# Symposium on Building the Financial System of the 21st Century
## An Agenda for Europe & the United States
### Armonk, New York • March 10-12, 2006

**<u>Friday, March 10</u>**

18:00-19:00 Cocktail Reception – Main Lobby

19:00 Dinner – Main Dining Room

**<u>Greetings</u>**
J Weinstein, Program on International Financial Systems (PIFS), Harvard Law School
Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies

**<u>Keynote Address</u>**
David Wright, Director for Financial Services Policy and Financial Markets, European Commission
Roel Campos, Commissioner, U.S. Securities and Exchange Commission

21:30-24:00 After-Dinner Cocktails – Main Lobby

**<u>Saturday, March 11</u>**

7:30-8:15 Breakfast – Main Dining Room
Breakfast Meeting of Panelists and Reporters (Please sit at the reserved tables.)

8:15-8:25 **<u>Welcome & Opening Remarks</u>** – Conference Room H
J Weinstein, Program on International Financial Systems (PIFS), Harvard Law School
Karel Lannoo, Chief Executive Officer, Centre for European Policy Studies

8:25-8:45 **<u>Panel Session</u>** – Conference Room H
**Topic 1: Regulatory Convergence in Transatlantic Capital Markets**

Europe Panelist: Dan Lambeth, Regulatory Strategy, London Stock Exchange
U.S. Panelist: Emily Altman, Managing Director/Head of International Government Relations, JPMorgan Chase & Co.

8:45-10:10 **<u>Small Group Sessions</u>**

| *Group / Room* | *Facilitators* | *Reporter* |
|---|---|---|
| **1** Room A | R. Boden, M. Andrews | Brandon Becker |
| **2** Room F | N. Collier, M. Sobel | Karel Lannoo |
| **3** Room H | A. de Bresson, R. Pickel | Eric Morgan de Rivery |
| **4** Room J | D. Heller, M. Green | Andy Kuritzkes |
| **5** Room B | P. Tils, C. Ilako | Stavros Gkantinis |

10:10-10:20 Refreshment Break

10:20-10:40 **<u>PANEL SESSION</u>** – Conference Room H
**Topic 2: Current Issues Affecting the Regulation and Operation of the Asset Management Industry in the EU and the U.S.**

Europe Panelist: Hubert Reynier, Managing Director, Regulation Policy and International Affairs Division, Autorité des Marchés Financiers
U.S. Panelist: Stefan Gavell, Executive Vice President and Head of Industry & Regulatory Affairs, State Street Corporation

10:40-12:15 **<u>SMALL GROUP SESSIONS</u>**

| *Group / Room* | *Facilitators* | *Reporter* |
|---|---|---|
| **1** Room A | G. Schieren, K. Coppenholle | Brandon Becker |
| **2** Room F | J. Arias, P. Lee | Karel Lannoo |
| **3** Room H | C. Stypulkowski, M. Kopatschek | Eric Morgan de Rivery |
| **4** Room J | S. Jerneck, G. Ferrarini | Andy Kuritzkes |
| **5** Room B | J.P. Marson, M. Slaughter | Stavros Gkantinis |

12:15-13:30 Lunch – Main Dining Room

**<u>KEYNOTE ADDRESS</u>**
Jonathan Evans, Member of the European Parliament

13:30-15:00 **<u>PANEL SESSION – PLENARY DISCUSSION ONLY</u>** – Conference Room H
**Topic 3: Supervision of Cross-Border Activity of Banks and Insurance Companies**

Europe Panelist: Chris Bates, Partner, Clifford Chance LLP
Europe Panelist: Dagmar Linder, Director, Regional Management, Central and Eastern Europe, Deutsche Bank AG
U.S. Panelist: Richard O'Toole, Managing Director, Head of Government Affairs, Goldman Sachs International
U.S. Panelist: Therese Vaughan, Robb B. Kelley Distinguished Professor of Insurance and Actuarial Science, Drake University

15:00-17:45 Free Time, Optional trip to Neuberger Museum of Art

15:00-17:45 Reporters meeting – Conference Room G

18:00-19:00 Cocktail Reception – Main Lobby

19:00-21:30 Dinner – Main Dining Room

**<u>KEYNOTE ADDRESS</u>**
Andrew Crockett, President, JPMorgan Chase International

21:45-24:00 After-Dinner Cocktails – Main Lobby

**SUNDAY, MARCH 12**

7:30-8:15 Breakfast – Main Dining Room
Breakfast Meeting of Discussion Chairs and Reporters
(Please sit at the reserved tables.)

8:15-9:15 **PRESENTATION & DISCUSSION** – Conference Room H
**Topic 1: Regulatory Convergence in Transatlantic Capital Markets**

Europe Chair: Nicolas Collier, Head of Regulatory Policy, International Capital Market Association
U.S. Chair: Jeffrey R. Shafer, Vice Chairman, Global Banking, Head of Economic and Political Strategies, Citigroup

9:20-10:20 **PRESENTATION & DISCUSSION** – Conference Room H
**Topic 2: Current Issues Affecting the Regulation and Operation of the Asset Management Industry in the EU and the U.S.**

Europe Chair: Pierre Bollon, Chief Executive, French Asset Management Association
U.S. Chair: François Veverka, Executive Managing Director, Institutional Affairs Europe, Standard & Poor's

10:20-10:30 Refreshment Break

10:30-11:30 **PRESENTATION & DISCUSSION** – Conference Room H
**Topic 3: Supervision of Cross-Border Activity of Banks and Insurance Companies**

Europe Chair: Simon Gleeson, Partner, Allen & Overy LLP
U.S. Chair: Richard G. Liskov, Partner, White & Case LLP

11:30-13:30 Closing Lunch

# SYMPOSIUM REPORT

## BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY:

## AN AGENDA FOR EUROPE & THE UNITED STATES

March 10-12, 2006
Armonk, New York

## BUILDING THE FINANCIAL SYSTEM OF THE 21$^{ST}$ CENTURY: AN AGENDA FOR EUROPE & THE UNITED STATES ARMONK, NEW YORK MARCH 10-12, 2006

The Fourth Symposium on Building the Financial System of the 21$^{st}$ Century: An Agenda for Europe & the United States was held at Citigroup's Executive Planning Center in New York, during a period that marks the end of one chapter in EU-U.S. financial services relations and the beginning of another. Sharp differences in regulatory policy, often amounting to direct conflicts between policymakers and industry representatives, had characterized the early 2000s. The establishment of the informal EU-U.S. Financial Services Regulatory Dialogue ("the Dialogue") provided a mechanism for constructive relations. The Dialogue allowed all interested parties to express their views around a table, debate policy approaches, understand the other side's motivations, and ultimately agree on practical solutions that smoothed out regulatory differences without rejecting each party's valid concerns. Under the Dialogue's aegis, negotiations in a number of important issues, ranging from the extraterritorial consequences of the Sarbanes-Oxley Act, to the implementation of the EU Financial Conglomerates Directive on U.S. securities firms, to accounting standards convergence, reached productive outcomes.

Past debates focused on dismantling explicit barriers to cross-border trade by divergent regulatory policies; today, U.S. and EU views are much closer. As regulators begin to implement these policies, new issues emerge: differences of interpretation, resources, infrastructure, and even culture raise concerns as to the actual degree of convergence.

One problem is that national authorities are not always willing to rely on supervision by other regulators. Thus, uniform implementation of cross-border regulatory policies is now a question that dominates the agenda in many diverse fields, from Basel II to accounting standards. The industry needs mechanisms to bring regulators to cooperate, so as to avoid duplication of compliance efforts and costs.

In addition, the international climate has changed. As emerging markets (largely China and India) grow in importance for financial services, U.S. and EU firms face similar regulatory challenges as they enter these markets. Many symposium participants called for the U.S. and EU to combine forces and promote a regulatory agenda in regard to these countries. Still, another issue is that developments have proved that sentiments of protectionism may still prevail despite commitments to open market policies. Finally, a number of industry developments, such as the growth of hedge funds, pose new challenges to regulators around the world.

Working together on a common approach to these developments *ex ante* may prove more fruitful for the U.S. and the EU, rather than trying to resolve any differences *ex post*. These developments warrant greater cooperation not only among regulators, but also among lawmakers.

Discussions in the symposium evolved around three topics. For the first topic, *Regulatory Convergence in Transatlantic Capital Markets*, participants talked about the success of the Dialogue and the challenges for the future, and contemplated the benefits and limits of convergence and regulatory competition, building on the experiences of the Dialogue. For the second topic, *Current Issues Affecting the Regulation and Operation of the Asset Management Industry*, the focus was on regulatory changes in Europe for the traditional asset management industry and the regulatory response to the growth of hedge funds. For the last topic, *Supervision of Cross-Border Activities of Banks and Insurance Companies*, participants provided an overview of transatlantic trends in issues relating to risk management and prudential supervision, especially in view of the implementation of Basel II.

## Session I

## Regulatory Convergence in Transatlantic Capital Markets

### *Transatlantic Financial Services Regulatory Dialogue: Success and Underlying Principles*

Participants unanimously agreed on the most important achievement of the Dialogue: the establishment of mutual confidence between the two parties involved. In the past, controversial issues such as the implications of Sarbanes-Oxley for European firms and the EU Financial Conglomerates Directive had contributed to a climate of suspicion between U.S. and EU officials. The negotiators' willingness to bridge cultural gaps and misunderstandings, and the informality of the process established an atmosphere of mutual trust that was essential for the Dialogue's success. Gradually, it became clear that both parties shared the twin goals of building open capital markets and responding to the challenges of globalization. The commitment of the EU and the U.S. to these policies forms a common policy basis for the foundations of the Dialogue.

Many participants expressed concern that recent outbreaks of protectionism in both jurisdictions may threaten the undisturbed continuation of policies seeking to maintain market openness. In Europe, the French government has offered political backing to a merger between two French energy companies that would create a "national champion" and avoid a takeover by an Italian energy giant. In the U.S., Congress announced its intention to block the assignment of commercial ports operating contracts to a Dubai-based company. In the financial services area, these protectionist trends were particularly evident in the banking sector, where the Bank of Italy attempted to block two cross-border mergers. (Following the resignation of the former head of the Bank of Italy, and the referral of one of the merger cases to the European Courts, this problem headed towards resolution.)

Other participants characterized these instances as exceptional, and pointed to steadfast pledges by political leaders to continue a policy of market openness. For example, President Barroso recently confirmed the European Commission's commitment to increasing market openness and achieving the integration of national markets to a single European market, emphasizing that the Commission will not turn a blind eye to attempts by national authorities to protect local companies.

***Transatlantic Financial Services Regulatory Dialogue: Progress in Specific Issues***

Participants then discussed the progress of the Dialogue with regard to specific topics on its agenda, focusing mainly on issues that still await final resolution. The success of the Dialogue is particularly evident in the area of accounting standards, where the U.S. and the EU have been presented with an opportunity to forge a single set of rules to apply on a global level. Participants pointed that the agreement between IASB and FASB to bring the two sets of standards closer to each other is an important step in the convergence process. An agreement between the SEC and the European Commission calls for a "roadmap" of technical measures for removing the requirement for foreign issuers to reconcile their IFRS-based accounts with U.S. GAAP when issuing in the U.S. public markets. Most participants viewed this agreement as one of the Dialogue's greatest achievements. They noted that the roadmap was particularly welcome in the EU.

European participants, also, welcomed the SEC proposals on facilitating deregistration of foreign issuers from the U.S. markets, which European companies have long been requesting. The European participants, however, noted that the proposals affect only 26% of foreign issuers, thus leaving the remaining 74% with no option but to remain registered in the U.S. Many participants urged the SEC to further facilitate deregistration and to show greater reliance on EU disclosure rules. Other participants pointed out that the divergent views between U.S. and European regulators on facilitating deregistration stem from their different perceptions of investor protection. In particular, they suggested that the SEC rules, which allow deregistration only if the number of U.S. investors holding a stock falls below certain thresholds, do not distinguish between institutional and retail investors holding that stock. Thus, the SEC extends protection of the U.S. disclosure regime to a group of investors that the EU regime does not take into account.

With regard to implementing the Sarbanes-Oxley Act, participants agreed that the most complex issues, which dominated the agenda of the Dialogue in the past, have been largely resolved. However, they worried that companies have become overcautious in complying with Sarbanes-Oxley requirements, thus further increasing the costs of its implementation. Participants pointed to the long-term consequences of Sarbanes-Oxley for the U.S. arguing that the cost it entails for issuers is effectively a cost for American capital markets and doubting whether this is the correct price to pay for Enron's excesses. Some participants wondered whether the SEC will take into account the competitiveness of U.S. markets when designing future policies, and suggested that the SEC has a general responsibility to ensure that U.S. markets provide U.S. companies with sufficient means of financing.

Participants recognized that progress in some other areas will require more effort from both sides. On insurance regulation, the EC Commission asks for speedier resolution of the "collateralization" problem (as explained below), which creates a burden for access by European companies' access to U.S. consumers. Problems for firms operating in both jurisdictions may also arise due to the impact of Basel II rules. European participants expressed hope that the debate surrounding the implementation of Basel II in the U.S. will not be politicized, but will focus on the most appropriate way to preserve global financial stability.

In news that weekend, the London Stock Exchange turned down a friendly takeover bid by NASDAQ. Participants discussed the possibility of a transatlantic merger between stock exchanges and the regulatory challenges it would entail. Participants' views depended largely on the possible shapes a transatlantic merger might take. In general, they agreed that the combination of the two exchanges under a holding company structure is not particularly problematic, but that the benefits it will bring to the two exchanges are limited. Given that neither the SEC nor the FSA would be willing to cede their authority over their local marketplaces, participants also wondered about whether it is possible for a single exchange to operate under two quite different sets of rules. It was highlighted that difficulties arose from the recently passed Regulation NMS, which requires all trades initiated on a U.S. exchange to be concluded at the best available price across all markets. Some participants turned to Euronext as an example of a stock exchange operating a common trading platform under multiple regulators. Other participants, however, pointed out that Euronext is a costly and time-consuming structure, precisely because many regulators have competence over parts of its market. In addition, regulatory regimes for stock exchanges, stock exchange trading and issuer disclosure in the Euronext jurisdictions were relatively homogeneous, in comparison to the differences between the EU and the U.S. regime. Overall, participants agreed that a merger between a U.S. and European exchange could generate significant uncertainty in both U.S. and European markets.

***The Future of the Dialogue: More Convergence or More Regulatory Competition?***

Given the universally accepted success of the Dialogue and the benefits it entails for markets in both jurisdictions, participants would like to see the Dialogue's scope expanded. Participants agreed that the objective of the Dialogue should be to improve the quality of financial services regulation while maintaining market openness, and pointed out that this double goal can be achieved either by attaining regulatory convergence or fostering competition among regulators. The future Dialogue agenda should include instances of both regulatory convergence and regulatory competition since different techniques may be appropriate for different areas of regulation. Participants suggested that identifying the areas of financial services for which each technique is most appropriate will pose a challenge for further research in this field. Some argued that the two concepts are not necessarily mutually exclusive, as greater competition may result in convergence. Others, however, feared that regulatory competition may lead to a race to the bottom, which regulators must avoid. To this, other participants responded that groundbreaking developments in financial services, such as the creation of the Eurodollar markets, were the result of regulatory arbitrage. Thus, we should not uniformly dismiss regulatory arbitrage as harmful. In many ways, participants felt that the EU has been experimenting in techniques of regulatory convergence since 1957, and thus developments within the EU should also attract the attention of U.S. regulators.

These thoughts sparked a discussion among participants on (1) the reasons for divergence in the regulatory policy of the U.S. and the EU, (2) the benefits and limits of convergence, and (3) the future direction of capital markets regulation. Some noted that the two jurisdictions agree on the fundamental principles of financial services regulation, such as adequate disclosure and investor protection, and on the benefits associated with free trade and a market economy. Therefore, eliminating remaining differences is a realistic goal. These participants interpreted divergence as a result of factors, such as domestic institutional history (and crises such as the Enron collapse); different political, legal and cultural systems; different local geography; and different stages of economic development. For example, frequent changes in the European regulatory framework prevented greater convergence.

Others pointed to trends of protectionism as a factor preventing convergence. Still, others pointed to the tendency of regulatory authorities to maintain their turf, citing examples from U.S. domestic policy: for example, the conflict between the U.S. Federal Reserve Board and the Office of the Comptroller of the Currency following the demise of the Glass-Steagall Act. Others drew attention to regulators' distrust of the effectiveness of oversight in jurisdictions that follow even a slightly different approach.

It was generally agreed that, given the current degree of integration of global financial markets, convergence would result in a number of benefits for local markets, in addition to free trade in capital. These benefits include maintaining a level playing field among firms in both jurisdictions, reducing the costs and complexity of cross-border transactions, avoiding regulatory arbitrage, and facilitating best practices in both jurisdictions. On the other hand, participants thought that convergence has evident limits as a policy choice. For example, convergence might not be appropriate for every market due to local particularities. Also, the need to follow a common regulatory mandate might result in excessive rigidity in policy implementation. Moreover, regulatory policy convergence often requires lengthy and time-consuming negotiations. Convergence can lead to compromises, often expressed in texts that are complex, so as to fit every possible situation (such as Basel II), or to regulatory approaches that are not particularly interventionist, so that the most recalcitrant parties are satisfied (MiFID).

### *Mechanisms to Expand the Agenda and Further the Objectives of the Dialogue*

Participants then turned their attention to the mechanisms that would identify whether convergence or competition are appropriate, and would expand the agenda of the Dialogue. Many participants expressed their belief that increased contact between authorities from both sides of the Atlantic will further enhance the Dialogue's effectiveness and improve the quality of regulation in both jurisdictions. Participants suggested measures such as exchange of personnel among regulators. Some participants confessed that their own views often changed as a result of the Dialogue. Previously they thought that national treatment was a necessary evil, they were now more willing to adopt a mutual recognition approach.

In addition, many participants thought that inviting representatives of the legislative bodies to participate in the Dialogue would enhance its effectiveness since it would expose domestic politicians to developments in the other jurisdiction and thus lead gradually to a shared way of thinking. Other participants, however, expressed doubts about the effectiveness of such a move, not only because of the powers of the U.S. Congress and the European Parliament are very different, but because there are some constitutional limits to Congress's involvement in foreign policy. Most participants, however, agreed that it is necessary to secure some degree of political support for expanding the agenda of the Dialogue, so that negotiators are flexible enough to reach meaningful and feasible solutions to which they can commit.

All participants believed that the industry should take an active role in raising concerns with regulators and submitting constructive proposals. Some participants pointed out that most industry initiatives originate from U.S. firms, and suggested that EU authorities make additional efforts to get continental European firms more engaged in the process of the Dialogue. However, some industry participants expressed concern that complicated regulatory structures often make it hard for the industry to undertake organized action so as to turn authorities' interest to a specific problem. Although this problem is common in both jurisdictions, it is particularly pronounced in the EU, where the institutional structure is new, and the role of member states is still important.

As to specific directions the Dialogue will take in the future, participants felt that the Dialogue will focus more on regulation of marketplaces and financial intermediaries, rather than issuer regulation. Marketplace regulation will become a major part of the Dialogue agenda, partly because of technological developments, but also because of MiFID. Potential stock exchange mergers may also contribute to this trend. Finally, many participants expressed a desire for the agenda to expand in the direction of greater cooperation between the EU and the U.S. in international institutions and, more generally, in their policy toward emerging markets. Again, many participants emphasized that the U.S. and the EU share a common agenda on many international issues. In the matter of institutions, the Basel Committee, IOSCO, the WTO, and the Financial Stability Forum are organizations in which greater cooperation between the U.S. and the EU would be welcome. In regard to emerging markets, many participants emphasized that the Dialogue could play a role in uniting the U.S. and the EU behind a common agenda. For some, the exponential growth of the Chinese, and to a lesser extent the Indian, market dictates a certain degree of urgency in achieving greater integration between the U.S. and the EU markets. It is not simply a question of competitiveness of U.S. firms toward European ones and vice versa, but also a question of competitiveness of U.S. and EU firms against firms from the rest of the world. These participants felt that long debates over regulatory differences are a luxury that the U.S. and the EU cannot afford for much longer.

## Session II

## Current Issues Affecting the Regulation and Operation of the Asset Management Industry in the EU and the U.S.

### *Traditional Asset Management Industry: Developments in the U.S. and Europe*

The U.S. asset management industry has just undergone some of the most dramatic changes to its regulatory framework in recent years. The recent market timing and late trading scandals produced a firm regulatory response from the SEC. Participants observed a trend toward "deconsolidation" in the industry, partly driven by regulatory changes. Industry giants such as Merrill Lynch or Citigroup outsourced fund management to specialized entities, but retained distribution of funds' shares through their network. As to the growth potential of the U.S. traditional asset management industry, participants were divided. Some believed that crises in some industries, such as car manufacturers and airlines, will lead investors to move retirement funds out of defined benefit plans to mutual funds, thus spurring growth in the mutual fund industry. Others believed that the traditional asset management industry is the U.S. is close to reaching its full potential, and that the hedge funds segment of the market will lead growth in the future.

In contrast, the traditional asset management industry in Europe is growing very rapidly, and participants were confident that this growth will continue in the future. However, the current regulatory framework in Europe presents the industry with significant challenges. Cross-border activity faces hurdles due to lack of harmonization in a number of significant areas, such as withholding tax regulation, transaction taxes, rules governing encumbrances on securities, availability of bilateral netting, and conflict of laws rules. Perhaps, the single most important problem for the industry, participants said, is the high cost of compliance with multiple registration requirements in various jurisdictions.

Moreover, the fragmented European clearance and settlement regime also prohibits the asset management industry from reaping the full benefits of consolidation within the EU. Although these difficulties continue to press the industry, participants agreed that the UCITS regulatory framework has largely been an impressive success. The main thrust of the UCITS Directives has been the effort to establish a single European asset management market. A participant reported that, under the UCITS framework, her institution was able to reduce the number of legal entities it controls in Europe from 52 to 30.

Participants welcomed recent reforms in the UCITS framework that will further simplify documentation and approval requirements for distribution across Europe. They pointed out that the Commission needs to take yet another step in liberalizing markets, by allowing fund management companies to operate in a jurisdiction other than the location of the fund itself, through a clear and unambiguous “passporting” regime. Under the current regulations, a participant argued, only 16% of European mutual funds are distributed outside their home country.

Participants also called for expansion of the UCITS framework to other products that do not currently fall under MiFID’s scope, and urged that the rules governing distribution of funds’ shares to institutional investors should be simplified, since institutional investors warrant less protection. For example, industry representatives highlighted that, under the current regime, each member state imposes different rules for simplified prospectuses. Finally, participants saw the adoption of MiFID as a positive development for the asset management industry, because it expands the range of products that can be sold cross-border, clarifies rules regarding cross-border distribution, and introduces a requirement for classification of customers as retail or institutional investors for these products.

***Traditional Asset Management Industry: Transatlantic Trends***

Participants highlighted the importance of the Dialogue for the asset management industry since the top 20 asset managers are either U.S. or European firms. A number of issues that currently dominate the Dialogue agenda, such as accounting standards convergence, are also important for the asset management industry. Some participants predicted that the convergence of accounting standards, which requires liabilities to be reflected in balance sheets at market prices, will drive investments away from equities to fixed income securities. In addition, the future of the asset management industry in both jurisdictions is closely associated with social security reform, currently at a standstill in both Europe and the U.S.

Unlike banking or securities regulation, a common understanding among asset manager regulators is now only beginning to form. As a result, the concept of home country recognition by host country regulators is still underdeveloped. In some respects, the opposite trend seems to be emerging: local regulators are unwilling to rely on home country regulation.

Some participants reported that, although the Securities Industry Association had identified the inefficiencies regarding distribution of European funds in the U.S. long ago, there has been no specific pressure on the negotiators to include this topic in the Dialogue agenda. At the moment, it looks like the responsibility for the resolution of this issue will rest in the WTO, rather than the Dialogue. Thus, some participants were afraid that parties to the Dialogue might undermine the process currently being debated before the WTO.

In addition to the WTO, IOSCO is another forum for discussion between the U.S. and the EU with regard to asset management regulation. IOSCO's regulatory agenda is set by its Technical Committee, supported by five specialized Standing Committees. The mission of Standing Committee 5 (SC5), which deals with asset management issues, is to develop common international approaches and to promote information sharing, cooperation, and coordination among regulators. The SC5 has recently released a report on fund governance regulation, which has only recently attracted attention in Europe. The report notes the significant differences in fund structuring within the EU (for example, trust structures often do not have boards of directors). Other topics on which SC5 has issued a set of regulatory principles for public consideration include market timing, late trading, and anti–money laundering guidance. Recently, SC5 also launched a public discussion on hedge funds regulation.

With regard to future developments in the asset management industry, participants pointed out that, despite the good climate between the U.S. and the EU at the moment, there has been no common effort to develop a joint regulatory framework for hedge funds, the most rapidly growing segment of the industry. In addition, tax and other regulatory barriers render it impossible to trade the same mutual fund in Europe and the U.S. The industry sought to overcome regulatory hurdles by creating "mirror-funds" in each jurisdiction, duplicating various fees and other transaction costs in the process. It is also difficult to trade the same Exchange-Traded Funds on both sides of the Atlantic. Participants were disappointed that past problems with regulatory divergence failed to prompt the U.S. and the EU to develop a common regulatory response to new challenges, instead of permitting local regulatory approaches to crystallize. Thus, any convergence efforts undertaken will be harder and more complicated.

Another trend that some participants focused on relates to the consequences of the blurring of traditional boundaries between the banking industry, the securities industry, and the asset management industry. Although these industries have been traditionally regulated very differently, they are now offering products that have gradually grown very similar, resulting in a distribution of regulatory burdens that some participants regarded as unequal and unfair. In some cases, a product based on the same market portfolio may require a number of approvals if it originates in the asset management industry, while no such administrative complications will arise if it originates in the banking industry.

***Regulatory Responses to Hedge Funds' Growth***

Participants' views of hedge funds regulation diverged significantly, reflecting the current uncertainty as to the optimal regulatory response to the impressive growth of the hedge fund industry. Some pointed out that the dynamism of the hedge fund industry lies in the very fact that it is unregulated, while others saw significant risks in letting such a major part of the industry remain unsupervised. Most participants seemed to agree on a midpoint solution to this dilemma. While a part of the industry will probably remain unregulated, to cater for the needs of specific investors, a regulatory response to the hedge funds phenomenon becomes unavoidable as the industry continues to grow. Many participants viewed the various approaches that different regulators currently follow as evidence that there is no consensus among supervisors as to what the main focus of hedge funds regulation should be.

Ultimately, the rationale for regulating hedge funds is not clear. To some participants, the near-collapse of LTCM revealed the enormous systemic risks that hedge funds entail. In addition, they suggested that, although hedge funds themselves are not regulated, their counterparties are, and therefore regulators should be able to respond to circumstances generating systemic risks. However, others argued that a lender-of-last-resort function is unavoidably associated with greater control over hedge funds' activities, which is contradictory to the very nature of these vehicles. Regulation would also raise questions relating to asset valuation techniques and accounting, which could deal a mortal blow to this industry.

A second alternative rationale for regulating hedge funds relates to the increasingly easy access that retail investors have to this industry. Retail investors should be given information about the risks of investing in a hedge fund, some participants argued; but others claimed that, in many cases, disclosing to investors a hedge fund's investment strategy would irreparably harm its efficiency. Finally, some participants wondered whether regulators first need to collect information about the hedge fund industry, and only then formulate views on the optimal regulatory strategy. In the end, no consensus was reached among participants on this issue.

Participants also discussed in more detail the divergent approaches national regulators have followed with regard to hedge fund registration. Some viewed the hedge funds phenomenon as concentrated largely in the U.S. and the UK, and less successful in continental Europe. Others, however, suggested that this view is somewhat biased because of the different paths of development for hedge funds in continental Europe, as well as the different regulatory responses these paths generated. For example, the traditional asset management industry in the U.S. has sought to keep its distance from hedge funds, red-flagging them because they are not regulated. Therefore, the SEC's regulatory response to hedge funds has focused on collecting information to determine whether hedge funds' practices put investor protection at risk. In contrast, French asset managers were pioneers in establishing hedge funds, which thus grew out of the traditional industry's attempt to cater to clients' needs that its other products could not satisfy. As a result, hedge funds in France are included in the scope of the main collective investment schemes law. The participants conceded that some hedge funds may have to be regulated eventually. In any case, participants agreed that this divergence of approaches may potentially lead to greater differences in specific regulatory measures and give rise to harmful regulatory discrepancies for the industry.

## Session III

## Supervision of Cross-Border Activity of Banks and Insurance Companies

### *Global Consolidation in the Banking Industry and Legal Challenges*

Participants stressed the importance of the Dialogue for resolving issues relating to cross-border supervision of banking services since mergers and acquisitions involving parties on both sides of the Atlantic have increased. The lack of intra-European cross-border mergers gives rise to concerns for the competitiveness of European firms against U.S. and Japanese banks, whose aggressive consolidation strategy has allowed them to take advantage of increased economies of scale. Some participants predicted a rise in intra-EU cross-border mergers following the removal of certain regulatory barriers, while others argued that more work remains to be done by the EC Commission. Most participants also pointed to the current trend for acquisitions in emerging markets, which has reached the levels of a “gold rush”.

The implications of the wave of banks’ expansion in emerging markets are extensive. U.S. and European banks usually enter these markets by acquiring a so-called “strategic stake” in a local credit institution, which often grows to obtaining full control of that institution in a couple of years. Foreign banks’ subsidiaries have clear advantages in comparison to local banks, such as superior know-how, improved IT systems, and, perhaps most importantly, high (“double A”) credit ratings that ensure access to financing on better terms. As a result, foreign banks outperform their local competitors and collectively control large enough portions of the emerging economies’ banking markets—up to 70% in some countries—to give rise to antitrust considerations. Some participants also pointed to the impact of a foreign-dominated banking market for local industry. Foreign banks are perceived as less willing to lend to local small- or medium-sized enterprises, thus blocking local entrepreneurial initiatives’ access to financing.

This pattern was more pronounced in the case of EU accession countries, such as Poland, where, at the time of the Symposium, consolidation activity resulted in a clash between national banking regulators and the EC Commission pertaining to the merger between Unicredito and HVB. Following the conclusion of the merger at the holding company level, Unicredito sought to merge its subsidiary in Poland with the Polish subsidiary of HVB. Although the EC Commission had cleared the merger on competition grounds on an EU-wide level, Polish banking regulators refused to authorize the merger and suggested that Unicredito sell the local HVB subsidiary. They argued that, upon acquiring control of a local Polish bank as a result of a privatization, Unicredito had agreed with the state, as the selling shareholder, not to acquire another Polish bank.

Some participants argued that, despite cries of protectionism, the Polish government's intention was not to protect local industry groups, but to preserve competition in the Polish market. The participants viewed the merger as a development potentially favorable for the EU banking market as a whole, but certainly harmful for the Polish banking market. Why should Poland compromise competition in its market in the name of a quest for a European banking superpower? In addition, participants noted that the Polish government had favored Unicredito against other bidders at the privatization stage precisely because it sought to maintain a certain level of competition in the local banking market.

Other participants doubted whether this reasoning constituted a sufficient basis for prohibiting the merger. The Polish government, they argued, had decided that consequences to the local markets should take precedence over the EC treaty objective of creating a single European market. The participants felt that the Commission would successfully pursue these cases before the ECJ and predicted that the Commission's stance would be harsh. In addition, they called for further limiting the situations under which national regulators can block a cross-border banking merger on the basis of prudential supervision considerations. In any case, participants agreed that these circumstances led to a so far unforeseen conflict between banking supervision rules and antitrust law that warrants further consideration by policymakers.

***Impact of Global Consolidation on Prudential Supervision***

Global consolidation raises potential challenges for the current regulatory framework for prudential supervision of banking activities. As large financial institutions are supervised by an increasing number of national regulators, they restructure their internal allocation of resources and operation principles to conform to multinational regulatory oversight. For example, institutions used to manage liquidity at the home country level, but are now gradually moving away from this practice. At the same time, the emergence of sophisticated financial products that often involve a multitude of parties and jurisdictions and call for complex risk management techniques raises further difficulties for local supervisors. Thus, while each national supervisor sees a small part of the picture, no single regulator maintains an overview of each institution's financial condition. While industry participants, regulatory authorities, and academic research identified these problems long ago, they have become more pronounced in recent years for two reasons. First, the presence of foreign banks in domestic marketplaces has increased considerably and second some banks have grown immensely. According to conventional wisdom, these banks are simply "too large to fail," in the sense that regulators will have very little choice but to rescue them in case of a mishap. However, they have also become "too big to save," as many national regulators are unlikely to possess the resources necessary for their rescue. Participants wondered whether funds aggregated under deposit insurance schemes will be sufficient to avert a major financial crisis in the future.

Although the consequences of this unsatisfactory situation are far-reaching, especially as to crisis management and institutional structure regulation, moving into a single-regulator structure is highly impractical. Ultimately, lender-of-last-resort facilities are financed by taxpayers' money, and thus national authorities are understandably unwilling to cede sovereignty as to management of these funds to a supra-national institution. As a result, plans to overhaul national regulators are unlikely to succeed. The challenge is to devise another method of cooperation among national authorities. Participants stressed that the need for greater cooperation among banking regulators is equally pressing at the national level (e.g., banking supervision is fragmented within the U.S.), the EU-U.S. level (where the Dialogue has already led to greater convergence and improved quality of regulation), and the global level.

***Basel II Implementation: Challenges and Implications***

The advent of the Basel II rules is a significant step towards greater convergence of substantial rules, and at the same time a great challenge for regulatory cooperation, given the importance of the second pillar (regulatory oversight) in the Basel II framework. One of the panelists presented the approach that a major international credit institution, Deutsche Bank, is planning to adopt so as to comply with the Basel II rules. Deutsche Bank has presence in 73 countries, and its group includes approximately 1,300 legal entities. Initially, its intention was to follow the Advanced Basel II Approach for credit and operational risk throughout its network. However, as the implementation deadline approaches, the logistics of adopting the Advanced Approach and obtaining the approval of 73 independent regulators seem to present an almost impossible task. Proof of compliance with the Advanced Approach submitted by Deutsche Bank to the German Financial Supervisory Authority ("BaFin") ran to thousands of pages. It was clear that multiplying this effort 72 times, only to reveal clashes of opinion among supervisors, was not a practical solution. Thus, Deutsche Bank will probably follow the Standardized Approach in all other jurisdictions. Although some participants expressed concerns as to the implications of this strategy for risk allocation, other participants believed that the internal risk management of a bank is not affected by such choices.

Some participants pointed out that, with regard to capital adequacy supervision for securities firms, the Basel II rules already apply to U.S. companies under the EU Financial Conglomerates Directive and the Consolidated Supervised Entity Regime devised by the SEC to facilitate compliance with this Directive.

Participants agreed that the challenges posed by Basel II to national regulators are multifaceted. There is a clear risk of crippling easy access to finance if each jurisdiction requires additional regulatory capital from multinational institutions, thereby freezing funds for redundant capital adequacy purposes. Thus, some degree of common implementation of Basel II principles and cooperation among regulators is necessary. On the other hand, the Basel Committee itself views the Basel II rules as a constantly evolving framework that will be continuously revised and improved, as opposed to a set of permanent rules, as was the case with Basel I. (As some participants pointed, there will be no “Basel III”.) To achieve its goal, the Basel Committee will need as much input from national regulators as possible, while national regulators will be required to constantly update their approach to capital adequacy. Participants observed that as some regulators become more familiar with the Advanced Basel II Approaches, and as large international banks come to an understanding with their home regulators, it is possible that these banks will turn their local subsidiaries to branches of the parent entity, largely supervised by their home regulator.

### *A Major Challenge for Global Banking Regulation: Greater Cooperation Among Regulators*

Hopefully, the pressure to implement Basel II rules will also bring regulators to work more closely with each other. In general, participants felt that, despite the uncertainty surrounding the implementation of Basel II by the U.S., jurisdictions around the globe share a common approach to regulation, with common interests and common objectives. Moreover, as regulated firms have expanded globally, the interests of the regulated entities in each jurisdiction also tend to converge. Given the existing level of coordination on a global scale at the level of rules, and a common body of regulated entities across national borders, efforts for greater convergence should focus on the remaining links between the rules and regulated entities. On the one hand, application of the same rules by different regulators should be uniform. On the other, regulators in one jurisdiction should be willing to rely more on the output of the regulators in another jurisdiction.

Participants viewed the regulators' lack of trust in each other's supervision as the single major hurdle to a more homogeneous regulatory environment for banks worldwide. At the moment, the lack of reliance on other authorities' conclusions is highly problematic; one participant reported that, following a recent acquisition, her institution was required to effectively "guarantee" the whole balance sheet of the new entity to its home regulator. Most participants accepted the valid concerns of regulators who are asked to rely completely on conclusions reached by foreign jurisdictions: not only is this reliance contrary to their mandate to protect local consumers, but it also places a heavy burden on foreign authorities, who ultimately have little incentive to protect consumers in other countries. Some participants suggested, however, that there is still ample scope for cooperation: foreign regulators have done significant work, which should be of value to local regulators. Reliance on each other's findings should not be seen as delegation of responsibility (and ultimately sovereignty) by local authorities to a foreign country's authorities, but to outsourcing some of the tasks of regulatory oversight to another regulator. In other words, regulators should be prepared to share the process of oversight.

What are the mechanisms that will lead to greater cooperation among regulators? Some participants reported that the work done for the implementation of Basel II constitutes a forum for continuous interaction among officials and presents an encouraging picture for the progress of regulators in small countries. Others placed more value in the concept of regulatory competition as a process of improving the quality of regulation and putting national authorities under the pressure to "keep an eye" on regulators in other jurisdictions. Many participants, however, pointed out that regulatory competition can occur only among regulators operating in the same jurisdiction, or those in jurisdictions that allow firms to move in and out of their borders with minimal burdens. Regulatory competition, however, is unlikely to develop among authorities that monopolize power in their individual jurisdictions.

Given that the current level of integration of the transatlantic or global markets does not induce regulators to compete and cooperate, the initiative for greater interaction should originate either from international organizations or from the industry. Participants argued that international banks should undertake an active role in promoting the exchange of information among national regulators, in providing educational and training advice, and in creating venues for communication and interaction among national officials. Given that banks will be the major beneficiaries of this movement, they should be willing to provide channels for greater cooperation among national authorities (e.g. through IOSCO or possibly the WTO). The case of China indicates the success of the WTO in integrating this emerging market in the global economy, but also illustrates the limits of the current WTO framework for financial services. Some participants suggested that the industry should work together with international organizations to develop the regulatory infrastructure in emerging markets, submitting specific proposals and sharing some of the education costs.

### ***Regulatory Barriers in Insurance: the Case of Collateralization Requirements***

Reinsurance is an important risk management tool, handled by an industry which has grown globally at a rapid pace. Today, losses connected with a major catastrophic event or accident in one jurisdiction affect reinsurers throughout the world. Historically, however, reinsurance is outside the ambit of regulation.

U.S. law introduced a distinction between U.S.-licensed and non-U.S.-licensed reinsurers, allowing firms to take credit for reinsurance on their balance sheets only if reinsurers were U.S.-licensed or had fully collateralized their obligation. Foreign, and especially European, reinsurers saw the collateralization requirement as a barrier to trade, complaining to the U.S authorities that it unduly discriminated against them. The U.S. argued that the collateralization requirement was based solely on concerns of prudential character, given that U.S. regulators had no control over foreign reinsurers and were thus unable to assess their ability to perform their obligations.

As this regime persisted, however, U.S. regulators came to realize that, although claims against foreign reinsurers were readily settled because of the availability of the collateral for seizure, claims against U.S.-licensed reinsurers took substantially more time to be settled since these domestic reinsurers often contested their obligation to repay. Recently, the National

Association of Insurance Commissioners (NAIC) announced its intention to revise the collateralization requirement. The direction in which the NAIC will move is not yet clear, nor is it certain that state regulators will follow NAIC's initiative, due to the decentralized structure of the U.S. insurance regulatory framework. Some participants characterized the turn in NAIC's policy as an incident of "enlightened self-interest," resulting from the advantages for fast repayment conferred to European reinsurers. The participants expressed their wish that NAIC provide a schedule indicating the timing of future review of the collateralization requirement.

Another area in insurance regulation where divergence in U.S. and European law may raise concerns relates to solvency supervision. The U.S. solvency regime, developed by NAIC in 1993, was considerably more sophisticated than the then prevailing Basel I Accord for banks since as the NAIC solvency regime covered more types of risks. In addition, the U.S. regime adopts a more risk-sensitive approach that takes advantage of credit ratings, especially helpful for the insurance industry that holds significant amounts of publicly issued debts. In 2000, internal models similar to the Basel II framework were also introduced in the U.S. Nevertheless, the U.S. solvency regime in insurance remains fragmented across state borders, as a result of the state-based structure of the U.S. regulatory framework.

In contrast, Europeans have traditionally adopted a simpler approach. Insurance regulators in continental Europe disagree on whether the current "confidence limits" system should be replaced by a risk-sensitive system similar to Basel II or NAIC. On the enforcement side, the Solvency II Directive sought to foster greater cooperation among insurance regulators in different jurisdictions that supervise companies belonging to the same group. The Solvency II Directive promotes the model of a leading group supervisor, responsible for assessing the financial condition of the group, the group's risk management techniques, the fitness and properness of senior management and the board of directors.

Participants then focused on more general issues regarding insurance regulation within the U.S. Some wondered whether a national regulator for insurance in the U.S. is necessary. Others indicated that the most realistic option for insurance regulation reform would be a dual model. Insurance companies could choose between a federal charter and state charters. Even this solution is unlikely to find sufficient support under the present circumstances, due the diverging interests of life insurance and casualty insurance companies. As the life insurance market has become integrated at the national level, life insurers would favor a federal charter that would allow them full flexibility to move across state borders. Casualty insurers, however, operate on segregated state markets, and they would support a federal charter only if it granted them relief from the mandatory rates set by individual states for insurance products. Given that a federal charter is unlikely to offer rate relief (for casualty insurers), the casualty insurance industry will fight against federal charter legislation since the legislation would present an advantage for life insurers. Without the unanimous support of the industry, a bill for a federal charter is unlikely to pass.

Some participants lamented the current state of U.S. insurance regulation, which they described as fragmented along state borders. They pointed out that NAIC is not a federal agency and that states retain the option not to incorporate the rules that NAIC proposes. Some participants argued that pressure on the U.S. to move to a federal charter could originate from international institutions such as the WTO and internationally active insurance companies.

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