US-Europe Capital Market Integration and its Implications for Japan

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Capital Markets: Compete or Integrate?

From 2006 until mid-2007, the main debate over capital markets in the US, the UK, and Japan was mostly over how to become more competitive as a global financial center.

A number of proposals on raising the competitiveness of US markets have been published in the US, including one by the Committee on Capital Markets Regulation on 30 November 2006, one co-authored by New York City Mayor Michael Bloomberg and New York Senator Charles Schumer on 22 January 2007, and one by the US Chamber of Commerce's Commission on the Regulation of U.S. Capital Markets in the 21st Century on 12 March 2007. Henry Paulson, who has shown relentless interest in this issue since being appointed Treasury Secretary in July 2006, announced in May 2007 that work would begin on crafting detailed action plans for two business areas: the financial reporting system and the auditing profession, and then in June 2007 announced initiatives for another six areas, financial regulatory structure modernization, best practices for hedge funds, modernization of Treasury's cash management and debt management, Basel II rulemaking, financial education, and mutual recognition with overseas markets.

In the UK, meanwhile, the Chancellor of the Exchequer at the time (and Prime Minister since June 2007) Gordon Brown launched an initiative, outlined in the government's March 2006 budget, to solidify London's position as a global financial center. In October 2006, Mr. Brown held a meeting of influential financial executives and top bureaucrats to debate measures aimed at strengthening the international competitiveness of London's markets.

In Japan, Prime Minister Shinzo Abe had made a campaign pledge in summer 2006, in the run-up to the election for a new LDP leader, to "strengthen Japan's financial markets" and put them "on par with London and New York," although real debate over the issue in Japan did not actually begin until the end of 2006. On 20 April 2007, the Working Group on Financial and Capital Markets, under the Expert Committee on Reforms Addressing Globalization of the Council on Economic and Fiscal Policy (CEFP), released its initial report, entitled Toward the Establishment of Truly Competitive Financial and Capital Markets. In response to this report, the Economic and Fiscal Reform ("Basic Policies") approved by the Cabinet Office on 19 June 2007, called for the Financial Services Agency (FSA) to devise a plan for enhancing the competitiveness of financial and capital markets by the end of 2007.

In parallel with the debate occurring within the working group noted above, the FSA formed its Study Group on the Internationalization of Japanese Financial and Capital Markets in January 2007, and that group published its Interim Summary of Issues (Phase 1) on 13 June.

The world's major markets have thus been working to improve their inter-market competitiveness, although an important point to note is the progress being made by the US and Europe on cross-market collaboration and eventual market integration. These moves are aimed at broader economic and financial integration between the US and the EU, a concept also referred to as Transatlantic Economic Integration that has long been the subject of talks, but has been placed on an accelerated track since the start of 2007.

These moves toward US-EU market integration are progressing on three different levels. First, there is the US-EU (European Union) senior level initiative, which made strides during talks within the US-EU summit held in April 2007. The concept of creating a transatlantic market, promoted by European Commissioner Charlie McCreevy prior to the summit, has also garnered attention. Second, there are moves by the SEC (Securities and Exchange Commission) in the area of securities regulation that envision, under the concept of mutual recognition, a substantial easing of regulations governing the US market activities of European securities exchanges and securities firms. Third is movement in the private sector. In this report, we look at activities of the EU-US Coalition on Financial Regulation, which comprises industry associations from both regions, and also at moves to standardize financial trading messages. We look at all three levels, in the order listed above.

The US-EU summit

The US and the EU have held summits (initially annually and now twice a year) since the Transatlantic Declaration of November 1990, which marked a strengthening of the transatlantic relationship for the post-Cold War era.

At the summit held in Washington DC on 30 April 2007, President George Bush, Chancellor Angela Merkel of Germany (which held the rotating EU presidency at the time), and European Commission President Jose Barroso agreed to adopt the Framework for Advancing Transatlantic Economic Integration Between the United States of America and the European Union ("the Framework").

The Framework included agreements on (1) promoting cooperation and reducing the regulatory burden, (2) a program for pursuing "Lighthouse" priority projects (intellectual property rights, secure trade, financial markets, innovation & technology, and investment), and (3) establishing the Transatlantic Economic Council.

The Transatlantic Economic Council, comprised of cabinet-level officials, is charged with adopting a work program aimed at achieving the objectives of the Framework.

The focus of the Framework in the financial sphere will be as follows.

(1) Strengthen US-EU cooperation to promote smooth implementation of the Basel II framework, notably to address transitional issues and minimize differences of implementation between the EU and US.

(2) Regarding accounting standards, promote conditions for US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) to be recognized in both jurisdictions.

(3) Regarding auditor oversight, support roadmap discussions between the Public Company Accounting Oversight Board (PCAOB) and the European Commission.

(4) Advance convergence in the area of reinsurance regulation.

(5) Work on greater regulatory convergence in the direction of highest quality and most effective regulation, and, where appropriate, strive for mutual recognition in the field of securities regulation.

(6) Increase cooperation between EU and US financial regulators.

Charlie McCreevy's Transatlantic Market proposal

Prior to the US-EU summit in April 2007, the European Commissioner for Internal Market and Services, Charlie McCreevy, visited New York and Washington on 5-9 March 2007 as part of the Financial Markets Regulatory Dialogue. He emphasized in his speeches the need to minimize EU-US differences in regulations, particularly those covering hedge funds and the limited liability of auditing firms, and in accounting standards. He also called for the building of a transatlantic market as one of the ultimate manifestations of these efforts to minimize EU-US regulatory differences.[1]

A transatlantic market in this context means an open market in which investors in Europe and the US can trade the financial products of the other region (US financial products for European investors and European financial products for US investors) in the same manner and with the same level of investor protection as in their home region.

Commissioner McCreevy noted that even though no immediate regulatory problems are expected with the NYSE-Euronext merger, he recognized that moves toward the integration of liquidity pools across the Atlantic are likely in the future, and this will raise issues regarding differences in the regulatory system of the EU and

[1] McCreevy, C. "Building the Transatlantic Marketplace", Heyman Center on Corporate Governance, New York, 7 March 2007.

the US. What he wanted to see over the next several years was strengthened cooperation between EU and US regulatory authorities, and proposed the following six principles as essential for the creation of a transatlantic market.

(1) Limit intervention by regulators to that which is absolutely necessary

(2) Do so in a coordinated multilateral manner

(3) Eliminate as much regulatory duplication as possible

(4) Base recognition of equivalent regulations on global understanding and global standards

(5) Let transatlantic markets serve as the laboratory of globalization

(6) Ensure consistent implementation, information sharing, and enforcement at a technical level between individual jurisdictions.

As noted below, the concept of mutual recognition proposed by the SEC in 2007 could become a concrete step toward such a transatlantic market.

SEC mechanisms

Within the Framework announced at the latest US-EU summit, one future mechanism proposed for the financial sphere is implementation of the principle of mutual recognition of securities regulations. One of the items in the action plan proposed in June 2007 by Treasury Secretary Paulson was "mutual recognition with overseas markets."

Mutual recognition, which is for situations when the regulations in two different countries are mutually acceptable to both, is when both countries agree to follow an approach under which home-country regulations are not always strictly applied when a market player subject to home-country regulations conducts activity in the host country.

Support for the idea of promoting mutual recognition of regulations between overseas markets and the US market is nothing new. In 2002, for example, the International Securities Market Association (ISMA), in cooperation with the Council on Foreign Relations, published a report entitled Building a Transatlantic Securities Market, authored by Benn Steil, a senior fellow at the Council on Foreign Relations. The report proposes mutual recognition by US and European securities exchanges of direct electronic trades in listed stocks by securities houses and institutional investors in both Europe and the US, arguing that such direct trading would be more efficient for US investors than trading ADRs on US exchanges or executing orders on European exchanges via a European securities firms.

Shedding new light on this approach was a paper written by two staff members of the SEC's Office of International Affairs and published in the Winter 2007 issue of the

Harvard International Law Journal.[2] The paper argues that in an age in which technological progress has made it possible even for traditional retail investors to conduct cross-border transactions, traditional methods of regulatory oversight used by the SEC and their overseas counterparts are being rendered ineffective, and proposes that the exchanges of countries with regulations comparable to those of the US should be able to place trading terminals in the US, and that the securities firms of that country should he allowed to solicit US investors, without registering with the SEC.

The paper also argues, however, that under the traditional approach of mutual recognition, equality assurances could be insufficient, and that even in cases where at one time an agreement was concluded, the lack of subsequent review and reassessment led to the risk of regulation arbitrage It goes on to propose, as a more sure-footed approach than mutual recognition, using a framework of substituted compliance, in which regulations equivalent to US regulations are applied in the host country.

For example, the conditions under which firms could be exempted from US registration requirements and SEC oversight of their financial soundness would be that the SEC could confirm that regulators in the home country would take care of that oversight, and that agreements were in place for the necessary information sharing. A formalized process would also be implemented to ensure that the equivalence of regulations is reviewed and reassessed every five years.

The paper makes the argument that this greater welcoming of overseas players into US markets will not only invigorate competition and lead to lower transaction costs, it will also encourage other countries to introduce regulations with the same level of strictness as those in the US, since the US would be in a position to choose which countries to allow in.

Although the paper is by authors writing as individuals and therefore not the SEC's formal opinion, SEC Chairman Christopher Cox apparently agrees with both the content of the paper and its publication, and some think it may have been a trial balloon sent out by the SEC to better gauge public opinion.

The thinking expressed in the paper "merits serious study," according to a report issued by the US Chamber of Commerce's Committee on Capital Markets Regulation.

On 12 June 2007, the SEC sponsored a public roundtable on the mutual recognition of securities regulations. As noted above, Tafara and Peterson's thinking on substituted compliance has some elements that differ from mutual recognition, but it appears that the SEC has chosen to use the term mutual recognition based on its wider currency. At the roundtable, however, the phrase "selective mutual recognition" was used repeatedly in place of mutual recognition alone.

The roundtable specifically addressed three topics: 1) the impact on US market participants brought by increased access to overseas markets; 2) the impact on US

2 Tafara, E. & R. Peterson, "A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework", *Harvard International Law Journal*, Volume 48, Number 1, Winter 2007

market participants abroad from increased access to US investors by overseas securities firms; and 3) how best to define and measure the equivalence of regulatory regimes. The roundtable's participants, in addition to Chairman Cox and other SEC staffers, included past SEC commissioners, academics, and industry executives. The debate at the roundtable was notable for the following three aspects, in particular.

(1) The SEC's most important goal is the protection of investors. US investors are already investing, through the Internet and other means, in overseas securities that are not registered with the SEC, and regulations have yet to catch up with this segment of the market. The SEC therefore needs to grab the initiative in regards to regulating cross-border securities transactions.

(2) The SEC can take a leadership role in promoting the optimization of global securities regulations by furthering the mutual recognition process. Mutual recognition is not harmonization toward a bad system, but rather harmonization in the best possible direction. The SEC will seek to upgrade its capabilities in securities supervision and market oversight in regards to Europe, as well.

(3) Mutual recognition could create a number of different risks, however. If US investors gain easier access to companies listed on overseas markets, there is a possibility that either overseas companies will no longer bother to list on US markets or that foreign securities will become less likely to be registered with the SEC. This would inevitably lead to such securities entering US markets through the back door, as a way to avoid direct regulation by the US. There is also a possibility that US corporations would attempt to access US investors via an overseas subsidiary in order to avoid US regulation. This will also probably lead to the argument that if overseas markets and securities firms are able to offer in the US securities that are not registered with the SEC, then domestic markets and securities firms should be able to, as well.

(3) The seriousness of the risk in (3) will probably depend on the extent to which harmonization toward the better system noted in (2) can be achieved. Underlying the motivation to identify risk (3) is probably the perception that the US currently has the best regulatory regime, and that the other jurisdictions have yet to achieve either regulatory equivalence or functional sameness.

In fact, Southwestern University Law Professor David Ruder, who was SEC Chairman from 1987 until 1989, emphasized the importance of knowing the competency of the regulatory authorities in the other country. Specifically, is it appropriately staffed, does it maintain political independence, does it have the capacity for inspections and surveillance, and is it committed to aggressive enforcement?

The hurdles seem to be quite high when taking these factors into consideration, but the SEC has made it clear that it plans to make some progress this year toward mutual recognition of securities regulations. Because of the possibility that a new SEC chairman will be named after the 2008 presidential elections, the level of progress achieved from 2007 to 2008 will probably be key.

EU-US integration in the area of financial regulation

Active efforts to integrate the financial markets of the US and Europe are occurring not only at the governmental and regulatory levels, but also within the private sector. In fact, it is probably more accurate to say that it was the growing need for greater equivalence in both systems and practices at the private-sector level, where the actual cross-border economic transactions between the US and Europe take place, that initially triggered the increased activity at the governmental and regulatory levels.

Activity in the private sector is taking many shapes and forms, one of which is the EU-US Coalition on Financial Regulation.

The Coalition is comprised of eight financial and securities industry organizations[3] on both sides of the Atlantic, and its objective is to promote the following agenda to lawmakers and financial regulators in both the EU and the US.

(1) When there is an acceptable level of proximity in regulatory principles, standards, and rules, accelerate negotiations aimed at deepening regulatory integration and the mutual recognition of regulations.

(2) Pay proper attention to the needs and priorities of the financial sector in a way that improves business efficiency and regulatory consistency, by establishing a formal framework aimed at incorporating industry input in the above process.

The Coalition was launched in 2005, at a time of increasing financial activity between the US and the EU, to address the widening of differences between the US and the EU in their regulatory regimes that resulted from the Sarbanes-Oxley Act being enacted in the US and the Markets in Financial Instruments Directive (MiFID) being introduced in the EU.

The Coalition started out by listing the regulatory differences between the two jurisdictions, and then commissioned a survey by Clifford Chance. A report based on the survey, published in September 2005, did a comparative analysis of licensing, registration, and conduct rules related primarily to wholesale stock and stock derivative transactions, and concluded that integration was a possibility.[4] As priority sectors for improving the efficiency of the transatlantic market, the report identified the definition of "customers," the suitability principle, money laundering measures, equity operations-related rules (including best execution, handling of customer assets, order allocation, research distribution, and documentation), and regulatory impact assessments, and noted that it was important to achieve commonality in these sectors.

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3 American Bankers Association Securities Association (ABASA), Bankers' Association for Finance and Trade (BAFT), British Bankers' Association (BBA), Futures Industry Association (FIA), Futures and Options Association (FOA), International Capital Markets Association (ICMA), Securities Industry and Financial Markets Association (SIFMA), Swiss Bankers Association (SBA)

4 EU-US Coalition on Financial Regulation, "The Transatlantic Dialogue in Financial Services: The Case for Regulatory Simplification and Trading Efficiency," Volumes I and II

The Coalition plans to publish a second report soon, covering phase 2 of its activities. According to persons involved, this next report will make proposals on integration for the short term, medium term, and long term.

The primary emphasis of the Coalition, given that it comprises industry organizations, is on simplification and efficiency, including avoiding US-EU regulatory duplication by integrating regulations, and enabling the implementation of common business processes, practices, and documentation.

Moves concerning financial messaging protocol standards

The moves taking place in the private sector, rather than aiming at broad "market integration," are based more on practical needs, and there are a number of areas in which there is a growing commonality of standards for the various inter-market trading practices and trading systems.

The substantial volume of transatlantic financial transactions, as well as the large number of both US-based financial service providers setting up shop in Europe, and Europe-based providers setting up in the US, is what sets the US-Europe relationship apart in this move toward common standards.

We discuss here one example of this, the trend toward establishing financial messaging protocol standards. Although numerous different financial transaction segments are now moving to an electronic format, a major prerequisite to achieving electronic trading in global financial transactions is that the electronic messages sent by each country's trading systems to describe the content of transactions be mutually intelligible.

ISO 15022 is the international standard that is now used for securities transactions, but an improved version of that, ISO 20022 (UNIFI), is a universal financial industry messaging scheme for not only securities transactions but all types of financial transactions, including bank operations. This standard is being increasingly used, particularly in the more integrated markets of Europe, in such areas as securities transactions, Forex transactions, trade financing, and small-scale settlement and clearance.[5] Consequently, there has been a growing trend of ISO 20022 being used in the US, primarily by those banks and securities firms that also have operations in Europe.

The pre-settlement matching system launched in 2001 by the Japan Securities Depository Center (JASDEC) uses ISO 15022. Although this is a positive example of Japan proactively using international standards in its securities trading infrastructure, Japan has failed to keep up with the many version upgrades to ISO 15022 that have since been developed. Consequently, the system originally touted as an international standard is now under fire for having devolved into a local standard. Some of the players involved, having watched developments in Europe and the US, have proposed

5 Institute of Monetary and Economic Studies, Bank of Japan, *Kin'yuu Jouhou Gijitsu no Kokusai Hyoujunka ni tsuite* (On global standardization of financial information technology), *Nihon Ginkou Chousa Kihou* (Bank of Japan Research Bulletin), Fall 2006 (in Japanese)

upgrading to ISO 20022,but there are doubts over whether such an upgrade could be pulled off smoothly in view of the current situation.

Often it is market players in the US and Europe that wind up taking the initiative when it comes to finance-related international standards. In terms of Asia's involvement, although Korea, which is highly focused on electronic financial transactions, is said to have a relatively strong presence, in most cases Japan's participation has not been that impressive.

One reason why Japan's commitment to global standards has not been that strong is that the majority of the companies involved in supporting Japan's trading infrastructure have businesses that are overwhelmingly weighted toward local transactions, and this makes it difficult for them to support measures that force additional system changes and expenditures for cross-border transactions. As this example shows, it is probably important to recognize that developments aimed at standardizing transactions internationally of the sort seen in the US and Europe are unlikely to occur in Japan until there are actually changes at the private-sector level, such as an increased volume of international transactions by domestic market participants or an increase in the proportion of international market participants.

The Outlook for, and Impact of, US-Europe Capital Market Integration

If integration of the various regulations governing financial and capital markets in the US and Europe starts to happen, the result is likely to become the de facto global standard. The Norwalk Agreement of 29 October 2002 marked a shift in the philosophy of the Financial Accounting Standards Board (FASB), which had until then appeared intent on maintaining the independence of US GAAP. The FASB's agreement to work toward convergence of US standards with the International Accounting Standards Board (IASB) in the direction of global accounting standards came as a big shock to accounting professionals in Japan, which had likewise been adhering to a stance of maintaining independent standards. In 2007, the US took a more strident position, allowing the use of international accounting standards in the US market (and by US corporations), rather than a convergence of accounting standards. This will probably have even more serious implications for Japan.

If initiatives originated in the US and Europe gradually start to form global standards in not only accounting but a variety of other segments such as securities regulation and trading systems, those markets that fail to adopt the standards may wind up being left behind.

Of course, there are important differences between the US and Europe in their regulatory environments, making a path to immediate market integration unlikely. Even among those who agree with integration, those on the regulatory side appear to share the notion that integration should aim at the higher level of regulation, and that integration at lower levels would be problematic. There are problems, however, including the possibility of a surge in securities litigation, and there is still the question of whether other countries can be expected, or should be expected, to establish a similar environment to that of the US, which has a strong enforcement mechanism via the SEC and self-regulatory organizations.

One legislative staffer interviewed by the author argued that the next step after achieving convergence of accounting standards should be targeted at convergence of listing standards, although corporate governance is another area where there are clearly large differences between Europe and the US in the approach taken.

As indicated by the arguments made at the SEC's Roundtable, some of those involved who think that investor protections in the US are superior to those of other countries have voiced concerns over whether mutual recognition might bring risks to the US market. It is also important to note, meanwhile, that those involved on the European side have other concerns. For example, Pervenche Beres, EMAC Chairwoman of the Economic and Monetary Affairs Committee of the European Parliament, along with others, has argued that in the process of the US implementing IFRS without reconciliation, the importation of certain rules-based elements from US GAAP into the IFRS, which has succeeded with a principles-based approach, would create problems.[6]

A look back at the history of various requests from the EU regarding the application of Sarbanes-Oxley to overseas corporations listed in the US also suggests that if the US stance on market integration is predicated on exporting the US approach, it will probably be unacceptable to Europe.

Even the SEC's argument on mutual recognition has the SEC in the position of selecting overseas markets based on SEC standards, which means that those overseas markets that want to be selected by the SEC have no choice but to adapt their frameworks to SEC standards. There is also the possibility of more direct intervention by the SEC in the event of illegal activity.

The private sector, meanwhile, is interested in simplifying, and eliminating redundancies in, regulations, and would probably not welcome developments that may lead to a heavier regulatory burden.

Nevertheless, financial market integration between the US and the EU is progressing on multiple levels -- governmental, financial regulator, and private-sector -- and has clearly gained momentum in 2007. Comprehensive integration is more of a goal for the distant future, but if integration begins with those segments where the barriers are small and initial successes can be built upon in some way, it is possible that the process could lead to a breakthrough allowing integration to spread to other sectors.

Japan's financial regulators have carried on an active dialogue with regulators in the US and EU. Nevertheless, the concept of market integration, although discussed in pan-Asian terms, has yet to take shape in the context of integration with Europe and the US. There are currently no mechanisms for such a concept in place, neither high level, as seen by the decision at the latest US-East summit to establish a Transatlantic Economic Council aimed at market integration, nor at the industry association level.

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6 Joint press release by Ms. Pervenche Beres and Mr. Alexander Radwan, "International Financial Reporting Standards and US GAAP", June 22, 2007

Rather, as noted earlier, in segments such as financial messaging standards, the majority of Japan's market participants engage only in domestic transactions, and therefore are largely satisfied with Japan's current standards. The same can probably be said regarding accounting standards. It appears that many participants view the actual costs associated with adapting Japanese standards to international standards as greater than any potential benefits they may gain from the change. The Japanese market is already quite large as it is, and its participants seem to have concluded that profits are sufficient to get by even while remaining heavily dependent on domestic transactions.

When the private sector makes that choice, i.e., decides that the Tokyo market is good enough as a local market, it may make the promotion of globalization politically difficult, not only for financial regulators, but for the government overall. Although debate over financial globalization is gaining momentum, realistically it seems that Japan has already started off in the direction of becoming more of a local market.

Once US-EU integration becomes a reality, and once it becomes clear that Japan's strategy for improving the future productivity of its economy has failed and that its power as a nation is in decline, it is possible that there could be a resurgence of debate over the need for Japan, while keeping its good traditions, to stop adhering to those unique systems and standards that have become unsuitable for global business, to stop depending solely on domestic business, and to follow a path to globalization. It is important to be conscious of the risk that if Japan waits until then to finally implement an aggressive set of measures aimed at financial globalization, it may already be too late.