as the main inhibiting factors for US acquisitions of European companies. Indeed, the M&A flows have been mainly in the opposite direction for many years now.

Furthermore, the poison pill argument is overstated. While US companies are able to employ defensive strategies under many of the state company statutes, they can be and are frequently overturned. US directors can be sued for breach of their fiduciary duty to shareholders if they continue to block a transaction that is clearly in the shareholders' interest. Partly because Europe (or at least the civil law systems in continental Europe) do not have such a well developed legal concept of fiduciary duty, boards have been able to block takeovers without prior agreement of shareholders (and occasionally to protect the positions of managers). There has also been a strong tendency to block foreign bids even by bidders from other EU countries. The takeover directive is, therefore, more important in the European context as a facilitator of pan European consolidation, while its main transatlantic significance is as an indicator of Europe's willingness to undertake politically difficult but economically necessary reforms.

European Company Law

A significant competitive advantage for companies in the US is the existence of advantageous regulatory locations for companies to incorporate (e.g. Delaware). The EU's comparatively rocky company law terrain is a disincentive for inward investment and hampers cross-border consolidation. M&A experts point out that in the European context, many mergers have never gotten off the drawing board because the CEOs could not agree in which of their respective countries of origin to locate the official headquarters of the newly merged entity. A pan-EU corporate identity and clear rules on transfer of head offices would alleviate this problem.

Establishing common European company law rules forms an important part of the creation of a Single Market for Financial Services. European legislators have been active in providing European company law legislation, which has resulted in legislation dealing with issues ranging from disclosure requirements, capital maintenance and company mergers, to accounting. Member States also adopted the directive for the establishment of a European Company Statute, forming one of the cornerstones of European company law.

However, with the exception of the provision for a European Company Statute, legislation so far focused mainly on coordinating safeguards for the protection of the interests of creditors and shareholders and making these safeguards equivalent throughout the European Union. The focus of the Commission is now shifting to providing a legal framework for company law. The aim is to facilitate the efficiency and competitiveness of business and to eliminate obstacles for cross border activities, while still ensuring the protection of shareholders and investors.

Following the failure to adopt a proposal for a directive on takeover bids in the Summer 2001, the European Commission set up a High-level group of company law experts, under the chairmanship of Professor Jaap Winter, in September 2001. The group was mandated to provide independent advice and recommendations on issues related to pan-European rules for takeover bids, as well as a modern regulatory framework for company law in Europe. The mandate of the group was extended to include corporate governance, following the conclusions of the Oviedo informal ECOFIN in April 2002.

While several proposals on company law, such as the proposals for directives on takeover bids, cross border mergers, and transfers of head offices, have been in the pipeline for a rather long time and the Commission has (with the exception of the draft takeover directive) been unable to adopt any of the proposals to date due to Member State and other opposition, there seems to be increasing agreement among Member States now on the need for a common and modern framework on company law and corporate governance.

Merger Control Review

Anti-trust review for transatlantic transactions remains a significant transaction risk. It is well known that the EU and the US have worked hard to develop an extensive and positive cooperative working relationship on merger review cases. They have achieved significant convergence, but some important areas of difference remain.

The fallout from the failed GE/Honeywell transaction was the culmination of a build-up of angst among CEOs regarding what they perceived as an ever-toughening stance by the EU Merger Task Force on transactions, which were being blocked with increased frequency. However, be that as it may, following GE/Honeywell, many CEOs were wary of bringing forward transactions, fearing that they would not gain approval. This caution was justified because the cost of failure is high: CEOs lose their jobs, companies face staff defections, and strategy decisions are slowed, sometimes fatally. The MTF correctly pointed out that the increase in blocked transactions occurred during a merger wave, where companies tried increasingly daring and complex transaction combinations. In addition, it is important to note that the EU *de facto* does have a more conservative approach to merger review, for very legitimate (often historic) reasons.

The complaints against the EU system persist, and some have been given greater weight by a recent string of court defeats for the Commission (Airtours/First Choice, Schneider/Legrand and Tetra Laval/Sidel). Issues raised by parties included bias, due process failures such as lack of proper checks and balances on case handlers, undue weight given to competitor arguments, and inability to apply economic theories correctly. Commissioner Monti has pledged to address the concerns and noted that the court cases have led to strengthened reform efforts.

The new EU merger control reforms proposed by Commissioner Monti in December 2002 go a long way toward answering the criticisms and promoting further convergence with the US system, though much will depend upon how and most importantly in what spirit they are implemented. The reforms aim to address the systemic and attitudinal issues, while preserving the system's many advantages, including: facilitating Europe's corporate restructuring in furtherance of the single market programme; maintaining a one stop shop for large, cross border megers, tight deadlines, transparency and review based on competition criteria only.

The EU and US have issued a common set of best practices principles on cooperation in reviewing mergers requiring approval on both sides of the Atlantic. The new principles encourage companies to permit the agencies to exchange information, and even to allow joint EU-US interviews. The US has moved to permit companies to meet at an early stage with the authorities, an advantage of the EU system previously available on a more limited basis in the US. Finally, the practices designate key points during the investigation at which it may be appropriate for direct contacts between senior officials on both sides. This provides useful transparency to parties regarding how the

cooperation operates. In addition, the EU's new horizontal merger guidelines closely track the US guidelines, introducing an efficiencies defence and permitting other mitigating factors such as buyer power and ease of market entry to be taken into account. Finally, the appointment of a Chief Economist and hiring of additional staff with strong economic expertise, plus more consistent use of the Herfindahl Index for concentration analysis bring the role of economics in the EU system closer into line with US practice.
The key remaining items to resolve are:
Substantive test – the EU considered changing its current "creation or strengthening of a dominant position" test to the broader US "substantial lessening of competition" test. Instead, the test will be amended to include "unilateral effects", to try and plug the gap between the EU and US tests. What this will mean in practice remains to be seen. This is significant because it is this test gap that is making it hard for the EU to apply its collective dominance theory, and which was one of the main areas of divergence on GE/Honeywell.
The US open ended second request process and relative lack of transparency of process – the fact that there is no deadline for second requests in the US (equivalent to a Phase II investigation in the EU system) means that parties have less certainty regarding when they can expect a decision, with some cases stretching out for years. The EU by comparison has never missed a deadline for a Phase II decision, giving greater certainty of timing, although not of outcome. The EU publishes all its decisions, while the US does not. The EU has recently taken to helpfully publishing greater detail about its reasoning even in press releases for transactions withdrawn by the parties where a final decision was never issued. This is very helpful for establishing precedents and benchmarks for future transactions.

Potential General Policy Solutions
We must ensure that effective mechanisms exist to reduce and resolve strains where they exist and encourage mutual recognition and convergence on regulatory best practice.   There are some initiatives and proposals already underway.
1. EU-US Financial Markets Dialogue
This is already under way, promoting regulators to get to know their counterparts and pick up the phone to each other regularly. It is intended to help prevent extraterritorial disputes from arising by encouraging early stage consultation. It is also being used to resolve existing disputes, including those over Sarbanes Oxley and the Financial Conglomerates Directive
Over the last couple of years, and particularly after experience of the EU data protection directive and the financial conglomerates directive, there have been more vigorous efforts to initiate more serious and detailed upstream dialogue between US and European policy-makers and regulators. The objective has been precisely to avoid surprises and unintended effects and to promote regulatory convergence. Last year's EU-US summit provided the platform for an intensification of such exchanges. While no formal process has been initiated at staff level in the area of financial market policy, there has been an evident increase in the frequency and depth of the exchanges - visits to Brussels by SEC, Fed and US Treasury; more frequent visits to the US by Commissioner Bolkestein and Commission staff, and a range of contacts right down the line. Forthcoming trips by Bolkestein and Director-General Schaub are scheduled for early 2003).

The formal framework for all this is the 'Positive Economic Agenda' launched by Presidents Bush and Prodi at the annual EU-US summit earlier in 2002.

To ensure success, there are two areas that need to be tackled:

process – build in mechanisms and build up relationships between regulatory counterparts for proper EU-US consultation during the rulemaking process. It will be important to find some practicable means of including both policy-makers AND regulators from each side in the dialogue. While the Commission's efforts in this area are very welcome - the Commission is a key interlocutor in this area – it is also important to find ways of including member state officials from both finance ministries and regulatory authorities in this transatlantic dialogue.

substance – a commitment by both sides to recognise that convergence is important and that it will therefore be necessary to make compromises and work toward the best practice. The goal should be an ongoing mutual exchange of information and practice between policy-makers and regulators, similar to the practice and relationship in the competition policy area between the US Dept of Justice and Federal Trade Commission and the European Commission.

Looking ahead, more specific priorities for EU-US regulatory convergence might include:

Action Plan on corporate governance and company law/ Sarbanes Oxley: seeking to secure convergence and mutual learning in these processes of legislation, policy-making and implementation.

Accounting: To achieve demonstrable progress over the next few years in convergence of accounting rules, and consequent alleviation of the accounting aspect difficulties of Sarbanes-Oxley for EU companies.

Conglomerates: close collaboration at working level on how the directive will be applied to US-parented firms.

Capital adequacy: efforts to prevent structural differences between US and EU financial markets leading to a clash on key elements of these rules.

To develop better process disciplines which reduce the risks of unintended conflict.

Mutual Recognition: possibly a bridge too far at this stage in general terms, but there may be scope for specific targeted mutual recognition arrangements to breathe life into the idea of extending the transatlantic market. Commissioner Bolkestein noted on IAS that mutual recognition for purposes of a US listing is high on the EU agenda, and will be a necessary part of any 'global infrastructure'.

2. Transatlantic Business Dialogue (TABD)

The TABD launched a Financial Markets Dialogue last year with discussions so far focused on Sarbanes Oxley, accounting standards and trading screens. The TABD has been and should continue to be an important vehicle for resolving differences in approach to horizontal issues that can affect financial markets e.g. differences in approach to data protection.

3. Mutual Recognition – Transatlantic Financial Marketplace

The idea of a single transatlantic financial marketplace has been floated by leading policy-makers, such as Commissioner Bolkestein and UK Chancellor Gordon Brown, as well as academic commentators. In a recent paper sponsored by ISMA and the Council on Foreign Relations, Dr. Benn Steil argues that market integration does not require full regulatory harmonisation. In fact, he says that harmonising in advance of liberalising may eliminate successful business practices in different jurisdictions without producing any offsetting benefits in terms of investor protection or market efficiency. He argues instead for a transatlantic market liberalisation agreement based on mutual recognition and home country control, rather than national treatment or prior creation of common regulations. [5]

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[5] Dr. Benn Steil, *" Buildilng A Transatlantic Securities Market",* International Securities Market Association and Council on Foreign Relations, 2002

Until the EU resolves some of its regulatory fragmentation issues, it is unlikely that the SEC will feel a strong incentive to accept mutual recognition on a broad basis. However, mutual recognition may work in some areas, and should be treated as a serious long-term goal. Short of full mutual recognition, there is nothing preventing the US and EU from legislating with the transatlantic (indeed global) marketplace in mind. This means drafting legislation in a sufficiently flexible manner to allow for equivalence findings for other regimes, which result in similar standards of regulation, even if arrived at by alternative means.