TESTIMONY OF
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CONCERNING CERTAIN PENDING PROPOSALS BY THE EUROPEAN COMMISSION

BEFORE THE COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

May 22, 2002

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

Thank you for the opportunity to testify before you today on behalf of the Securities and Exchange Commission ("Commission") on certain pending proposals of the European Commission ("EC"). My testimony will focus primarily on the EC's proposal for a directive on the consolidated supervision of financial conglomerates. I will also briefly discuss the adoption of international accounting standards, the proposed prospectus directive, and the capital adequacy directive.

Proposal for a Directive on the Consolidated Supervision of Financial Conglomerates

European capital markets have been undergoing a major transformation. One aspect of this transformation is the EC's commitment to integrate financial markets in the European Union ("EU"). The EC has stated that a single financial market will be a key factor in promoting the competitiveness of the European economy. An integrated market is being facilitated, in part, by the EC's development of the Financial Services Action Plan ("Action Plan"), a series of legislative proposals that would subject all financial services firms active in the EU to consistent standards of regulation. If properly implemented, the Action Plan could help Europe achieve economic growth and strength. U.S. securities firms can contribute to these goals.

One of the primary legislative proposals by the EC under the Action Plan is the proposal for a directive on the consolidated supervision of financial conglomerates ("Proposed Directive"), which would establish minimum requirements for group-wide supervision of "financial conglomerates" and "mixed financial holding companies" doing business in the EU. The Proposed Directive is the EU's response to containing and supervising risks arising in cross-sector groups containing securities firms, credit institutions, and insurance companies. The Proposed Directive imposes prudential supervision on a group-wide basis of financial conglomerates and mixed financial holding companies. It attempts to address concerns that there could be a threat to financial stability if any firm within the group were to face financial difficulty. The Proposed Directive would also attempt to align the rules for financial conglomerates with those for firms dealing in a single financial sector, and would require cooperation and information sharing among supervisory authorities.

Consequences of the Proposed Directive on U.S. Registered Securities Firms

Generally, the current form of the Proposed Directive would impose a series of quantitative and qualitative requirements at the holding company level of a financial conglomerate or mixed financial holding company, which would be applied by an EU Member State's home regulator designated as the "co-ordinator." If a financial conglomerate or mixed financial holding company operating within the EU does not have its "head office" within the EU, the Proposed Directive provides for the verification by EU authorities that the firm is subject to supervision that is "equivalent" to the EC's Proposed Directive. If an equivalence determination is not made, then under the EC's proposal, EU authorities could adopt other methods, such as imposing additional requirements on the firm to achieve the objectives of the Proposed Directive.

The Commission does not have direct consolidated supervisory authority over securities firm holding companies, except as described below. In substance, however, the Commission and EC approaches to group-wide supervision are based on the same principles. These principles focus on the importance of capital adequacy, regulatory scrutiny of the risk profile of the group, fit and proper or other qualification tests for key personnel, and information-sharing among supervisors of a financial conglomerate. Although the Commission does not conduct consolidated supervision precisely as described in the Proposed Directive, the Commission does undertake group-wide supervision that, like consolidated supervision, provides sufficient tools to identify the major risks of the entire enterprise.

Several U.S. securities firms have communicated to the Commission that they have serious concerns with the Proposed Directive. They fear that the EU authorities that will make the "equivalence" determination may take the position that the Commission's supervision of securities firms at the holding company level is not equivalent to the EC's standards. They conclude that the Proposed Directive would not only increase their cost of doing business in Europe, but would also place them at a competitive disadvantage with European-based firms. In particular, under the Proposed Directive, in the absence of an "equivalency" determination, a U.S. securities firm operating within the EU could be subject to higher capital and risk control requirements than an EU-based firm. Alternatively, a U.S. securities firm may be required to create a sub-holding company in the EU. The possibility also exists that the EC could impose more stringent requirements on the European activities of such U.S. entities than those imposed on EU-based companies. Further, the EC could require that the entire U.S. holding company be subject to European consolidated supervision.

At a time when we are carefully evaluating the impact of our U.S. rules and regulations on foreign entities, in an attempt to move to more global markets, we are concerned about the possible imposition of standards on U.S. firms by the European Community in the form of "equivalence" determinations. To the extent that "equivalence" signals an effort to harmonize both regulatory regimes, we welcome the effort. To the extent "equivalence" is really a means of having a "co-ordinator" in the EU evaluate the quality of our regulatory regime, we do not think that approach will be productive or add to investor protection. The Commission, of course, shares many of the EC's concerns about how to contain and supervise risks posed by financial conglomerates, and believes that our approach to the supervision of securities firms is as effective as that in the Proposed Directive. The Commission staff has discussed the issue of equivalence with EC representatives and how our respective approaches can best address the need for group-wide supervision of financial conglomerates in today's global markets. We believe that we have had productive discussions with EC representatives on this issue and look forward to continuing our dialogue with these representatives.

Commission Oversight

The U.S. capital markets are among the largest and most successful in the world. Our equity markets alone comprise almost half of the total global equity market capitalization.[1] Much of this success is attributable to the activities of the securities firms based here in the U.S., which contribute to economic well-being and capital formation in countries the world over. The U.S. capital markets are among the most well-regulated markets in the world. The Commission's mandate includes ensuring that our securities firms have the highest level of financial integrity and operate in a manner that promotes the protection of investors. Our regulatory regime has operated with remarkable success since the Commission's financial responsibility regime was implemented in 1975; very few large securities firms have failed, and in no instance has a failure had any significant impact on markets or required federal funding to liquidate a firm.

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[1] Data obtained from the Securities Industry Association ("SIA") reflects that, as of the end of the calendar year 2000, the capitalization of the U.S. equity market was approximately $15.1 trillion, which amounted to approximately 47 percent of the global equity market capitalization. The countries with the next largest equity markets outside of the United States were Japan (approximate size of $3.2 trillion), the United Kingdom (approximate size of $2.6 trillion), France (approximate size of $1.4 trillion), and Germany (approximate size of $1.3 trillion). The value of shares traded in the U.S. equity markets was approximately $31.8 trillion, which represented approximately 67 percent of the global value of shares traded.

Based on a joint survey between the SIA and the Investment Company Institute, an estimated 49.2 million U.S. households owned equity securities as of the end of the calendar year 2000. Further, with regard to foreign investor participation in the U.S. securities markets, gross activity (both purchase and sales) totaled approximately $7.8 trillion in U.S. Treasuries, $7 trillion in U.S. stocks, $1.3 trillion in U.S. agency securities, and $773 billion in U.S. corporate bonds.

Before discussing the Commission's regulation of securities firms, which serve the important role of intermediary between customers and other capital market participants, it is important to recognize that, unlike other types of financial services firms, U.S. securities firms generally maintain highly liquid balance sheets. Substantially all financial instruments used in a securities firm's trading and non-trading activities are carried at fair value or amounts that approximate fair value, and unrealized gains and losses are recognized in earnings. Secured financing transactions are margined daily, limiting credit losses to nominal amounts, and securities firm assets are generally highly liquid marketable securities or are short-term receivables collateralized by liquid securities. The highly liquid nature of these assets provides securities firms with flexibility in financing and managing their business.

Examples of liquidity policies implemented by U.S. securities firms include policies for diversifying funding sources, liquidity planning (e.g., structuring liabilities to avoid significant amounts of debt coming due within a certain time range), and relying on markets which have proven to be consistent sources of funding during periods of market stress (e.g., the repurchase agreement markets). A number of securities firms also maintain a liquidity cushion consisting principally of unencumbered U.S. government obligations.

Financial Responsibility Requirements for Securities Firms

The financial responsibility requirements imposed on registered securities firms are an important component of the Commission's supervision of securities firms.

All U.S. registered securities firms are subject to the Commission's financial responsibility program, which is designed to enhance the financial integrity of securities firms. This program requires that securities firms maintain prescribed amounts of liquid net worth (also referred to as "net capital"), safeguard customer funds and securities, keep and maintain accurate books and records, and regularly file detailed financial information with the Commission and the self-regulatory organizations of which the firm is a member. The most important financial responsibility requirements for securities firms are set forth in the Commission's "net capital" and "customer protection rules," Rules 15c3-1 and 15c3-3 under the Securities Exchange Act of 1934, respectively.

The net capital rule prescribes minimum liquidity standards for securities firms. The theoretical underpinning of the net capital rule is to ensure that each securities firm maintains sufficient net liquid assets to allow a securities firm, in the event the firm fails, to self-liquidate without the need for a formal judicial proceeding, and to satisfy promptly the claims of customers. In determining net capital, a securities firm first computes its net worth in accordance with generally accepted accounting principles and then adds to that amount subordinated liabilities. From that figure, the securities firm subtracts assets not readily convertible into cash, such as fixed assets, exchange seats, and most unsecured receivables. The securities firm then subtracts prescribed percentages of the market value (otherwise known as "haircuts") of securities owned by the securities firm to discount for market movement. The resulting figure is the securities firm's net capital, a figure that reflects the current liquidity status of the securities firm (i.e., its ability to pay promptly all liabilities). Any receivable from an affiliate of a securities firm must be deducted from the securities firm's net capital to the extent the receivable is not secured by marketable securities.

The customer protection rule is designed to protect customer funds and securities held by securities firms. Generally, the rule requires securities firms to maintain possession or control of all customer fully-paid and excess margin securities, and permits firms to use customer money only to the extent necessary to finance customer-related business.

To assist in monitoring securities firm compliance with the Commission's financial responsibility rules, the Commission requires, among other things, that securities firms file monthly, quarterly and audited annual financial reports, as well as notices in the event a firm's capital declines below certain levels or its books and records are not kept current in accordance with the Commission's books and records rules.

In addition, all large securities firms in the United States that hold customer funds or securities are subject to annual financial responsibility examinations by the self-regulatory organizations and periodic examinations by the Commission staff.

Risk Assessment Rules

Because of the potential harm to a securities firm that may arise from losses at an affiliate, in 1990, Congress amended the Securities Exchange Act of 1934 to provide the Commission with specific authority to obtain information regarding the financial activities of affiliates of securities firms. In 1992, the Commission adopted two rules under this authority, one for recordkeeping and another for reporting. Under these rules, often referred to as the "risk assessment rules," securities firms that are part of a holding company structure – which generally includes all major U.S. securities firms – are required to provide the Commission with comprehensive financial and operational information, on a periodic basis. This information allows the Commission staff to evaluate the material risks to securities firms posed by their affiliates.

Categories of information required by the risk assessment rules to be reported to the Commission on a quarterly and annual basis include:

- a holding company organizational chart (reflecting all affiliates);
- legal proceedings;
- consolidated and consolidating financial statements; and
- detailed financial and securities activity related data provided for every "Material Associated Person."

The Commission staff reviews these comprehensive filings for, among other things, significant balance sheet and income statement changes, double leverage, asset liquidity and capital structure, unusual positions or concentrations, and systemic trends.

Derivatives Policy Group

Information reported to the Commission under the risk assessment rules is supplemented on a voluntary basis by risk information provided by the Derivatives Policy Group ("DPG"). The DPG was developed in March 1995, and is intended to provide a framework for monitoring the activities of affiliates of securities firms. The reporting framework for DPG members has recently been changed so that DPG members now file with the Commission on a monthly basis certain internal financial and risk management reports at the holding company level. These reports generally contain extensive information regarding the firm's financial condition and risk exposures, including granular detail with respect to their value at risk computations and credit risk exposures. This detail typically includes value at risk breakdowns by products (i.e., equity, interest rate, currency, and commodity) and as well as by significant business units, such as merchant banking. As part of the DPG program, Commission staff also regularly meets with representatives of the firms with respect to the reports.

Investment Bank Holding Company Proposal

In 1999, when Congress passed the Gramm-Leach-Bliley Act, it created a new type of holding company called a "supervised investment bank holding company." A supervised investment bank holding company is generally defined as an entity that owns or controls one or more U.S. registered securities firms but is not affiliated with an insured bank, a savings association, or certain foreign banks. The Gramm-Leach-Bliley Act also authorized the Commission to create a regulatory framework for this new type of holding company, giving the Commission the ability to monitor more of the activities of both regulated and unregulated affiliates that may affect the financial stability of their affiliated securities firms.

The Commission staff is currently preparing draft rules for consideration by the Commission that would implement the regulatory structure for supervised investment bank holding companies. The regulatory structure the staff plans to recommend that the Commission adopt includes:

- requiring supervised investment bank holding companies to calculate and report capital on a monthly basis in accordance with the Basel Capital Accord;
- subjecting supervised investment bank holding companies to reporting and record keeping requirements, and to a thorough review of their group systems and internal controls; and
- Commission staff inspection of supervised investment bank holding companies and their unregulated affiliates.

The holding company would remain subject to all regular Commission disclosure reporting requirements for public companies, and the securities firm would remain subject to all current regulatory requirements and self-regulatory organization supervision.

International Accounting Standards

The EU has announced its intention to adopt International Accounting Standards ("IAS") as the official standard for EU listed (public) companies as of January 1, 2005. EU listed companies that currently prepare their primary financial statements under another country's accounting standards will be given an additional two years to implement IAS (e.g., German companies using U.S. GAAP).

The movement of the EU from many national accounting standards of varying quality and comprehensiveness to a single EU standard that is developed in an independent and transparent manner is a positive development both for issuers and investors. European issuers coming to the U.S. today can use (1) home country GAAP and reconcile to U.S. GAAP, (2) IAS with a reconciliation to U.S. GAAP, or (3) U.S. GAAP outright. Many issuers today use home country GAAP. The current complexities in reporting and in reviewing EU issuer filings would be reduced under a common EU standard. IAS, applied correctly and consistently, and enforced effectively, would provide a higher degree of quality and transparency in financial statements than the present systems in the EU countries. Comparability of financial data among EU issuers would also be improved.

It is important to note that the benefits of using a common set of accounting standards throughout the EU will be achieved only if there is also an effective infrastructure in place for consistent application, interpretation, auditing and enforcement of the standards. The EC and national securities regulators in Europe have recognized and acknowledged this, and have begun to set up the necessary structures and processes.

From a U.S. issuer standpoint, the effects appear to be generally favorable. In addition to the positive effects noted above, whereby U.S. acquirers or partners of EU companies would also receive better information, it is expected that U.S. companies will continue to be able to list in the EU using U.S. GAAP, as they do today. The EC has not indicated that it contemplates any change for non-EU listed companies, and it seems unlikely at this time that they would do so.

And finally, there is a potential that the benefits of IAS adoption in the EU may take on even greater significance if the U.S. Financial Accounting Standards Board and the International Accounting Standards Board make significant progress in achieving convergence in accounting principles. Both standard setting bodies have begun efforts to reduce the major differences between IAS and U.S. GAAP, many of which were noted in the Appendix to the Commission's February 2000 Concept Release on International Accounting. The Commission has been supportive of such efforts.

Prospectus Delivery Requirements

The proposed EU prospectus directive would permit EU companies that are offering securities and listing the securities on a regulated market in the EU to use one prospectus that would be accepted throughout the EU. Issuers would obtain approval of the prospectus by their home market regulatory authority, and the prospectus would be accepted throughout the EU based on a simple notification procedure to the host country regulator that would not require separate approval by that regulator. The disclosure requirements of the EU prospectus directive are based on IOSCO's International Disclosure Standards for Cross-Border Offerings and Listings of Equity, which were incorporated by the Commission into Form 20-F effective September 30, 2000. Form 20-F is the core disclosure document used by foreign private issuers to register and list securities in the U.S. markets. Generally, under the proposed EU prospectus directive, listed EU companies would be providing the same level of disclosure in their prospectuses that foreign private issuers currently provide to the SEC.

The Capital Adequacy Directive

The final capital adequacy directive will likely mirror the Basle Capital Accord. The Basle Capital Accord was developed by banking regulators primarily for commercial banks. It does not take account of the different business mix and balance sheet and off-balance sheet positions of the securities firms, as well as their accounting models. U.S. securities firms do not generally make unsecured loans and generally do not take deposits. Their assets and liabilities are fair-valued, which means, as to liquid securities, that they are marked to the market, whether in the trading book or otherwise. If the Basle Capital Accord were modified to more precisely reflect the risks of trading activities, it would not seem that its application should cause substantial problems for U.S. securities firms that do business in Europe.

Conclusion

The Commission firmly believes that its regulation of U.S. registered securities firms and their affiliates satisfy the Proposed Directive by providing “equivalent” group-wide supervision. Commission staff meet on a regular basis with foreign regulatory authorities to discuss regulatory issues and concerns relating to global securities firms. The Commission is committed to continuing its detailed discussions with foreign regulators regarding our regulatory regime in order to assist them in making a favorable equivalency determination under the Proposed Directive.

Thank you for the opportunity to testify before you today. I would be happy to answer any questions.