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002	Report	FASB Proposal, "Principles-Based Approach to U.S. Standard Setting"	1	10/21/2002	P5;

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Corporate Governance Briefing Book: Summer/Fall 2002 [3]

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KPMG's U.S. Arm Must Stand Trial In Lernout Suits

Updated: Tuesday, August 27, 2002 11:11 PM ET



BOSTON -- A federal court ruled that the U.S. arm of accounting firm KPMG must stand trial along with KPMG Belgium in shareholder suits arising from accounting fraud at Lernout & Hauspie Speech Products NV.

The ruling by Judge Patti B. Saris of the U.S. District Court here greatly expands the possible pool of recoverable assets for Lernout plaintiffs. It also further complicates the legal problems of KPMG, which is facing potential liabilities for its role as auditor of other high-profile companies laid low by accounting scandals -- including Rite Aid Corp. and Xerox Corp.

In her decision, Judge Saris cited a "panoply of 'red flags,'" which "taken together is more than sufficient to strongly support the inference that KPMG US acted with recklessness or actual knowledge" in helping prepare Lernout's 1999 Form 10-K, which later proved fraudulent.

Lernout & Hauspie, a onetime European highflier that sold speech-recognition software, was based in Belgium but had substantial U.S. operations. It filed for bankruptcy in 2001 after an audit revealed it had booked \$373 million in phony revenue from 1998 to 2000.

In her ruling, Judge Saris excluded KPMG UK, KPMG Singapore and KPMG International, a Swiss verein, or membership association, from the U.S. action, but denied motions to dismiss the suit against the Belgian and U.S. unit. The U.S. audit firm had fought inclusion in the case, arguing that unlike KPMG Belgium, it hadn't signed the audit reports.

Glen DeValerio, a partner at Boston law firm Berman DeValerio Pease Tabacco Burt & Pucillo, co-lead counsel for the shareholders, said the ruling is "a very significant victory for all the plaintiffs," because of the size of the U.S. accounting house. He said plaintiffs haven't specified damages, but he said that "it's in the billions," and could be as much as \$3 billion.

In New York, KPMG said "the allegations against KPMG are completely without merit," because "there was massive fraud inside L&H" designed to fool both investors and auditors. It said it would defend itself "vigorously."

Judge Saris cited a number of allegations made in a shareholder class-action suit and in two separate suits brought by holders of companies acquired by L&H as providing sufficient reason to include the auditors in the suit. She noted that owners of two companies acquired by Lernout, who have also sued the auditors, said KPMG U.S. representatives told them in conference calls that Lernout's accounting met U.S. standards.

She also cited other warning signs that plaintiffs have alleged: that Lernout had ignored a KPMG recommendation that it write off \$444,000 in obsolete inventory; that KPMG knew Lernout had limited KPMG's ability to investigate allegations of false revenue recognition in foreign countries; that Lernout had issued a press release about its financial results 13 days before the audit committee of the company met to discuss the results; and that KPMG knew that the Securities and Exchange Commission had started an inquiry into Lernout accounting practices.

She wrote that according to the allegations, Robert McLamb, a partner of KPMG's U.S. Capital Markets Group who worked first in London and later in Houston, "played a pivotal role" in KPMG's Lernout reviews and in making sure the results complied with generally accepted accounting principles. KPMG said Mr. McLamb wasn't available to comment.

Write to William M. Bulkeley at bill.bulkeley@wsj.com

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Cindy Alexander

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SAP AG, SGL CARBON AG

August 16, 2002

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609
U.S.A.

Re: File No. S7-21-02 – Certification of Disclosure in Companies’
Quarterly and Annual Reports

Dear Mr. Katz:

We are submitting this letter in response to the request of the Securities and Exchange Commission (the “Commission”) for comments on the Commission’s proposed rules implementing specified statutory certification requirements for principal executive officers and principal financial officers under Section 302 of the Sarbanes-Oxley Act of 2002 (the “Act”).¹ We appreciate the opportunity to comment on the matters discussed in the Section 302 Release and the Original Proposal.

I. Introduction

We are a group consisting of several of Germany’s largest New York Stock Exchange-listed companies. We take the unusual step of writing to you as a group to emphasize our shared concerns about Section 302 of the Act.

¹ SEC Release No. 34-46300 (August 2, 2002). We refer to this release as the “Section 302 Release”. The Section 302 Release proposes changes to the rules and certifications the Commission proposed in June in SEC Release No. 34-46079 (June 14, 2002). We refer to the earlier release as the “Original Proposal”.

We strongly favor the efforts of the U.S. Congress and the Commission to restore the confidence of investors in the integrity and fairness of the U.S. financial markets. The crisis in a number of major U.S. corporations threatens to diminish the significant benefits for non-U.S. issuers of the U.S. markets, such as transparency, liquidity and stability, that initially drew us there. We therefore are generally in support of policies, designed to improve corporate governance and accountability to ensure that those benefits remain present both in fact and in public perceptions.

Our corporations are organized under a body of corporate law that differs significantly in numerous technical respects from the corporate legal regimes governing U.S. corporations but which offers substantially equivalent safeguards for stakeholders. We do not therefore believe it necessary, either under the terms of the Act or to achieve its goals, rigidly to impose the same technical requirements on German and other non-U.S. companies as are imposed on U.S. companies.

II. The Commission's Proposed Rules Should Not Apply to Foreign Private Issuers

In the Original Proposal, the Commission stated that the rules proposed in that release would not apply to foreign private issuers² subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") and provided a rationale for this conclusion. In the Section 302 Release, the Commission stated that Section 302 of the Act also applies to foreign private issuers and that the Commission therefore intended to adopt final rules that would apply the certification requirements to foreign private issuers filing annual reports on Form 20-F. We believe that the language of Section 302 should be, and its legislative construction and legislative history argue that it must be, interpreted not to apply to foreign private issuers, and that the Commission should therefore refrain from applying the certification requirements to them.

A. The Arguments the Commission Advanced in the Original Proposal Argue Strongly for the Exclusion of Foreign Private Issuers from the Certification Requirements

In the Original Proposal, the Commission indicated several reasons for excluding foreign private issuers from the coverage of the certifications requirement the Commission was proposing at that time. It noted that Form 20-F under the Exchange Act need only be signed on behalf of the company by any authorized officer (which generally would include the principal executive officer or principal financial officer). Unlike Form 10-K under the Exchange Act, it does not have to be signed by a company's principal executive officer or officers, principal financial officer, controller or principal accounting officer and a majority of the board of directors. In addition, as the Commission correctly noted, imposing mandatory requirements regarding companies' internal procedures raises several issues, since those requirements may be inconsistent with the laws or practices of the foreign private issuers' home jurisdiction and stock exchange requirements.

The Commission accordingly concluded that applying the proposed rules to foreign private issuers would raise additional issues that do not exist for domestic companies.

² As defined in Rule 3b-4 under the Securities Exchange Act of 1934. Each of the companies joining in this letter is a foreign private issuer.

and decided not to require the certifications from foreign private issuers. This would certainly be the case in Germany. As the Commission is aware, the body of a German corporation that bears the majority of executive responsibilities is its management board, or *Vorstand*. Under German corporate law, the management board itself, and not the individuals comprising it, is the body responsible for corporate direction. Moreover, back in 1998, German law introduced the express requirement that the management board should establish risk management systems and financial early warning procedures which comprise effective internal control mechanisms. The effectiveness of such procedures must be examined and evaluated by the company's auditors. In our view, this leads to results that are comparable and equivalent to what is required by Section 302 of the Act. Finally, we note that making false or misleading statements in publicly-released reports is already subject to administrative and criminal sanctions under the German Commercial Code and the German Stock Corporation Act.

The Commission has traditionally accommodated foreign issuers by refraining from imposing undue burdens that would duplicate, or be inconsistent with, requirements already imposed by their respective home country laws and thus might discourage them from accessing the U.S. capital markets. For example, foreign issuers are generally not required to file quarterly reports on Form 10-Q, or current reports on Form 8-K. Foreign issuers are generally exempt from the proxy rules under Section 14 of the Securities Exchange Act and from the reporting and short swing profit rules of Section 16 of the Exchange Act. Both the NYSE and Nasdaq have exempted foreign issuers from certain listing requirements to accommodate inconsistencies between home country practices and the standards applicable to U.S. companies. At the same time, foreign issuers have been required to include in their U.S. disclosure documents descriptions of the ways in which their internal governance procedures and the legal regimes under which they operate differ from those to which U.S. issuers are subject. This additional disclosure has provided U.S. investors with the information they needed to make an informed decision about investing in the securities of foreign issuers, while at the same time assuring U.S. investors that the local laws governing the foreign issuers provide adequate controls and corporate governance procedures.

The latest corporate governance rule proposals from the NYSE and Nasdaq reflect understanding for the differences between U.S. issuers and non-U.S. issuers. We respectfully urge the Commission to continue its tradition of extending comity in this case—a tradition that was important in convincing us to become U.S. registrants in the first place.

For these reasons, we recommend that the Commission not add true foreign private issuers to the companies required to submit certifications under Section 302.

B. The Legislative History and Structure of Section 302 Support a Differentiated Approach

At least one important element of the legislative history points to an understanding that the Act was not meant to apply equally to domestic and foreign private issuers. During the Senate conference debate to approve the final version of the bill, Senator Enzi stated:

In addition, I believe we need to be clear with respect to the area of foreign issuers and their coverage under the bill's broad definitions. While foreign issuers can be listed and traded in the U.S. if they agree to conform to [generally accepted accounting principles in the United States] and New York Stock Exchange rules, the [Commission] historically has permitted the home country of the issuer to implement corporate governance standards. Foreign issuers are not part of the current problems being seen in the U.S. capital markets, and I do not believe it was the intent of the conferees to export U.S. standards, disregarding the sovereignty of other countries as well as their regulators.

Section 302(a) of the Act specifies that the certification requirement is to apply to "each company filing periodic reports under section 13(c) or 15(d) of the [Exchange Act]". As such, the provision appears on its face to cover foreign private issuers which file such reports. However, Section 302(a) should be read in the light of Section 302(b) and the legislative history underlying the Act. Section 302(b) deals with the concern that U.S. companies will reincorporate outside the United States in order to evade the certification requirements. On its face, it assumes that reincorporating outside the United States would in fact relieve the company of some or all of the requirements of Section 302(a). Were Section 302(a) read to apply identically to domestic and foreign private issuers, there would have been no reason for Congress to include Section 302(b) to prevent domestic issuers from circumventing the rules.

Because the wording of the Act and its legislative history do not clearly indicate that the certification requirements of Section 302 must apply to foreign private issuers, and in fact argue more persuasively that they should not, we request that the Commission reconsider its Section 302 Release and exercise its broad rulemaking discretion to exclude foreign private issuers from the certification requirements.

We wish to emphasize that we are strongly in favor of good reporting practices, and that we are conscious of the paramount importance of maintaining investor confidence in the capital markets. We are concerned, however, that imposing the Section 302 requirements on true foreign private issuers will make the United States public capital markets less attractive, even to corporations that are fully confident about the integrity of their reporting systems. With the broadening of the Euromarket that has occurred over the past several years and the availability of Rule 144A, we wonder whether, on balance, new entrants will conclude that the benefits of a U.S. listing outweigh the uncertainties and risks.

We are also concerned that the departure from traditional principles of policy/comity represented by some of the initiatives under the Act will lead to a multiplication of inconsistent national regulatory initiatives with extraterritorial application, resulting in a setback for the globalization of the capital markets.

III. Additional Suggestions

A. Timing

Before any decision is reached to extend the certification requirements to foreign private issuers, the Commission should conduct a detailed study of the potential local law conflicts and the adverse consequences. The limited comment period between President Bush's signature of the Act and the August 19 comment deadline is not sufficient time for many foreign private issuers to respond. Some foreign private issuers may be unaware of the call for comments before August 19, or unable to coordinate a timely and thoughtful response within the time frame available. Moreover, we respectfully submit that further discussion with European regulators may be useful before the imposition on foreign private issuers of a change that represents such a radical departure from past practice. In light of the absence of a clear mandate to extend Section 302 to true foreign private issuers, we believe the Commission would risk significant adverse consequences for foreign private issuers and the U.S. capital markets if it were to rush and extend Section 302 to foreign private issuers on the same time frame as it is being applied to non-foreign private issuers.

B. Form 6-K Reports

We note with satisfaction that in the Section 302 Release reference is made to reports by foreign private issuers on Form 20-F, without reference to reports on Form 6-K. We fully endorse the principle that if foreign private issuers are to be required to submit certifications under Section 302, this requirement should remain limited to reports on Form 20-F.

* * *

We thank you for the opportunity to comment on the Section 302 Release. We would be happy to discuss with you our comments or any other matters that you feel would be helpful in your review of the proposal. We have very serious concerns about the compatibility of other aspects of the Act (particularly with regard to audit committees and corporate governance) with the requirements of German law, but we understand that your call here is for comments on Section 302 of the Act, so we expect to address those other concerns at a later date. Please do not hesitate to contact

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The Federal Reserve Board

Testimony of Mark W. Olson

The European Union's Financial Services Action Plan

Before the Committee on Financial Services, U.S. House of Representatives

May 22, 2002

Thank you, Mr. Chairman, for the opportunity to speak today on matters relating to the operations of U.S. banking organizations in the European Union. This is a time of significant change within the European Union with the ongoing efforts to complete the single market in financial services.

I join with my colleagues here today in welcoming the European Union's plans to make its market more efficient and transparent. The United States has always been a strong supporter of European unity as well as market reforms that eliminate unnecessary regulatory burden and promote better functioning of markets and financial systems.

The Financial Services Action Plan of the European Union includes proposals that are aimed at achieving these same goals. The FSAP involves a series of regulatory and legislative measures designed to achieve, among other things, a single wholesale European market; open and secure retail markets; and state-of-the-art prudential rules and supervision. To further these goals, a number of directives have been or will be adopted that deal with issues such as money laundering, investment services, implementation of new Basel capital rules and international accounting standards, and supervision of financial conglomerates. I will deal with the latter three areas later in my testimony. These directives, and all of the other measures being adopted in the FSAP, will affect U.S. financial services firms with operations in Europe.

The FSAP is intended to modernize and enhance the efficiency and structure of the regulatory regime for financial services within the European Union. To the extent that the FSAP achieves these goals, U.S. firms are well-positioned to offer innovative and efficient services to customers throughout Europe.

At the Federal Reserve, we follow with interest changes to foreign bank regulatory and supervisory systems and seek to understand how these systems affect the banking institutions for which we are responsible. This is especially important in the European Union, in which U.S. banking organizations have substantial operations. As of December 2001, 27 U.S. banking organizations operate in the European Union with aggregate EU assets of over \$650 billion. Moreover, 66 EU banking organizations conduct commercial banking and other financial services in the United States with aggregate U.S. assets of over \$1.7 trillion.

These figures demonstrate that globalization is not a new concept or recent process. As U.S. industry has expanded its foreign operations, U.S. supervision has had to evolve to take account of the fact that our banks operate in many different legal and regulatory environments. We have strengthened existing cooperative relationships with bank supervisors in other countries and established new ones as U.S. banks continue to expand their operations into other countries. At the Federal Reserve, we conduct bilateral consultations with individual authorities and participate in international groups of financial services supervisors. We engage our EU counterparts both bilaterally and through these groups.

The Federal Reserve and the other federal banking agencies participate regularly in the Basel Committee on Banking Supervision, which was formed in order to improve communication and cooperation among supervisors of internationally active banks. Some of the key achievements of the Committee include the 1988 Basel Capital Accord, which created for the first time an internationally accepted standard for assessing levels of bank capital. The Accord replaced an uneven system of national standards and has allowed banks to expand internationally on more competitive basis. Similarly, the Committee adopted its Minimum Standards for Consolidated Supervision in 1992, establishing the principle that a bank should be subject to a supervisory regime in which its financial statements are consolidated and subject to review by home country authorities. Both the Capital Accord and the principle of consolidated bank supervision have become the internationally recognized standards that bank supervisors should aspire to meet.

Nine of the member states of the European Union are also members of the Basel Committee and a representative of the European Commission participates as an observer. The Federal Reserve and eight of these nine EU countries, and a European Commission observer, also participate in the Joint Forum, a group established by the Basel Committee, International Organization of Securities Commissioners (IOSCO), and the International Association of Insurance Supervisors (IAIS). The Joint Forum discusses issues arising from the operation of financial services conglomerates and has developed principles appropriate to the supervision of entities that operate within financial groups. These group meetings, as well as many working group meetings on specific issues, provide regular opportunities for U.S. regulators to meet and discuss issues of common interest with European officials.

In addition to regular meetings of international groups, the Federal Reserve has longstanding relationships with both national regulators in the European Union and staff of the European Commission. For internationally active banking organizations with operations in both the United States and the European Union, national supervisors may participate in joint examinations of particular institutions, confer with each other on specific issues and meet periodically to discuss an institution's operations or financial condition. Ongoing communication is recognized as critical for effective supervision. Home and host countries' interests are both furthered by dialogue and strong supervisory relationships.

Regular contact with Commission staff goes back to the 1980s when the EU considered and adopted its Second Banking Directive, aimed at promoting the internal market by establishing the so-called "European passport" for banks chartered in the EU. Under the

passport, a bank chartered in one EU country is entitled to establish branches in any other EU country under the authority and supervision of its home country rules. Since that time, several U.S. banks have taken advantage of this early EU regulation by establishing a local bank in a European member state, which then used the "passport" to establish branches in other EU member countries.

European subsidiaries of U.S. banks are able to take advantage of the passport under the principle of "national treatment." National treatment generally means that a country provides parity of treatment between domestic and foreign-owned firms, resulting in equality of competitive opportunity. National treatment has long been the prevailing practice with respect to foreign banks operating in the United States and this practice was incorporated into statute in 1978 with the enactment of the International Banking Act (IBA). This principle has also been incorporated in various trade agreements to which the United States is a party, such as the North American Free Trade Agreement (NAFTA) and the General Agreement on Trade in Services (GATS). The EU member states are also subscribers to the GATS and consequently to the national treatment principle it contains.

Implementing national treatment can be difficult precisely because one country is trying to adapt its own legal and regulatory structure to a foreign firm that is incorporated in a different home country environment. This is a challenge the Federal Reserve has faced over the years as we seek to apply U.S. laws that were adopted for a system of bank holding companies to foreign banks that generally do not have a bank holding company structure. The United States also requires that a foreign bank be subject to comprehensive consolidated supervision by its home country supervisor before it can buy a bank in this country. Under this law, the Federal Reserve must evaluate supervision systems that are different from our own and yet ensure that we are fairly applying the principle of national treatment.

U.S. private sector firms may be concerned about new regulatory and supervisory initiatives in the EU because such proposals may require changes in existing operations and/or reporting standards. There may also be a concern that initiatives designed for European firms or industries would not properly take account of home country supervisory structures or regulatory practices. Foreign banks have expressed similar concerns about U.S. regulatory initiatives in the past. At the Federal Reserve, we have found that our open and transparent regulatory process is crucial in helping us to understand how our proposals affect foreign banks and where problems arise, and gives us useful information for evaluating the merits of particular complaints. We have at times proposed regulations on which foreign banks and their governments, including the European Commission, filed adverse comments. These comments helped us to reevaluate our regulations and to determine whether our supervisory and regulatory objectives could be achieved in a different way, consistent with the principle of national treatment.

With respect to the implementation of the FSAP in the European Union, the European Union has an obligation to ensure that the rules adopted are consistent with the principle of national treatment. It is our expectation that the European Commission and the member states will seek to do so. Federal Reserve staff has met with Commission staff to discuss a

number of matters, including the application of the financial conglomerates directives to U.S. banking organizations. The Federal Reserve is committed to continuing the dialogue with the Commission on matters of mutual interest, both bilaterally and as part of financial markets discussions led by the Treasury Department. We understand that the Commission has begun to engage in industry consultation as part of the rule writing process and we endorse a process that allows all affected institutions, including those that are foreign-based, to participate actively in the process.

The FSAP has a far reaching agenda. I will comment briefly on three issues of particular interest to U.S. banking organizations. With respect to the conglomerates directive, we understand that the impetus for the directive came from the Joint Forum's principles for the supervision of financial conglomerates. The three parent bodies of the Joint Forum (the Basel Committee, IOSCO and the IAIS) were concerned that, although individual financial companies within a group might be subject to prudential supervision, the consolidated financial group might not be subject to appropriate oversight. This in turn could lead to relationships or transactions that could pose financial risk to the regulated parts of the group. The Joint Forum's principles were developed to help assure that there are no material gaps in supervisors' understanding of inter-affiliate relationships within a financial group that could ultimately result in financial instability. We understand that the EU financial conglomerates directive is concerned with this same issue.

In the United States, U.S. banking organizations have long been subject to consolidated supervisory oversight. We believe that the Federal Reserve's supervisory programs and practices for bank holding companies, including financial holding companies, are fully consistent with the requirements that are contemplated under the EU's financial conglomerates directive.

With regard to the capital adequacy directive that is being developed for credit institutions and investment firms in the European Union, we also believe that the ultimate product will not present difficulties for U.S. banking organizations. The European Commission is mindful of the work that is underway in the Basel Supervisors Committee to replace the existing Basel Capital Accord with a more comprehensive risk sensitive framework for assessing an organization's capital adequacy.

When the EU issued its capital adequacy directive for public comment in 2001, commenters raised concerns about the regulatory burden that would be imposed on institutions that would be subject to both the EU capital rules and the Basel capital rules at the national level. The EU committee responsible for the capital adequacy directive has recognized this potential burden and has taken steps to ensure that the EU directive is as consistent as possible with the final revised Basel Accord. Technical working groups of the Basel Committee have been communicating with the EU technical drafting groups with the objective of harmonizing the two frameworks to the fullest extent possible.

The most sweeping changes in the Basel capital initiative are intended for internationally active banking organizations. The EU capital adequacy directive is intended to apply to a much wider range of institutions, both those with international operations as well as those

that are purely domestic. Thus, the capital adequacy directive will likely address EU specific issues for smaller institutions. Internationally active European banks currently are subject to the Basel capital rules as they have been adopted in individual countries, as well as to the existing EU capital adequacy directive. Some differences between the two sets of rules do exist. Supervisors, however, are aware of these differences and continually strive to minimize the associated regulatory burden on institutions. Because the Basel revisions and the EU capital directive revisions are underway in tandem with similar estimated time frames for completion, there is a good likelihood that the final products will be substantively and significantly more consistent than the current Basel and EU capital rules.

The FSAP also contemplates mandating adherence to international accounting standards. Currently, banking organizations in the European Union may prepare their annual financial statements in accordance with the accounting standards of the International Accounting Standards Board (IASB), U.S. generally accepted accounting principles (U.S. GAAP), and/or national standards. The use of U.S. GAAP is usually limited to those banking organizations or other companies whose securities are publicly traded on U.S. stock exchanges and are registered with the Securities and Exchange Commission. In many cases, these companies will also provide separate financial statements based on their national accounting standards and disclosure rules. The European Union will require all EU companies listed on EU exchanges that are currently following national standards to follow IASB standards by 2005 and will require those EU companies that currently follow U.S. GAAP to adopt IASB standards by 2007. The EU is also working to adopt international auditing standards for external audits of EU companies, including banks.

The IASB is now independent of the international accounting profession and independently funded. It has adopted many of the structural elements of the FASB in the United States, which are intended to promote an independent, objective standards-setting environment. Many senior American accounting experts serve on the IASB and its staff. IASB GAAP has many similarities with U.S. GAAP and the IASB plans to propose extensive enhancements to its standards later this year.

The Federal Reserve has long supported sound accounting policies and meaningful public disclosure by banking and financial organizations with the objective of improving market discipline and fostering stable financial markets. The concept of market discipline is assuming greater importance among international banking supervisors as well. The most recent proposal of the Basel Committee to amend Basel Capital Accord (called Basel II) seeks to strengthen the market's ability to aid bank supervisors in evaluating banking organizations' risks and assessing capital adequacy. It consists of three pillars, or tools: a minimum risk-based capital requirement (pillar I), risk-based supervision (pillar II), and disclosure of risks and capital adequacy to enhance market discipline (pillar III). This approach to capital regulation, with its market-discipline component, signals that sound accounting and disclosure will continue to be important aspects of our supervisory approach.

The Federal Reserve and the other U.S. banking agencies are also actively involved in the efforts of the Basel Committee to promote sound international accounting, auditing, and

disclosure standards and practices for global banking organizations and other companies. For example, an official of the Federal Reserve Board is a member of the Standards Advisory Council that advises the IASB and its trustees on its projects, proposals and standards. The U.S. banking agencies have been active in supporting the Basel Committee in its work with the IASB's technical advisory groups to enhance the IASB's standards for financial instruments and bank disclosures and the Basel Committee's projects with other international groups to promote sound global bank auditing practices.

In conclusion, I believe that the European Union should be encouraged to continue its program to strengthen and modernize the rules under which financial services firms operate in Europe. This can only increase competition, enhance efficiency and contribute to economic growth in the EU and globally. We are pleased that the European Commission is broadening its consultation and comment processes on proposals being considered under the FSAP. Supervisory and regulatory measures benefit significantly from an open and transparent process in which affected companies may participate. We would expect that the European Commission and member state national authorities will apply the FSAP's measures to U.S. firms on a fair and national treatment basis.

U.S. banking organizations are dynamic and more than competitive with the rest of the world. Accordingly, we are confident that U.S. firms will benefit from a strengthened and more efficient European market for financial services.

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Financial services: Commission proposes Directive on prudential supervision of financial conglomerates

The European Commission has presented a proposal for a Directive that would introduce group-wide supervision of financial conglomerates. The proposal would require closer co-operation and information sharing among supervisory authorities across sectors. The proposal would also introduce initial steps to align the rules for financial conglomerates with those for homogeneous financial groups (dealing in a single financial sector, such as banking) so as to ensure equivalence of treatment and a level playing-field. The proposal, a priority measure under the Financial Services Action Plan, has been prompted by continuing consolidation in the financial services sector that has created cross-sectoral financial groups with activities in both the banking/investment services and insurance sectors. The emergence of these groups, known as financial conglomerates, requires an appropriate regulatory framework.

Internal Market Commissioner Frits Bolkestein, said: "This proposal represents an important step forward towards an integrated European financial market and enhanced financial stability. The proposed regulatory framework would benefit consumers, depositors and investors in the European Union by stimulating financial market efficiency and increasing competition."

The creation of financial conglomerates calls for careful consideration of structures for containing and supervising risks arising in such groups. Cross-sector structures and operations may amplify existing risks in one specific sector, as well as create new risks. These risks should be adequately supervised. Where appropriate, inconsistencies between sectoral financial legislation that give rise to loopholes and opportunities for inappropriate circumvention of the regulations should be removed. The Commission's proposal would therefore introduce specific legislation for the prudential supervision of financial conglomerates. The three main objectives are:

- To ensure that the financial conglomerate has adequate capital. In particular the

proposed rules would prevent the same capital being counted twice over and so used simultaneously as a buffer against risk in different entities in the same financial conglomerate ('multiple gearing'). The proposal would also prevent "downstreaming" by parent companies whereby they issue debt and then use the proceeds as equity for their regulated subsidiaries ("excessive leveraging");

- To introduce methods for calculating a conglomerate's overall solvency position and
- To deal with the issues of intra-group transactions, exposure to risk and the suitability and professionalism of management at financial conglomerate level.

The proposal would also require Member States to ensure that an authority was designated to coordinate between the different supervisors involved in the group-wide supervision of financial conglomerates. The proposal thereby aims to enhance effective supervision of supervisors, both within and across financial sectors and borders. Finally, the proposal takes the necessary minimum steps to remove unnecessary inconsistencies between the regulations for homogeneous financial groups and for financial conglomerates, in order to ensure a minimum of equivalence in the treatment of these groups.

Background

Current financial regulation is still very much sector-based and addresses primarily homogeneous financial groups, namely those groups whose activities are limited either to banking/investment or to insurance. The ongoing consolidation of financial institutions, one of the most notable trends in financial markets over recent years, has led to the creation of cross-sectoral groups across the EU. Financial conglomerates hold a substantial share of the domestic financial markets in certain Member States. Some financial conglomerates belong to the biggest groups in the EU financial markets and provide financial services on a global basis. If the regulated entities in such a financial conglomerate were to face financial difficulties, these could seriously destabilise the financial system as a whole and adversely affect depositors, policy holders and investors throughout the EU. Currently these cross-sector financial groups are inadequately covered by existing legislation.

The implications for the supervision of banks, insurance undertakings and investment firms that are part of a financial conglomerate are now well recognised. The G-10 Joint Forum on financial conglomerates issued in 1999 a set of recommendations on the supervision of financial conglomerates. The proposal for a Directive takes account of consultations with Member States' experts and authorities and of the EU financial services industry (consultation paper issued in December 2000). The need for such an initiative was mentioned by the Economic and Finance Committee in its report on Financial Stability, which was endorsed by the Economic and Financial Affairs Council in May 2000.



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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 20.9.2002
SEC(2002) 995 final

2001/0095 (COD)

**COMMUNICATION FROM THE COMMISSION
TO THE EUROPEAN PARLIAMENT**

pursuant to the second subparagraph of Article 251 (2) of the EC Treaty

concerning the

Common Position of the Council on the adoption of a Directive of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and the Council

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1- BACKGROUND

Date of transmission of the proposal to the EP and the Council (document COM(2001) 213 final – 2001/0095(COD)) ¹ :	24 April 2001
Date of the opinion of the Economic and Social Committee ² :	17 October 2001
Date of the opinion of the European Parliament, first reading ³ :	14 March 2002
Date of adoption of the Common Position ⁴ :	12 September 2002

2- OBJECTIVE OF THE COMMISSION PROPOSAL

The heightened tempo of internationalisation and consolidation in the financial sector, together with the blurring of boundaries between financial sub-sectors, has led to the emergence of cross-sector financial groups involved in banking, insurance and securities activities ('financial conglomerates'). In some Member States the importance of financial conglomerates is quite significant and some of the biggest actors in the financial markets are financial conglomerates. It explains why a number of Member States have started introducing regulation and/or other supervisory measures at national level.

¹ OJ. C213E-31/7/2001 p.227.

² OJ. C36-8/2/2002 p.1.

³ Report A5-0060/2002.

⁴ 9754/3/02 Rev.3

European legislation however has not kept pace with this market evolution. In particular, the existing European legal framework for the supervision of financial institutions primarily deals with 'homogeneous' groups of financial institutions (banking groups, insurance groups or investment firm groups). A comprehensive set of rules on the prudential supervision of 'heterogeneous' financial groups combining institutions from the different financial sub-sectors is lacking. As a consequence, there is no appropriate regulation of such groups at conglomerate level. Therefore, the Financial Services Action Plan has identified legislation for supervising financial conglomerates to be a priority measure.

The Commission proposal for a Directive aims at addressing a major loophole in financial regulation by introducing a complementary supervisory regime for financial conglomerates that supplements the existing sectoral rules for credit institutions, insurance undertakings and investment firms. It will help to ensure European financial markets' stability and addresses concerns about systemic risks. In doing so, the Directive will also implement the G-10 Joint Forum recommendations regarding the supervision of financial conglomerates.

The main objectives of this Directive are:

- to ensure that financial conglomerates are adequately capitalised. In particular the proposed rules would prevent the same capital being counted twice over and so used simultaneously as a buffer against risk in different entities in the same financial conglomerate ('multiple gearing'). The proposal would also prevent "down-streaming of capital" whereby a parent company issues debt and uses the proceeds as equity for its subsidiaries ('excessive leveraging');
- to introduce methods for calculating a financial conglomerate's overall solvency position;
- to deal with the issues of intra-group transactions and group-exposure to risks;
- to deal with the suitability and professionalism of management at financial conglomerate level;
- to ensure adequate internal control mechanisms and appropriate risk management processes in a financial conglomerate;
- to require Member States to ensure that one single authority is appointed for the overview of each financial conglomerate and to ensure a co-ordination and proper exchange of information between the different supervisors involved in the supervision of a financial conglomerate's component parts;
- to introduce minimum steps to remove unnecessary inconsistencies between the regulations for homogeneous financial groups and for financial conglomerates, in order to ensure a minimum of equivalence in the treatment of these groups.

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FORM	SUBJECT/TITLE	PAGES	DATE	RESTRICTION(S)
Report	IAS v GAAP: Principles v Rules?	3	N.D.	P5;

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COLLECTION:

Council of Economic Advisers

SERIES:

Kroszner, Randall (Randy) - Subject Files

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RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

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U.S. Securities and Exchange Commission

Actions by FASB, IASB Praised

FOR IMMEDIATE RELEASE 2002-154

Washington, D.C., October 29, 2002 — The Chairman of the Securities and Exchange Commission today applauded the decisions by the Financial Accounting Standards Board and the International Accounting Standards Board to work together toward greater convergence between U.S. Generally Accepted Accounting Principles and international accounting standards.

"This is a positive step for investors in the U.S. and around the world," said SEC Chairman Harvey L. Pitt. "It means that reducing the differences in two widely used sets of accounting standards will receive consideration by both boards, as they work to improve accounting principles and address issues in financial reporting."

SEC Commissioner Roel C. Campos, who has been the Commission's participant in recent meetings of the International Organization of Securities Commissions, added: "I find it encouraging that interested parties in all countries can contribute their thinking. It is clear that investors globally could benefit to the extent that transparency and high quality information might be provided by a common worldwide approach."

Chairman Pitt and Commissioner Campos noted that international accounting standards have been a subject of interest for many years, and that the subject has received increased prominence with the decision of the European Union to adopt IAS in 2005, as well as similar actions being taken or considered in a number of other countries. They also noted that an effective infrastructure for interpretation and enforcement of accounting standards, and cooperation among regulators, will be critical to realizing the benefits of convergence.

"For years, many have believed that a desirable goal someday would be to move towards a single set of high quality accounting standards around the world," Pitt said. "Now the time frame has a more immediate focus. With so many new users of IAS coming in 2005, in Europe and elsewhere, there is a great opportunity to focus attention on ways to improve information for investors while working for greater convergence in both the short term and the long term."

Memorandum of Understanding

"The Norwalk Agreement"

At their joint meeting in Norwalk, Connecticut, USA on September 18, 2002, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) each acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. At that meeting, both the FASB and IASB pledged to use their best efforts to (a) make their existing financial reporting standards fully compatible as soon as is practicable and (b) to coordinate their future work programs to ensure that once achieved, compatibility is maintained.

To achieve compatibility, the FASB and IASB (together, the "Boards") agree, as a matter of high priority, to:

- a) undertake a short-term project aimed at removing a variety of individual differences between U.S. GAAP and International Financial Reporting Standards (IFRSs, which include International Accounting Standards, IASs);
- b) remove other differences between IFRSs and U.S. GAAP that will remain at January 1, 2005, through coordination of their future work programs; that is, through the mutual undertaking of discrete, substantial projects which both Boards would address concurrently;
- c) continue progress on the joint projects that they are currently undertaking; and,
- d) encourage their respective interpretative bodies to coordinate their activities.

The Boards agree to commit the necessary resources to complete such a major undertaking.

The Boards agree to quickly commence deliberating differences identified for resolution in the short-term project with the objective of achieving compatibility by identifying common, high-quality solutions. Both Boards also agree to use their best efforts to issue an exposure draft of proposed changes to U.S. GAAP or IFRSs that reflect common solutions to some, and perhaps all, of the differences identified for inclusion in the short-term project during 2003.

As part of the process, the IASB will actively consult with and seek the support of other national standard setters and will present proposals to standard setters with an official liaison relationship with the IASB, as soon as is practical.

The Boards note that the intended implementation of IASB's IFRSs in several jurisdictions on or before January 1, 2005 require that attention be paid to the timing of the effective dates of new or amended reporting requirements. The Boards' proposed strategies will be implemented with that timing in mind.

The Accounting Version of U.S. vs. Europe

By Paul Koster

09/05/2002

The Wall Street Journal Europe

Page A8

(Copyright (c) 2002, Dow Jones & Company, Inc.)

With the end of summer we can expect renewed interest in the supposed failings of U.S. accounting standards, and criticism that they're too detailed and too rules-based. Indeed, European Commission representatives are due back in Washington again this month to continue promoting the supposed merits of Europe's main system, the International Accounting Standards over the U.S. Generally Accepted Accounting Principles. But a word of caution might be appropriate in this IAS promotion campaign.

In the eyes of its critics, GAAP's strict adherence to rules resulted in the Enron debacle. Frits Bolkestein, the European commissioner for the internal market, has famously bragged that Enron would not have been possible under IAS. The argument for IAS is that it's better equipped to avoid misleading financial statements because auditors have to apply the "true and fair" override principle.

This principle forces auditors to look at the total economic picture of the company as presented in the financial statements, and to override an accounting standard if this standard would distort the economic picture of the company and thus make the statement misleading. An application of IAS -- so goes the argument -- would have forced Enron to include in its balance sheet its so-called special purpose vehicles.

Enron created special purpose vehicles with the sole purpose, it now seems, to disguise debt on its balance sheet. By finding equity holders with only 3% of the total equity to hold this debt, Enron was allowed under U.S. GAAP to include these vehicles in the footnotes and to leave them out of the balance sheet. This deprived investors of critical information about the economic aspects of Enron's operations. Hiding these vehicles in the footnotes would, however, have been a direct violation of the IAS "true and fair" test.

This is the bulk of the argument of those who suggest that the U.S. would do better to throw out GAAP and introduce IAS. But far too much has been made of this true and fair override principle. It is included in the spirit of GAAP if not in the wording, and this has had real-life consequences.

In *U.S. v. Simon*, the Second U.S. Circuit Court of Appeals found three auditors guilty of fraud after they certified fraudulent financial statements which were nonetheless in full compliance with GAAP. The judge in that 1970 case wrote that "if literal compliance with GAAP creates a fraudulent or materially misleading impression in the minds of shareholders the accountants could and would be held criminally liable."

Even a strict application of GAAP supplemented by a statement on whether, in the opinion of the auditors, a reader would have all the information necessary to understand what has truly

happened at the company, would make GAAP superior to IAS. This is why it is very unlikely that the U.S. will be willing to consider abandoning GAAP in favor of IAS.

The American officials who meet the EU delegation would do well to remind their guests that GAAP is the result of decades of development and practical experience, which have led to incredible refinement (though admittedly, a result of this has been the inclusion of too much detail, which sometimes can be confusing). IAS by comparison has just begun. One should not just blithely ignore this difference in the experience level.

Not one of IAS's 34 standards -- which formulate rules to be observed in the presentation of financial statements -- has ever benefited from being challenged in court or by regulators, mainly because no company has been legally forced in Europe to comply with IAS yet. It won't be till 2005 that most European companies have to comply with IAS, a handful of companies having been granted an extension till 2007. So it won't be for at least three years that we will start to see European regulators and courts challenge the IAS.

Such challenges will start the refinement process that GAAP has endured for decades. With the test of real life experience, the International Accounting Standards Board might discover that some of the IAS accounting standards are too broadly defined and would require more rules to explain them. This might make IAS in the end more similar to U.S. GAAP.

Rather than a wholesale adoption by one side of the other's standard, the U.S. and Europe might try to focus on differences in a limited number of core standards that create the biggest chasm between GAAP and IAS. The IASB is expected later this year to focus on some of these core standards, including those dealing with the valuation of financial instruments, the treatment of business combinations and accounting for share options. Down the line, the IASB is also expected to take up leasing and revenue recognition.

If the U.S.-based Financial Accounting Standards Board and the European IASB are able to reach a consensus on these core standards, wholesale adoption can be avoided. This would amount to progress for companies, which could then be allowed to file under U.S. GAAP or IAS without having to reconcile the two, provided the companies strictly adhered to these core standards.

This suggested harmonization, limited to the four to five core standards, should be combined with an serious attempt by the accounting standard setters to speed up the process of standard setting. Accounting standards setters should keep pace with important economic developments and trends, thus bringing investors better and more topical standards and a valuable contribution to restore confidence in the financial markets. That's the better way to avoid another Enron.

Mr. Koster, an accountant, is a member of the executive board of the Netherlands Authority for the Financial Markets.

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FORM	SUBJECT/TITLE	PAGES	DATE	RESTRICTION(S)
Report	FASB Proposal, "Principles-Based Approach to U.S. Standard Setting"	1	10/21/2002	P5;

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