



European
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Forum



DEUTSCHES AKTIENINSTITUT



Report on Wilton Park Conference 858

COMPETING IN A GLOBAL MARKET PLACE: THE EU'S CHANGING CAPITAL MARKET

Friday 30 November - Saturday 1 December 2007

Introduction

1. This conference with the European Financial Forum, the European Fund and Asset Management Association (EFAMA), Paris Europlace, and the Deutsches Aktieninstitut, the tenth in an annual series, was chaired by Mr Jochen Sanio, President of the German Federal Financial Supervisory Authority (BAFIN).

Regulation and Competition Between Market Places

2. The passage of Sarbanes-Oxley legislation in the US and the Markets in Financial Instruments Directive (MiFID) in the European Union (EU) has triggered a review of the relative costs of doing business and the relative competitiveness of US and EU capital markets. In the light of the US sub-prime crisis and transatlantic contagion in credit markets (including Northern Rock and IKB) there was new concern about supervisory and regulatory arrangements. On the one hand there were questions as to whether efforts to contain the costs of regulation might be promoting a 'race to the bottom'. On the other hand was a fear that the crisis might provoke a new wave of additional and costly regulation. In this context regulatory costs included not only the direct costs of compliance but also the 'indirect' costs of management time spent on regulatory issues.

3. In the US the combination of a new awareness of competition from foreign markets and the sub-prime crisis was stimulating a significant change in attitudes in both the private sector and within government. There was now a willingness on the part of the authorities to contemplate a major overhaul of supervisory and regulatory structures. Proposals under consideration include a consolidation of banking regulators, mergers between securities regulators, enhanced co-ordination between merged bodies, and a move to rationalise federal and state responsibilities. The latter might include, for example, a federal option for the incorporation and supervision of insurance companies. There was a new willingness to co-operate with international partners and a desire to avoid the frictions that accompanied claims of extra-territorial jurisdiction. The change in attitudes by the authorities was being supported by the private sector.

4. In the case of the EU it was suggested that the crisis had shown gaps in the international system and weaknesses in the EU's own internal co-ordination systems. It was said that there would inevitably be an impact on future EU legislation, but a well regulated market place was a plus for competition. The EU-US financial sector regulatory dialogue had to intensify and move beyond mutual recognition in accounting standards to other items. Greater international co-ordination was needed to handle such issues as the role of rating agencies and the risk management practices of banks and there was a need for stronger global structures. The EU had made major strides towards building a single market in financial service and it was important that nothing was done that undermined what had been achieved. After the current review of structures for cooperation between regulators in the EU (the Lamfalussy committees), the 'Wise Persons Group' would be needed to draw lessons from the crisis and to come up with proposals to fill any gaps that had been exposed. Some fresh thinking was needed.

From Product Regulation to the Regulation of Distribution

5. With regard to the regulation of savings products, producers and distribution channels, in the EU different approaches had been taken to different sectors of the market. For example Undertakings for Collective Investments in Transferable Securities (UCITS) were an example of product regulation but MiFID was an

example of regulation of distribution. On the other hand, distribution of insurance products does not fall under MiFID but is regulated by the Insurance Mediation Directive. A third group of products, structured notes, fall under MiFID but cannot be 'caught' by MiFID rules. However, in general MiFID was viewed as an important step towards a level playing field for the distribution of savings products. The issue was whether this differentiated approach was creating market distortions between products, legal uncertainties and unnecessary risks for consumers. If so, the question was whether the right way ahead was to shift away from product regulation towards the regulation of distribution or to look instead towards some more general rebalancing of product, producer and distribution regulation.

6. The market for UCITS products had not only grown within the EU but that UCITS had become a successful worldwide brand, particularly in Asia. Its success was based on confidence in the product and the high level of investor protection offered. Under present policies it seems as though the EU will continue with product regulation including modification of the UCITS Directive and updating various elements regarding regulation of distribution (for example the Insurance Mediation Directive). This would mean that the present complicated regulatory architecture would remain essentially in place (see chart below). It would leave pending such questions as to how far the interpretation of eligible assets can be stretched under the UCITS label.

Investment management – present regulatory architecture				
Product	Function	Execution, Admin. & Custody	Production IM. & product info	Distribution
UCITS		UCITS Directive		MiFID
Asset management (AM)		MiFID		
Structured products		MiFID	Prospectus Directive	
Hedge Funds		National regulation without public distribution / no regulation		
Publicly offered nationally regulated funds		National regulation		
Life assurance containing AM products		3 rd Life Assurance Directive		Insurance Med. Directive
Pensions containing AM products		2 nd pillar: Pension Directive 3 rd pillar: national regulation		

7. The subprime crisis had originated with and been spread by both regulated and unregulated producers and distributors and it was suggested that there were possible dangers in trying to impose or transpose any particular regulatory model on diverse and innovative investment products markets. Others suggest a priority was to harmonise regulation of distribution of retail savings products in using MiFID as benchmark and the UCITS Directive as a model for regulation of how information for investors should look.

The Development of New Exchanges

8. The meeting discussed the outlook for exchanges in the light of MiFID and international developments outside the EU. There were reasons to be optimistic that MiFID would stimulate positive changes in market structure and reduce the costs of trading and also some reasons for caution about the risks of market fragmentation. On balance, the reasons for optimism seemed to be more persuasive and the downside risks would be limited because technology would remain a potent force in favour of cost reduction. MiFID would put continuing pressure on exchanges to innovate and could be expected to encourage new entrants. Clearing and

settlements remained fragmented. Market supervision will need to react to these changes and the Committee of European Securities Regulators (CESR) members will have to swap much more information in order to keep on top of developments.

Improving Transparency in the Market for Investment Products

9. The meeting discussed the problem of how to ensure that consumers are making well-informed investment choices. 'Transparency' involved clarity from the originator of an investment product through to the final consumer: on the return offered; the risk over the life of the product and the lifespan of the consumer; and on the true costs of the product. There was a need to eliminate hidden costs. A further complication is that consumer perception of risks changes over time. Consumer information could not just stop at the point of sale but needed to be continuous. Consumer risk perceptions could also differ from the risks as seen by an adviser.

10. Even when greater clarity had been achieved, transparency could not be a complete answer to market imperfections. Consumers could not match the information available to the producer of an investment product and the risks were also asymmetric. The costs to any individual consumer could be huge from a wrong choice of say a pension, insurance or mortgage product. It was also difficult for consumers to find trustworthy sources of advice.

Changes in Investment Behaviour

11. In a discussion of whether investors were becoming excessively short termist it was suggested that each of the main approaches to investment strategy remained robust. Portfolio diversification supported the continued growth of mutual funds where there were innovations such as lifestyle funds and lifecycle funds. Efficient markets theory also had supporters and had seen a big growth in indexed funds. Behavioural strategies were largely the province of hedge funds but retail investors were becoming active in hedge-fund-like instruments. The current credit squeeze and market volatility would test each of these approaches but for the moment long term investors remained active and it seemed that the financial sector was still capable of producing the right products for a consumer's life span. Other features of the market were more important than alleged short termism. For example banks had

less resources available than in the past to offer consumers advice on the products they distributed. Decision taking on pensions was also subject to continual political interference, including changes in tax treatment. Regulation sometimes also failed to ensure the kind of clarity on product life cycle risks and fees mentioned previously.

The Transatlantic Dialogue: Accounting and Auditing

12. The switch to International Financial Reporting Standards (IFRS) from adoption by the EU in 2005 to the US in 2007 has been rapid. All major markets in the world were now working towards adoption including China (end 2009), Brazil (end 2010), Japan (2011) and India (2011). Accounting and auditing standards were now an integral part of the EU-US regulatory dialogue and 'so far, so good'.

13. In the case of the US, the Securities and Exchange Commission (SEC) accepted in November 2007 that financial statements from foreign private issuers could be used without reconciliation to US Generally Accepted Accounting Principles (GAAP). The SEC will shortly be deciding on giving US domestic issuers the same option. The public consultations underway suggested that opinion favoured the goal of a global standard. There is progress under the 2006 Memorandum of Understanding (MOU) between the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB). A 'roadmap' has been agreed to remove major differences between US GAAP and IFRS by end 2008 and to work towards improved joint standards over the longer term in cases where updating is required. A market solution would be to allow a long term choice for users between two equivalent, but not identical, standards but at the moment there seemed to be a push towards a regulatory solution involving eventually just one converged standard.

14. In the case of the EU, the action required in 2008 is the acceptance of US GAAP as equivalent to IFRS.

15. Action on achieving converged standards on auditing was not as advanced as in the case of accounting standards. International Organisation of Securities Commissions (IOSCO) was encouraging work to be completed in about one year.

Progress was also being made on inspection standards so that co-operative procedures could be relied on rather than extra-territorial inspections.

16. Over the longer term two general issues would need to be addressed in addition to the updating of converged standards. One involved the need to ensure that the principles based approach of the IFRS did not lead to multiple versions of IFRS. The other was the need to review IASB governance now that IASC and IASB have evolved from ‘think tanks’ to global standard setters.

17. An extremely important issue for fund managers is that while converged US GAAP-IFRS standards apply to listed companies, they are not specifically designed for investment funds where disclosure standards are fundamentally different. In general US GAAP as modified for mutual funds take the specificities of the fund industry far better into account than IFRS (see table below).

Comparison US GAAP - IFRS - LUX GAAP

	US GAAP	IFRS	LUX GAAP
Cash Flow Statement		X	
Fund shares as Liability		X	
Use of bid or prices		X	
Comparatives		X	
Consolidation		X	
Schedule of investments	X		X
3 years NAV per share	X		X
Financial highlights	X		

Principles Based Regulation for a Global Market Place

18. Global markets have already moved towards principle-based regulation. The current subprime crisis had underlined the importance of basic principles such as the need for sound underwriting, the need to carry out due diligence, need for diversified

sources of liquidity etc. Principles also lay at the heart of regulation because they stood behind the rules and provided the foundation for regulators to work with entities rather than encourage box ticking. At the same time some of the differences between a principles based approach and a rules based approach were exaggerated. For example, over-reliance on principles could increase the costs of legal uncertainty and principles would sometimes point to the need for more regulation rather than a 'light touch'. Similarly, while international co-operation could be helped by agreement on principles, in the final analysis what was also indispensable was practical cooperation between regulators on practical issues. Progress towards mutual recognition between systems involved both principles and co-operation in practice as US history of cooperation between state and federal levels demonstrated.

19. In relation to the development of international standards, problems often started at the conceptual level; therefore, getting agreement on principles was often the most productive way forward. A system of governance for the global economy was in fact coming into existence based around the kinds of agreements on principles seen in such forums as IOSCO, Bank for International Settlements (BIS), Organisation for Economic Cooperation and Development (OECD) and IASB.

20. The major issue with starting from principles concerns whether there is compliance in practice, what compliance exactly means and whether a 'comply or explain' approach could be relied upon. One methodology for checking on practical implementation involved a two stage review to check that the principles were incorporated at the national level and that they also were operational.

21. It was further suggested that there were too many differences between jurisdictions to achieve identical global or even regional rules and that the goal should be comparable rules based on common principles. A principles based approach however often called for an intermediate layer of 'guidance' or 'interpretation' from supervisors or courts in order to provide greater clarity about obligations and this intermediate layer could take various forms. The important aspect was that implementation should engage senior management in general rather

than rely just on lawyers. This, however, was a problem in the US where litigation was an ever-present risk and probably had to be addressed as a separate issue. The downside to a flexible approach remained however in the area of enforcement and the sanctioning of non-compliance. Again, buffering techniques, such as letters to Chief Executive Officers (CEOs) could play useful intermediate roles in moving from supervisory guidance to enforcement.

22. The techniques used in the 'intermediate layers' of guidance could be problematic. There were questions about the use of guidance notes, whose exact status might be unclear; that might be used to narrow down options. It was also important for supervisors to be clear when they referred to lessons from past cases and precedents.

23. In the case of the EU-US dialogue, differences in the relative weight given to rules on the side of the US and principles on the side of the EU did appear to be a source of difficulty. This underlined the need for substantive discussions between jurisdictions. The need to build trust between regulators around accumulated knowledge, exchange of information and experience was essential. Mutual recognition was likely to be the final step in a long process. 'Road maps' and MOUs and other techniques could all play a useful part along with practical cooperation in reaching this final goal.

New Global Markets

24. Emerging markets should not be looked at as a 'collective' but in terms of their individual characteristics that varied enormously. In this connection the success of Dubai in establishing itself as a new international financial centre was outlined. Dubai's use of familiar models for key market features such as settlement arrangements, the emphasis given to such aspects as governing law, the regulatory structure and links to other exchanges were all part of its success. Liquidity was growing. Hong Kong provides a very different formula for success. It has defined its role both as a fund raising centre for mainland companies and as a platform for mainland investors to invest overseas. In addition it is providing a conduit for mainland institutional savings vehicles. Again the fact that Hong Kong can draw on

a pool of professional expertise, a good regulatory structure and a predictable legal infrastructure are also a necessary part of its success.

25. For some successful markets with clear regulatory standards, mutual recognition of regulatory regimes was an achievable near to medium term goal. For many others, there was a long way to go to in order to raise standards. It was not just a question of what was on the rule book but also the spirit in which the rules were interpreted and enforced. While many emerging markets have grown through privatisations, the participation of foreign as well as domestic investors and, through formation of alliances with other exchanges, regulatory standards and enforcement remain a key obstacle to further development. These obstacles were being addressed in IOSCO.

26. The OECD and the International Monetary Fund (IMF) have been asked to examine the possible impact of Sovereign Wealth Funds on the development of global markets. The IMF has a huge depth of knowledge to draw on in respect of the management of reserves. The OECD has long established codes on investment and state owned enterprises that offer relevant benchmarks. In this context, the views of emerging markets had themselves to be factored into the discussions and into whatever codes or internationally agreed principles are developed.

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Papers and PowerPoint presentations for this conference are available upon request to *participants only* from Diana Munoz at the European Financial Forum on Diana.Munoz@epfiftd.org