

The Equivalence Approach to Securities Regulation

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TABLE OF CONTENTS

I. Introduction	2
II. The Concept of “Equivalence”	5
A. A Working Definition	5
B. The Dominant Understanding	5
C. A Counterpoint Understanding	7
D. A Market-Based Test for Equivalence.....	10
III. Examples of Equivalence.....	12
A. U.S. GAAP and IAS	13
1. U.S. GAAP in the U.S.	13
2. IAS in the E.U.....	15
3. U.S. GAAP in the E.U.	17
4. IAS in the U.S.	20
B. The E.U. Financial Conglomerates Directive	23
C. U.S. Regulation of Auditors.....	31
D. U.S.-Canada Multi-Jurisdictional Disclosure System.....	34
IV. Evaluating Equivalence	37
A. Potential Benefits	37
1. Reducing Transaction Costs	37
2. Feasibility.....	40
3. Flexibility to Address Real Differences.....	43
4. Competition of Rules	45
B. Potential Pitfalls	46
1. Insufficient Protection for Host Country Investors.....	46
2. Lack of Transparency	51
3. Competitive Advantage and Competitive Disadvantage	53
4. The Dilemma of Mutual Benefit and Reciprocity	54
V. Conclusion	60

I. Introduction

It is undisputed that the world's financial markets are becoming increasingly international and increasingly integrated. "How should regulators respond?" is an issue that that is hotly contested. The academic literature debates two competing approaches to international securities regulation – "harmonization" and "regulatory competition." Harmonization is the idea that rules and regulations should be standardized across countries as much as possible. Countries may achieve harmonization by ceding lawmaking authority to an international body or agency, or alternatively, countries may agree to enact similar rules through their normal, domestic rule-promulgating procedures. In contrast to the harmonization approach stands the regulatory competition approach. Under this model, countries do not coordinate with one another – each country is free to enact whatever rules and regulations it chooses.

Each approach has its merits. The main argument for harmonization is that it reduces transaction costs. Absent harmonization, it can be costly for multinational corporations to comply with different and perhaps conflicting regulatory regimes. Harmonization ameliorates this problem, and in particular, full harmonization eliminates the problem completely, as companies only need to comply with one set of regulatory requirements. Harmonization also has other benefits. Proponents argue that it reduces the cost of information, internalizes externalities across jurisdictions, achieves economies of scale, enhances the mobility of market participants, and prevents a regulatory "race to the bottom."

On the other hand, advocates of regulatory competition assert that countries should not restrict themselves to a one-size-fits-all approach. Different countries should

be able to enact different laws to accommodate different preferences and experiences. The regulatory competition model allows countries to tailor their laws to country-specific circumstances. Additionally, regulatory competition fosters innovation, because countries must compete with each other to attract market participants, and they attract market participants by offering the most efficient regulatory environment. Companies will choose to issue securities in countries where the regulation is not so strict that the cost of compliance is prohibitively high and also where the regulation is also not so lax that investors require excessively high returns to compensate for the additional risks they bear. Over time, financial activities will concentrate in countries that provide the “best” regulation. Also, the overall quality of financial markets regulation in the world will improve, as regulators learn through experimentation and trial-and-error.¹

Amidst the debate between harmonization and regulatory competition, a third approach to securities regulation has emerged in recent years – the “equivalence” approach to regulation. Under the equivalence approach, a host country exempts foreign firms from certain host country rules when the firms’ home country rules are sufficiently similar, or “equivalent.” The equivalence approach represents a compromise between harmonization and regulatory competition. Like harmonization, equivalence seeks to reduce the cost of doing business internationally; like regulatory competition, equivalence allows countries to experiment with slightly different rules and regulations.

¹ For a flavor of the harmonization-versus-regulatory-competition debate, *see, e.g.* Uri Geiger, The Case for the Harmonization of Securities Disclosure Rules in the Global Market, 1997 COLUM. BUS. L. REV. 241 (1997); Roger Van der Bergh, *Regulatory Competition or Harmonization of Laws? Guidelines for the European Regulator* in THE ECONOMICS OF HARMONIZING EUROPEAN LAW (2002); Roberta Romano, *The Need for Competition* in INTERNATIONAL SECURITIES REGULATION, YALE LAW SCHOOL JOHN M. OLIN CENTER FOR STUDIES IN LAW, ECONOMICS, AND PUBLIC POLICY WORKING PAPER SERIES (2001).

This paper proceeds as follows. Part II defines “equivalence” and discusses three different ways to understand the concept. Part III provides four examples of equivalence: (1) U.S. and E.U. accounting standards, (2) E.U. regulation of financial conglomerates, (3) U.S. regulation of auditors, and (4) the U.S.-Canada Multi-Jurisdictional Disclosure System.

Part IV evaluates the equivalence approach, listing some benefits as well as some potential pitfalls. This portion of the paper demonstrates that like harmonization, equivalence lowers transaction costs, but has the added advantage of being more feasible and more sensitive to real differences between countries. The danger, however, is that equivalence may diminish investor protection. Additionally, one problem that is sometimes overlooked is that equivalence does not automatically ensure mutual benefit or reciprocity. The principles of mutual benefit and reciprocity are often the basis for international cooperation – a country is unlikely to voluntarily yield to the demands of another country without some assurance that it will receive some benefit in return. In the case of equivalence, a country is unlikely to recognize another country’s regulations as equivalent without some assurance that the other country will reciprocate and recognize the first country’s regulations as equivalent. In the past, regulators failed to recognize this problem and ran into difficulties. More recently, regulators are beginning to address these concerns more explicitly, and equivalence is evolving into “equivalence-plus-reciprocity,” where one country agrees to accept a second country’s regulations as equivalent on the condition that the second country also accepts the first country’s regulations as equivalent. Equivalence becomes a bilateral determination rather than a unilateral determination.

II. The Concept of “Equivalence”

A. A Working Definition

As we shall see, “equivalence” is difficult to define. The basic idea is that a host country exempts foreign firms from certain domestic rules when the home country’s rules, to which foreign firms are subject, are sufficiently similar, or “equivalent.” This approach presumes that there are some differences between host country rules and home country rules, but to say that the rules are “equivalent” is to say that the disparities are not significant. Hence, equivalence does not mean that two sets of rules are “the same,” only that they are “close enough,” or functionally substitutable. In this sense, equivalence is different from full harmonization, which attempts to bring two sets of rules into full accordance with one another. Equivalence demands only partial accordance, such that the policy objectives of the host country are adequately served by the regulatory scheme of the home country.²

B. The Dominant Understanding

Equivalence enjoys increasing prevalence largely due to the efforts of European regulators. E.U. regulators tout equivalence as a way to dismantle legal barriers to international financial integration, and they apply equivalence widely, both in the cross-Atlantic context and in the E.U. internal markets context.

In addition to embracing equivalence themselves, European regulators have encouraged their American counterparts to do the same. In 2004, Alexander Schaub,

² See Alexander M. Donahue, *Equivalence: Not Quite Close Enough for the International Harmonization of Environmental Standards*, 30 *Envtl. L.* 363, 367-70 (2000) (discussing “harmonization” and “equivalence” in the context of environmental regulations).

head of the E.U. Internal Market Directorate-General, testified before the Committee on Financial Services of the U.S. House of Representatives to advocate equivalence as a basis for E.U. and U.S. cooperation:

But what all this comes down to in our view is that convergence alone is not the solution. In many cases convergence of details may not be practicable, not just between the EU and US, but even intra-EU and between States of the US. If we are to go forward, we will have to recognize that in some cases what is important is not that we take identical approaches, but that we agree that we have broadly equivalent approaches and that we share the same goal.

Before compelling service providers or businesses to comply with the full set of local rules – including ones which may even contradict those which they are asked to meet in their home jurisdiction – regulators and supervisors should follow a “rule of reason” approach. They should ask themselves whether the ways in which those companies are regulated in their home jurisdiction meet comparable or *equivalent* prudential and investor protection standards to those achieved by local rules. If there is indeed *equivalence*, it would not add to the quality of regulatory protection to insist on compliance with local rules; it would simply create an unnecessary hurdle to services being offered to those investors. That cannot be in the interests of either the EU or the US.

Working on the basis of *equivalence* is not an admission of defeat: it is a healthy recognition by both sides that there can be more than one way to achieve a common objective. [emphasis added]³

In making his case for equivalence, Schaub posits a specific type of relationship between “equivalence” and “harmonization” (to be precise, Schaub employs the term “convergence,” but this paper treats “harmonization” and “convergence” as interchangeable⁴). Here, harmonization and equivalence are entirely distinct concepts.

³ Alexander Schaub, DG Internal Market of the European Commission, Testimony before the Committee on Financial Services, U.S. House of Representatives (May 13, 2004), *available at* <http://financialservices.house.gov/media/pdf/051304as.pdf> (last visited Feb. 23, 2006).

⁴ Like equivalence, convergence sometimes seems too amorphous an idea to define with precision. One U.S. regulator quipped, “I am not sure I can define ‘convergence,’ but I will know it when I see it. Trust me!” Nevertheless, the regulator ventures the following thought: “Convergence is the movement of two or more sets of standards toward each other at a relatively high level, producing identical or nearly identical principles of regulatory purpose.” Roel C. Campos, SEC Commissioner, *Convergence and Beyond*, Speech at the U.S. - Europe Symposium: Program on International Financial Systems, Armonk, N.Y. (November 15, 2003), *available at* <http://www.sec.gov/news/speech/spch111503rcc.htm> (last visited Feb. 23, 2006). Thus described, convergence seems closely related to the notion of harmonization, which was discussed

Harmonization pushes for rules to become similar. Equivalence allows differences to persist. Though distinct, the harmonization and equivalence can be complementary. Harmonization is often a starting point. In actuality, however, full harmonization is rarely possible. Despite the best efforts of regulators to harmonize, differences between regulatory regimes usually remain. This may be because there is political opposition to legal reform, or it may be because the situation is such that it is preferable to converge only core principles and to allow slight variations in details. In such instances, the European view is that regulators should shift to the equivalence approach to regulation as a *substitute* for the harmonization approach. As long as there is broad equivalence between two regulatory systems, the host country regulator should defer to home country regulation. Forcing foreign companies to comply with local regulation is unnecessary – it would be costly and would not add significantly to investor protection. On this view, equivalence does not represent defeat in the reach for harmonization, but rather it is a way to allow different countries to accomplish similar ends, through different means.

C. A Counterpoint Understanding

Despite the efforts of E.U. regulators, some U.S. regulators remain skeptical about equivalence. To give one example, following the E.U.’s announcement that, unless it finds U.S. supervision to be “equivalent” to E.U. supervision, the E.U. will exercise supervisory power over U.S. financial conglomerates with subsidiaries in Europe, one U.S. regulator retorted, “to the extent that ‘equivalence’ signals an effort to harmonize both regulatory regimes, we welcome the effort. To the extent ‘equivalence’ is really a

earlier. One slight difference may be that convergence may be somewhat broader than harmonization, encompassing situations where there is less than full harmonization – situations where regulatory systems are harmonized at the level of general principles, but where they diverge at level of specific rules.

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.”⁵ This regulator made clear her distrust of the E.U.’s equivalence regime. And while not all U.S. regulators are “anti-equivalence,” there is sizable U.S. opposition that extends beyond the financial conglomerates context. Some U.S. regulators even avoid the term “equivalence” whenever possible. As the foregoing quote illustrates, these regulators prefer instead to talk in terms of “harmonization” or “convergence.”

More fundamentally, these U.S. regulators express a different view about the relationship between “harmonization” and “equivalence” than the European view. They insist that harmonization and equivalence are more alike than distinct – like harmonization, equivalence should focus on making rules more similar rather than acknowledge persistent differences. One SEC commissioner wonders whether it ever makes sense to think of “equivalence” as distinct from “harmonization,” asking, “[C]an you determine that equivalence has occurred if there is no harmonization? In that vein, can you reach ‘equivalence’ if you have only a small amount of ‘harmonization?’ If so, how much harmonization produces equivalence? And, finally, what exactly is ‘equivalence’ afterall?”⁶ Under this interpretation, equivalence cannot substitute for harmonization, as Europeans believe, but instead, harmonization produces equivalence. In other words, two regimes become “equivalent” *after* regulators work to make them converge. Conversely, if two dissimilar regulatory schemes never converge, at least to some degree, then they can never be equivalent.

⁵ Annette L. Nazareth, Director, Division of Market Regulation at the SEC, Concerning Certain Pending Proposals by the European Commission, Testimony before the Committee on Financial Services, United States House of Representatives, May 22, 2002, *available at* <http://www.sec.gov/news/testimony/052202tsaln.htm> (last visited Feb. 16, 2006).

⁶ Campos, *supra* note 4.

So we have two competing understandings of equivalence – the dominant understanding that equivalence can sometimes be a substitute for harmonization, and the counterpoint understanding that equivalence cannot exist without harmonization. What is the significance of this debate? What is really at stake here? On the U.S. side, one hypothesis is that some U.S. regulators are worried that the equivalence approach may result in less rigorous regulations and less protection for U.S. investors. These regulators are afraid that the U.S. may be forced to accept E.U. regulations as equivalent, when in fact, E.U. regulations are too lax. Before they are willing to defer to E.U. regulation, they want to make sure that that E.U. regulation is on par with U.S. regulation – hence, they insist on convergence as a prerequisite for equivalence. Later in this paper, we will revisit the issue of investor protection.

European regulators, in turn, are wary that when U.S. regulators advocate “convergence” instead of “equivalence,” what U.S. regulators are really talking about is not bilateral compromise, but for the E.U. conform to the U.S. way of regulating. For this reason, the European Commissioner for Internal Market and Services responded to a push by the U.S. for convergence between U.S. GAAP and IAS by insisting that, “the convergence exercise must be a two way street and it must not be allowed to destabilise the IFRS platform in Europe.”⁷ To rephrase the Commissioner’s concern, if the U.S. dominates the convergence project, Europe will view this as an intrusion of European regulatory prerogatives. This is another issue we will revisit – whether convergence is

⁷ See Charlie McCreevy, EC Strategy on Financial Reporting: Progress on Convergence and Consistency, Speech at European Federation of Accountants' (FEE) Seminar on International Financial Reporting Standards (IFRS) (December 1, 2005), *available at* <http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/05/750&format=HTML&aged=0&language=EN&guiLanguage=en> (last visited Mar. 02, 2006).

sometimes politically infeasible, because it is perceived as violating national sovereignty, and if so, whether equivalence can serve as a second-best alternative.

In short, regulators are engaged in a contentious debate over the definition of “equivalence.” This debate is complicated by fundamental disagreements over what the practical effects of “equivalence” and “convergence” will be – e.g. whether equivalence will result in less investor protection, and whether “convergence” means conforming to U.S. regulations. The remainder of this paper further investigates the concept of “equivalence” by examining the advantages and disadvantages of equivalence compared to other regulatory approaches. Part III examines some examples of equivalence, and Part IV draws from these specific examples to make some general observations about equivalence. But before turning to these topics, we briefly address a third way of understanding equivalence, one which has been articulated by economists and other academics, but one which as yet, has not been expressly endorsed by regulators.

D. A Market-Based Test for Equivalence

Both the dominant understanding and the counterpoint understanding of equivalence focus heavily legal similarities and differences. Both ask questions such as: What are the substantive laws in different countries? Are these substantive laws similar or different? If the substantive laws are similar, is enforcement of laws similar or different? An alternative approach is to focus on economic effects rather than law *per se*. Here, the appropriate questions are: How do regulations affect capital markets? Are these effects similar or different? How do market participants react to the regulations? Under this view, two regulatory regimes that have different legal characteristics may nonetheless be “equivalent” if they produce the same economic effects, i.e. capital

markets treat the regimes as interchangeable. This can be called the market-based test for equivalence.

One study⁸ applies the market-based test to compare U.S. Generally Accepted Accounting Principles (U.S. GAAP) with International Accounting Standards (IAS). The precise issue in the study is whether one accounting standard is better than the other in terms of reducing information asymmetries. This study examines firms that traded in Germany's "New Market" during 1999 and 2000. One listing requirement was that firms must prepare and publish annual financial statements in accordance with either IAS or U.S. GAAP. In either case, firms faced the same regulatory environment. The study compares IAS firms and U.S. GAAP firms using various proxies for information asymmetry – bid-ask spread, share turnover, analysts forecast dispersion, and IPO underpricing. The study finds that the choice of IAS or U.S. GAAP did not affect information asymmetry. One interpretation (the study suggests a couple) is that IAS and U.S. GAAP financial statements are of comparable quality; market participants do not distinguish between the two standards. On this view, one might deem IAS and U.S. GAAP to be "equivalent."

This market-based understanding of equivalence has yet to be embraced by regulators. Furthermore, it is not clear that a market-based test always exists – the above study, for example, draws from a very unique factual situation, and the study warns against generalizing beyond the German New Market context. Nevertheless, the market-based understanding is important, because it supplies one possible answer to a question that plagues both the dominant understand and the counterpoint understanding – the

⁸ Christian Leuz, *IAS versus US GAAP: Information-Asymmetry Based Evidence from Germany's New Market*, JOURNAL OF ACCOUNTING RESEARCH (2003).

question “how close is close enough?” The market-based test response is that two sets of rules are “close enough” when they produce the same economic effects in capital markets.

III. Examples of Equivalence

Equivalence is not unique to international finance. It has long been used in other areas of law, such as antitrust law, international trade law and environmental law. One example is from the World Trade Organization Uruguay Round negotiations in 1994. During these talks, participants discussed how to regulate food safety and animal and plant health. The resulting Agreement on Sanitary and Phytosanitary Measures recognized that governments have the right to enact sanitary and phytosanitary regulations, but only to the extent necessary to protect human, animal or plant life or health. Also, regulations should not arbitrarily or unjustifiably discriminate WTO member nations where identical or similar conditions prevail. The Agreement further encouraged countries to harmonize sanitary and phytosanitary measures by using international standards where possible. However, where differences persist, “Members shall accept the sanitary or phytosanitary measures of other Members as *equivalent*,... if the exporting Member objectively demonstrates to the importing Member that its measures achieve the importing Member’s appropriate level of sanitary or phytosanitary protection” (emphasis added).⁹ Essentially, the importing country will defer to the exporting country’s regulations, if it deems those regulations equivalent to its own. The U.S. ratified and codified this equivalence approach in 19 U.S.C. § 2578a (1994).¹⁰

⁹ Agreement on Sanitary and Phytosanitary Measures, *available at* http://www.wto.org/english/docs_e/legal_e/legal_e.htm (last visited Feb. 23, 2006).

¹⁰ For a discussion of equivalence in the food and drug law and international trade context, *see* Linda Horton, *Mutual Recognition Agreements and Harmonization*, 29 Seton Hall L. Rev. 692 (1998). For a discussion of equivalence in the environmental law context, *see supra* note 2.

Securities regulators have borrowed the concept of equivalence and applied it in a number of instances. The following are some examples.

A. U.S. GAAP and IAS

Currently, U.S. securities law requires companies to state their financial statements in U.S. GAAP, while E.U. law requires that statements be prepared in accordance with IAS. The fact that the U.S. and the E.U. employ different, sometimes incompatible accounting standards imposes significant costs on companies that issue securities in both markets, and there have been several attempts to address this problem. Through the 1990s, the SEC sought to ease the requirement on foreign issuers to reconcile their foreign financial statements to U.S. GAAP. Then in 2002, the Financial Accounting Standards Board (FASB), the promulgator of U.S. GAAP, and the International Accounting Standards Board (IASB), the standard-setter for IAS, announced the Norwalk Agreement, which aimed at reducing differences between IAS and U.S. GAAP. More recently, the European Commission has declared that it will allow U.S. companies to use U.S. GAAP in the E.U. if it determines that U.S. GAAP is equivalent to IAS. The SEC also announced a “roadmap,” which may lead to the use of IAS in the U.S. This section discusses these developments in more detail.¹¹

1. U.S. GAAP in the U.S.

In the U.S., under the Securities Exchange Act of 1934, the SEC has authority to establish accounting principles for businesses under its jurisdiction. Generally, the SEC has allowed the accounting profession and the private sector to self-regulate the

¹¹ This section draws from Stavros Gkantinis, *IFRS and US GAAP: Convergence and Equivalence* (2005) (paper on file with author).

accounting practice. Since 1973, the SEC has designated FASB, a private organization, the standard-setter of accounting principles. FASB establishes U.S. accounting standards by publishing several types of documents. The most important publication is the Statement of Financial Accounting Standard. The Statement of Financial Standard sets forth new accounting standards, the effective date and method of transition, background information, a brief summary of research done on the project, and the basis for the Board's conclusions. To further clarify the application of its Statements, FASB issues Interpretations. Interpretations modify or extend existing standards. Additionally, when businesses apply FASB Standards and Interpretations, they sometimes encounter difficulties or uncertainties, and they may ask FASB staff to provide further clarification. When fielding these questions, FASB staff may decide that some have widespread relevance and may wish to disseminate guidance more broadly. In this case, the staff may issue a Staff Position. Staff Positions are also used to make narrow and limited revisions to Statements or Interpretations. Finally, FASB publishes Statements of Concepts. Statements of Concepts do not announce new accounting standards; instead, they provide a general framework and agenda that FASB will follow to formulate new standards in the future. Together, these various FASB pronouncements, along with non-superseded statements by FASB's predecessors and certain SEC's accounting rules, form U.S. GAAP.¹²

Until 2002, Congress placed few restrictions on the SEC's authority to delegate the power to establish accounting rules to a private entity. Then in 2002, Congress passed the Sarbanes-Oxley Act, which includes a provision stating that before the SEC

¹² See <http://www.fasb.org> (last visited Feb. 7, 2006); DAVID R. HERWITZ & MATTHEW J. BARRETT, ACCOUNTING FOR LAWYERS 132-144 (2001).

may recognize a private entity as the standard setter of accounting principles, the SEC must verify that the private entity meets several requirements. The entity must (1) have a board of trustees, the majority of whom are not associated with any public accounting firm, (2) be funded as provided in section 109 of the Sarbanes-Oxley Act of 2002, (3) have procedures to ensure prompt consideration of changes to accounting principles necessary to reflect emerging accounting issues and changing business practices, and (4) consider the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest.¹³

2. IAS in the E.U.

In Europe, until recently, there did not exist a set of continent-wide accounting rules; accounting was the domain of national governments. Then in 2002, the European Council and Parliament adopted IASB as the E.U. counterpart to FASB by passing the IAS Regulation, which required E.U. companies listed in the European Union to use IAS starting in January 1, 2005.¹⁴ IASB, like FASB, is a private organization, but one difference is that IASB purports to be an international organization, which aims to set accounting standards for the world's capital markets.¹⁵

While the E.U. recognizes IASB as the standard-setter, the E.U. does not automatically defer to the IASB on accounting issues. When the IASB promulgates a new accounting standard, this standard undergoes an endorsement process in which the European Commission reviews whether the standard meets several requirements. The

¹³ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 108(a), 116 Stat. 745, 768 (2002). For additional discussion, *see also* Andreas M. Fleckner, *FASB and IASB: Organization and Influence* 15 (2005) (on file with author).

¹⁴ Regulation (EC) no. 1606/2002 of the European Parliament and of the Council (2002).

¹⁵ *See* INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE FOUNDATION CONSTITUTION (July 2005), Part A Sec. 2(a). *See also* Fleckner, *supra* note 13, at 6 (2005).

proposed standard must (1) not be inconsistent with the requirement that annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss, (2) be conducive to the European public good, and (3) meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.¹⁶ Only once the Commission is satisfied that an IASB standard meets these requirements may it adopt the standard by passing a new regulation.

This endorsement process is not mere formality. One particularly controversial IASB accounting standard was IAS 39, which dealt with the accounting of derivatives. In its initial proposal, IASB permitted entities to record derivatives at fair market value, as opposed to historical cost. The European Commission disagreed, arguing first that fair market value is not always easily verifiable, and second that the proposed standard would lead to increased earnings volatility. After extended discussions with European regulators, IASB made some concessions, and the final IASB version of the standard imposed various limits on the use of the fair value option. Nevertheless, the Commission remained less than fully satisfied and carved out portions of the IASB standard before adopting an incomplete version of IAS 39 in 2004. In 2005, IASB continued to work with the Commission, and the two parties were able to resolve some disagreements. This led the Commission to amend its IAS 39 regulation in November 2005; nevertheless, differences remain between the E.U. version of IAS 39 and the IASB's version of IAS 39.¹⁷

¹⁶ Art 3(2), Regulation (EC) no. 1606/2002 of the European Parliament and of the Council (2002).

¹⁷ For a more detailed discussion, *see* HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 69-70 (Foundation Press, 13th ed., forthcoming 2006) (on file with author).

In summary, the U.S. and the E.U. are separated not only by the Atlantic, but also by differences in accounting. Many are working to bridge these differences. In 2002, FASB and IASB announced the Norwalk Agreement, which aimed to converge IAS and U.S. GAAP.¹⁸ The Norwalk Agreement was not an official agreement between the U.S. government and the E.U. government, but a private agreement between two nongovernmental entities. Nevertheless, it was an important development and was praised by U.S. and E.U. regulators.¹⁹ Currently, while the Norwalk project remains ongoing, significant differences remain between the two accounting systems, and there is no indication that the Norwalk Agreement will yield full convergence, at least not within the short-term. Meanwhile, the SEC and the European Commission have undertaken their own efforts at addressing the trans-Atlantic accounting problem. We now address these efforts.

3. U.S. GAAP in the E.U.

Previously, accounting in Europe was only regulated at the nation-state level. Generally, member states permitted U.S. companies listed in Europe to publish their accounts in U.S. GAAP. Recently, however, the E.U. passed two Directives – the Prospectus Directive and the Transparency Directive – that will soon require foreign companies listed in Europe to state their financial statements in IAS starting January 1, 2007. Under the Prospectus Directive, non-E.U. issuers conducting a public offering within the E.U. will need to publish a prospectus, which must include financial

¹⁸ Memorandum of Understanding between FASB and IASB, “The Norwalk Agreement”, dated September 18, 2002, *available at* http://www.fasb.org/intl/convergence_iasb.shtml (last visited Dec. 12, 2005).

¹⁹ Press Release, Securities and Exchange Commission, Actions by IASB, FASB praised (Oct. 29, 2002), *available at* <http://www.sec.gov/news/press/2002-154.htm> (September 8, 2005). Press Release, European Commission, Financial Reporting: European Commission welcomes IASB/FASB convergence agreement (Oct. 29, 2002).

statements prepared in accordance with IAS.²⁰ Under the Transparency Directive, non-E.U. issuers whose securities are traded on an E.U. market will have to provide annual and half-yearly financial statements prepared in accordance with IAS.²¹

However, there is an important exception. Recognizing that the IAS requirement imposes a significant obstacle for companies, the E.U. has indicated that it may accommodate certain foreign companies using the equivalence approach. Specifically, non-E.U. companies will be able to use non-IAS accounting standards if the European Commission determines that such standards are equivalent to IAS.²²

For assistance in making the equivalence determination, the Commission turned to the Committee of the European Securities Regulators (CESR), an advisory committee of European regulators, and asked the committee for an assessment of whether certain non-IAS accounting standards, including U.S. GAAP, are equivalent to IAS. CESR responded, first, by publishing a Concept Paper discussing what “equivalence” means in the accounting context and the methods and criteria CESR will use for making its equivalence determinations.²³ CESR explained that "equivalent" should not mean “identical”; instead, CESR will focus on whether non-IAS standards provide sufficient information to enable investors to make similar decisions in terms of whether to invest or divest, as if they were provided with IAS financial statements. CESR also explained that for each non-IAS accounting standard, it will make three assessments. First, CESR will evaluate the non-IAS standard against four characteristics – relevance, understandability,

²⁰ Directive 2003/71/EC of the European Parliament and of the Council, November 4, 2003.

²¹ Directive 2004/109/EC of the European Parliament and of the Council, December 15, 2004.

²² Article 20, Directive 2003/71/EC of the European Parliament and of the Council, November 4, 2003; Article 23, Directive 2004/109/EC of the European Parliament and of the Council, December 15, 2004.

²³ CESR, “Concept Paper on Equivalence of Certain Third Country GAAP and on Description of Certain Third Countries Mechanisms of Enforcement of Financial Information,” Ref:CESR/04-509C (February 2005). Available at http://www.cesr-eu.org/data/document/04_509c.pdf (last visited Apr. 30, 2006).

reliability and comparability; investors should be able to take economic decisions on the basis of understandable, relevant, reliable and comparable information about the issuer's assets and liabilities, financial position and profit or loss. Second, CESR will conduct a technical assessment, meaning that it will examine the accounting principles, concepts, and rules of the non-IAS accounting standard to determine whether any differences with IAS are significant. Third, if IAS finds that there is non-equivalence due to significant differences between the two accounting standards, it will consider what remedy would be appropriate, and whether issuers should be required to restate their financial statements, or whether there may be more limited remedies.

Applying this methodology, CESR studied the accounting standards used in three countries: the U.S., Canada and Japan. The group published its findings in June 2005.²⁴ CESR concluded that these three GAAPs, each taken as a whole, are equivalent to IAS, subject to some conditions. With respect to U.S. GAAP, the conditions were (1) that certain companies that have subsidiaries which are not consolidated for U.S. GAAP purposes, but are required to be consolidated under IAS, must include unconsolidated entities on their U.S. GAAP pro-form balance sheets and income statements, (2) that the U.S. adopt accounting policies for the expensing of stock options on a basis equivalent to IAS, and (3) that with respect to certain IAS standards that are significantly different from U.S. GAAP, U.S. companies make additional disclosures.²⁵ The option expensing

²⁴ CESR, "Technical Advice on Equivalence of Certain Third Country GAAP and on Description of Certain Third Countries Mechanisms of Enforcement of Financial Information," Ref:CESR/05-230b (June 2005). Available at http://europa.eu.int/comm/internal_market/securities/docs/prospectus/cesr-05-230b_en.pdf (last visited Apr. 30, 2006).

²⁵ *Id.*

condition has since been satisfied²⁶, and with regard to the other two conditions, responsibility to comply rests with individual issuers.

The European Commission is currently considering the CESR's recommendations and must soon make a decision about U.S. GAAP (as well as Canadian GAAP and Japanese GAAP). There are several possible outcomes. The Commission may agree with CESR that U.S. GAAP is equivalent. Alternatively, the Commission may reject CESR's findings and require U.S. companies to prepare IAS statements beginning January 2007.²⁷ A third possibility is to postpone the equivalence decision for two years, and in the meantime, allow U.S. companies to continue to use U.S. GAAP. This last proposal was suggested by Charlie McCreevy, European Commissioner for the Internal Market and Services,²⁸ and later, we will examine why Commissioner McCreevy favors this option.

4. IAS in the U.S.

Currently, the U.S. does not recognize the IAS, or any other accounting standard, as an acceptable alternative to U.S. GAAP. The SEC requires that foreign issuers in the U.S. either prepare a set of financial statements in accordance with U.S. GAAP, or reconcile foreign statements, such as IAS statements, to U.S. GAAP.²⁹ Reconciliation is a difficult and costly process in which the foreign issuer must explain material variations

²⁶ The U.S. adopted option expensing under FASB Accounting Standard No. 123, Share-Based Payment, which in most cases became applicable in 2006.

²⁷ For a summary of the adoption of IAS in Europe, see Alexander Schaub, *The Use of International Accounting Standards in the European Union*, 25 NW. J. INT'L L. & BUS. 609 (2005).

²⁸ Charlie McCreevy, European Commissioner for Internal Market and Services, EC Strategy on Financial Reporting: Progress on Convergence and Consistency, Speech at European Federation of Accountants' (FEE) Seminar on International Financial Reporting Standards (IFRS) (December 1, 2005), available at <http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/05/750&format=HTML&aged=0&language=EN&guiLanguage=en> (last visited Mar. 02, 2006).

²⁹ See Items 17(c) and 18(c) of Form 20-F, and Rule 4-01(a)(2) of Regulation S-X, 17 CFR 210.4-01(a)(2).

between the foreign accounting method and U.S. GAAP. The requirement is a significant obstacle for foreign companies seeking to be listed on a U.S. exchange.³⁰

Since the 1990s, the SEC has permitted some exceptions to this reconciliation requirement. Foreign issuers are allowed to use certain IAS standards without reconciling to U.S. GAAP, including use of IAS 7 to prepare a statement of cash flows, use of IAS 21 governing the effects of hyperinflation, and use of certain of portions of IAS 22 regarding the method of accounting for a business combination.³¹ “[T]he objective of this approach,” the SEC explains, “is to protect the interests of U.S. investors by requiring that all companies accessing U.S. public markets provide high quality financial reporting that satisfies the informational needs of investors, without requiring use of U.S. standards in the presentation of that information.”³² Essentially, the SEC has decided that IAS 7, IAS 21, and IAS 22 provide the same information as their U.S. counterparts.

More recently, the SEC has signaled that it may be willing to consider wider acceptance of IAS. In a Concept Release issued in February 2000, the SEC invited comments on whether it should accept financial statements of foreign issuers prepared using IAS. The Commission explained that it was considering several alternatives: (1) maintaining the current reconciliation requirements in all respects; (2) removing some of the current reconciliation requirements for selected IAS standards and extending that recognition to additional IAS standards as warranted based on future review; (3) relying

³⁰ See, e.g., Rachel Carnachan, *A Third Way: The Case for Competition between U.S. GAAP and IFRS in U.S. Capital Markets*, 9 (2003) (paper on file with author); Richard A. Grasso, Chairman and CEO of the NYSE, *Equity Market Globalization: A View from 11 Wall Street*, Speech at Fordham University (January 13, 1997); F. R. Jenkins, *Listing of Foreign Securities on US Exchanges*, JOURNAL OF APPLIED CORPORATE FINANCE 28-36 (Winter 1993).

³¹ See Items 17 and 18 of Form 20-F., 17 CFR 249.220f.

³² SEC Concept Release on International Accounting Standards, Release Nos. 33-7801, 34-42430 (February 16, 2000).

on IAS standards for recognition and measurement principles, but requiring U.S. GAAP and SEC supplemental disclosure requirements for footnote disclosures and the level of detail for line items in financial statements; (4) accepting financial statements prepared in accordance with the IASC standards without any requirement to reconcile to U.S. GAAP.³³

Further progress was made in April 2005, when SEC announced a “roadmap” for moving toward the fourth alternative – accepting IAS statements without the reconciliation requirement.³⁴ In this roadmap, SEC Chief Accountant Donald T. Nicolaisen acknowledged the world needed a high quality accounting standard that can be applied in a consistent manner, and he hoped that IAS will gain global acceptance. Nicolaisen also expressed that he would like to see further convergence between U.S. GAAP and IAS, such that the standards be reasonably comparable to each other, and such that investors are capable of and comfortable in understanding the nature of differences between the two sets of standards. Nicolaisen envisioned a future in which U.S. GAAP and IAS coexist and enjoy widespread acceptance. The roadmap also indicated that over the next few years, the SEC intended to (1) identify any changes to SEC rules that will be necessary upon elimination of the reconciliation requirement, (2) review the faithfulness and consistency of IAS statements filed by foreign private issuers, and (3) review the status of IAS-U.S. GAAP convergence. Around 2009, the SEC will decide whether to eliminate the reconciliation requirement.

³³ SEC Concept Release on International Accounting Standards, Release Nos. 33-7801, 34-42430 (February 16, 2000).

³⁴ Donald T. Nicolaisen, *A Securities Regulator Looks at Convergence*, (Address at the Symposium on the Convergence of Accounting Standards) 25 Nw. J. Int'l L. & Bus. 661, 672 (2005).

When the SEC eventually confronts the issue of whether to eliminate the reconciliation requirement, the SEC will essentially be making an equivalence determination, even though the SEC refrains from using the term “equivalence.” If the SEC decides that it will accept IAS statements without reconciliation, then it means that the SEC believes that IAS serves an adequate substitute for U.S. GAAP. The 2005 roadmap seems to indicate, however, that before the SEC is willing to accept IAS as equivalent to U.S. GAAP, there must be substantial convergence between the two accounting standards. As to how much convergence is necessary, SEC Chairman Christopher Cox recently indicated in a Feb. 2006 press release that “while he would not insist on a particular degree of convergence as a prerequisite for elimination of the reconciliation, he would expect to see an effective process for converging IFRS and US GAAP, demonstrated by measurable progress in addressing priority issues.”³⁵

B. The E.U. Financial Conglomerates Directive

Another use of “equivalence” occurs in the E.U. Financial Conglomerates Directive. The Financial Conglomerates Directive was adopted in December 2002 and went into effect in January 2005.³⁶ Prior to the Directive, the E.U. regulated financial institutions on a stand-alone basis. This meant that different types of financial institutions – banks, insurance companies, investment companies, and securities firms – were supervised separately by different government regulators, such as central banks, securities commissions, and ministries of finance. However, with the emergence of financial conglomerates – financial groups that provide services and products in different

³⁵ Accounting Standards: SEC Chairman Cox and EU Commissioner McCreevy Affirm Commitment to Elimination of the Need for Reconciliation Requirements, *available at* <http://www.sec.gov/news/press/2006-17.htm> (last visited Apr. 22, 2006).

³⁶ Directive 2002/87/EC of the European Parliament and of the Council, December 16, 2002.

sectors of the financial markets – the E.U. came to feel that stand-alone supervision was inadequate. For example, one concern was that stand-alone supervision permitted conglomerates to cheat capital adequacy requirements. In general, regulators require that financial institutions maintain at least some threshold level of capital to ensure their continued viability; in the case of conglomerates, regulators were worried that conglomerates could move capital between its subsidiaries, using the same capital as buffer against risks in two or more subsidiary entities, a practice known as “double gearing.”³⁷ Responding to such concerns, the Financial Conglomerates Directive provides prudential supervision on a group-wide basis, also known as supplementary supervision. In particular, the Directive instructs European regulators to regulate financial institutions at the conglomerate level, by monitoring their solvency position and risk concentration, their intra-group transactions, their internal risk management processes, and the fit and proper character of the management.³⁸ As of November 2005, European regulators had identified sixty-three groups in Europe as financial conglomerates subject to supplementary supervision pursuant to the Directive.³⁹

To achieve group-wide supervision, the Directive appoints for each conglomerate a regulator who serves as the coordinator.⁴⁰ This regulator coordinates the supervisory efforts of the all other government regulators, each of whom oversees individual entities within the conglomerate. Prior to the Directive, the patchwork system of stand-alone

³⁷ MARKT/3021/2000, Towards an E.U. Directive on the Prudential Supervision of Financial Conglomerates, Consultation Document, 19.12.2000, *available at* http://europa.eu.int/comm/internal_market/financial-conglomerates/supervision_en.htm#legislation (last visited Feb. 14, 2006).

³⁸ *Id.*

³⁹ Clive Briault, Managing Director, Retail Markets, Speech at FSA Joint Level 3 Committees Conference, Brussels, (November 24, 2005), *available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2005/1124_cb.shtml (Feb. 18, 2006).

⁴⁰ Art. 10(1), Directive 2002/87/EC of the European Parliament and of the Council, December 16, 2002.

supervision resulted in undesirable “underlaps” – important conglomerate-level issues were unregulated – as well as undesirable “overlaps” – some financial entities were covered by different sets of regulations. After the Directive, the hope was that the conglomerate coordinators would close loopholes in the regulatory scheme, reduce duplicate supervision, which were burdensome and costly for supervisors and the supervised entities, and simplify procedures and supervisory efforts.⁴¹ The coordinators' specific responsibilities include gathering and disseminating information about the conglomerate, supervising and assessing the financial situation of the conglomerate, assessing whether the conglomerate is complying with rules on capital adequacy, risk concentration, and intra-group transactions, and planning supervisory activities.⁴²

Article 10 of the Directive governs the appointment of coordinators. Where a regulated entity heads a financial conglomerate, Article 10 appoints as the coordinator the government regulator that oversees the parent entity. Where a non-regulated entity heads a conglomerate, Article 10 selects from among the regulators of subsidiary entities by considering factors such as the locations of the head offices, and the relative importance and size of the various entities within the conglomerate.

The impact of the Directive is not restricted to European companies. Pursuant to the Directive, a non-European parent company that does not itself do business in the E.U. may nonetheless be subject to European regulation if it owns a subsidiary financial institution that operates in Europe.⁴³ Whether or not European supervision is warranted

⁴¹ MARKT/3021/2000, Towards an E.U. Directive on the Prudential Supervision of Financial Conglomerates, Consultation Document, 19.12.2000, *available at* http://europa.eu.int/comm/internal_market/financial-conglomerates/supervision_en.htm#legislation (Feb. 14, 2006).

⁴² Art. 11, Directive 2002/87/EC of the European Parliament and of the Council, December 16, 2002.

⁴³ Art. 5(3), Directive 2002/87/EC of the European Parliament and of the Council, December 16, 2002.

turns on an equivalence determination, a determination that is made by the coordinator of the conglomerate⁴⁴. If the coordinator determines that the parent is subject to third-country supervision that is *equivalent* to European supervision, then the coordinator does not have to exercise supplementary supervision. If the coordinator determines that third-country supervision is not equivalent, it may exercise supplementary supervision over the parent. Alternatively, the coordinator may require that the conglomerate establish a European holding company, which would be the parent company for the European subsidiaries of the conglomerate. This holding company would be subject to supplementary supervision. The Directive also permits coordinators to consider other solutions as they see proper.⁴⁵ As of November 2005, there were fifteen non-European conglomerates with a European presence (importantly, in this context Switzerland counts as a non-European country because it lies outside the European Economic Area).⁴⁶

To decide whether third-country supervision is equivalent, E.U. regulators must consider two issues. The first is whether the third-country's substantive rules, as enforced, are consistent with the Directive. Recital 13 of the Directive requires that European entities with foreign parents should be "subject to equivalent and appropriate supplementary supervisory arrangements which achieve objectives and results similar to those pursued by the provisions of this Directive." However, having comparable substantive regulations is not enough. Recital 14 additionally requires the full participation and assistance of the third-country regulator – "equivalent and appropriate

⁴⁴ Item 46, 14.11.2005 Issues arising from the transposition, interpretation and implementation of the Directive, available at http://europa.eu.int/comm/internal_market/financial-conglomerates/supervision_en.htm#legislation (last visited Apr. 30, 2006).

⁴⁵ Art. 18, Directive 2002/87/EC of the European Parliament and of the Council, December 16, 2002.

⁴⁶ Clive Briault, Managing Director, Retail Markets, Speech at FSA Joint Level 3 Committees Conference, Brussels (November 24, 2005), available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2005/1124_cb.shtml (last visited Feb. 18, 2006).

supplementary supervisory arrangements can only be assumed to exist if the third-country supervisory authorities have agreed to cooperate with the competent authorities concerned on the means and objectives of exercising supplementary supervision of the regulated entities of a financial conglomerate.”⁴⁷

In the U.S., the Directive had very little impact in the banking industry, but had significant impact on the securities industry.⁴⁸ With respect to U.S. banks, the Federal Reserve had long been supervising banking institutions at the holding company level. The Federal Reserve believed that its practices were fully consistent with the requirements of the Financial Conglomerates Directive, and it was confident that its regulatory scheme would be found to be equivalent to the European framework.⁴⁹

In the securities industry, at the time, the SEC only regulated companies at the broker-dealer level, and not at the holding company level. Consequently, U.S. securities firms expressed concern that E.U. regulators would find U.S. securities regulation not to be equivalent to European regulation, and that as a result, they would be adversely impacted by the Directive. In particular, U.S. companies worried that they would face increased cost of doing business in Europe, that they could be subject to higher capital

⁴⁷ Directive 2002/87/EC of the European Parliament and of the Council, December 16, 2002. *See also* 06.07.2004 - Third country supervision and equivalence: European Financial Conglomerates Committee issues general guidance to EU supervisors on supervision in the United States of America, *available at* http://europa.eu.int/comm/internal_market/financial-conglomerates/supervision_en.htm#legislation (last visited Feb. 14, 2006).

⁴⁸ Ivo Keltner, *Financial Conglomerates Directive And Its Impact on US Firms*, Harvard Law School LLM Thesis 23 (2003).

⁴⁹ Mark W. Olson, The European Union's Financial Services Action Plan, Testimony before the Committee on Financial Services, U.S. House of Representatives (May 22, 2002), *available at* <http://www.federalreserve.gov/boarddocs/testimony/2002/20020522/default.htm> (last visited Feb. 16, 2006).

and risk control requirements than an EU-based firm and be placed at a competitive disadvantage, and that they might be required to create a holding company in the EU.⁵⁰

Congress and the SEC responded to these concerns. In 1999, Congress passed legislation authorizing the SEC to supervise the holding company of a SEC-registered broker-dealer⁵¹, and in 2004, the SEC promulgated rules permitting holding companies to voluntarily apply for SEC supervision on a group-wide basis. Such a holding company would become a “supervised investment bank holding company” (SIBHC)⁵². In its release, the SEC expressed that it expected its new rules would meet the equivalence standard of the EU Directive. The release also contemplated significant cost savings for U.S. companies. The SEC calculated that in the absence of an equivalence determination, if an E.U. regulator were to require a U.S. company to create a European holding company, it would cost the U.S. company approximately \$8 million plus additional potential costs. These expenditures would not be necessarily, if E.U. regulators recognized the SEC as an equivalent supervisor.

The new SEC rules impose similar obligations on holding companies as the European Financial Conglomerates Directive. To qualify for SIBHC status, a U.S. holding company must have a subsidiary broker-dealer with a substantial presence in the securities markets, which may be demonstrated by a showing that the broker-dealer maintains tentative net capital of \$100 million or more. Upon becoming a SIBHC, the holding company must meet certain requirements regarding its group-wide internal risk

⁵⁰ Annette L. Nazareth, Director, Division of Market Regulation at the SEC, Concerning Certain Pending Proposals by the European Commission, Testimony before the Committee on Financial Services, U.S. House of Representatives (May 22, 2002), *available at* <http://www.sec.gov/news/testimony/052202tsaln.htm> (last visited Feb. 16, 2006).

⁵¹ Pub.L. 106-102, Title II, § 231(a), 113 Stat. 1402 (1999).

⁵² SEC Release No. 34-49831 (Jun. 8, 2004).

management control system, recordkeeping, and periodic reporting. Additionally, a SIBHC must calculate net capital on a consolidated basis according to rules designed to be consistent with Basel standards. The SEC believed that three U.S. companies would seek SIBHC status pursuant to the new rules.⁵³

Presently, European coordinators must determine whether U.S. supervision is equivalent to E.U. supervision. In June 2004, the European Financial Conglomerates Committee and the European Banking Advisory Committee jointly published a report issuing general guidance to EU supervisors.⁵⁴ After reviewing the U.S. regulatory system, the report found that there was broad equivalence across the various financial industries – banking, securities and insurance markets. However, the report contained certain caveats. The report noted that some U.S. regulators, including the SEC, were undertaking consolidated supervision for the first time (the report conceded that this was also true for European regulators), and that while on paper, U.S. regulations should be capable of achieving the objectives of the Directive, the report advised that final judgment should depend on how well the regulations work in practice. In particular, the report cautioned E.U. regulators that the new SEC rules were peculiar in that they created a voluntary regime, i.e., groups can opt into and withdraw from the regime; nevertheless, the report also expressed the opinion that this alone should not prevent the regimes from being effective. Finally, the report warned that the SEC rules were more lenient than European rules in one respect – that SEC rules permit holding companies to include unsubordinated

⁵³ *Id.*

⁵⁴ 06.07.2004 -Third country supervision and equivalence: European Financial Conglomerates Committee Issues General Guidance to EU Supervisors on Supervision in the United States of America, *available at* http://europa.eu.int/comm/internal_market/financial-conglomerates/supervision_en.htm (last visited Apr. 30, 2006).

long-term debt in capital for a transitional period. EU supervisors should consider whether this poses a problem.

Notwithstanding the June 2004 general guidance report, E.U. coordinators must ultimately decide for themselves whether U.S. supplementary supervision is adequate. For most U.S. companies operating in Europe, the Financial Services Authority (FSA) in the U.K. is the E.U. coordinator. The FSA has indicated that in the case of non-equivalence, it is likely to require the non-European conglomerate to establish a European holding company. The FSA would monitor and restrict activities between the European sub-group and the worldwide group, a regulatory practice known as “ring-fencing.”⁵⁵

Curiously, the FSA decides whether foreign financial conglomerates are subject to equivalent home supervision on a firm-by-firm basis rather than a country-by-country basis. Moreover, these decisions are not publicly available – they are communicated directly to firms through private letters. The only publicly available information about the status of U.S. conglomerates comes from an October 2005 speech by a SEC regulator. The regulator revealed that, as of the date of the speech, the FSA had accepted the SEC's oversight of U.S. investment bank Merrill Lynch as equivalent to the supervision described in the Directive. Also, the regulator expected the FSA to make equivalence findings with regard to other US broker-dealer groups within the following month.⁵⁶ Presumably, this is done, but the FSA has not made any public announcements. Later,

⁵⁵ Newsletter 204, Financial Services Authority, Financial Groups (October 2003), p.3, *available at* http://www.fsa.gov.uk/pubs/cp/cp204_newsletter.pdf (last visited Apr. 30, 2006).

⁵⁶ Cynthia A. Glassman, SEC Commissioner, Remarks before the Center for the Study of International Business Law Breakfast Roundtable Series (October 7, 2005), *available at* <http://www.sec.gov/news/speech/spch100705cag.htm> (last visited Feb. 18, 2006).

the paper will discuss the non-transparent manner in which the FSA makes its equivalence determinations.

C. U.S. Regulation of Auditors

A series of corporate scandals, beginning with the collapse of Enron in late 2001, prompted many to question the integrity of the accounting profession. To address these concerns, Congress passed the Sarbanes-Oxley Act in 2002. Among the changes it brought, Sarbanes-Oxley created the Public Company Accounting Oversight Board (PCAOB), a private-sector, nonprofit organization charged by federal law to oversee the accounting profession. Such a regulatory body had never existed before. The PCAOB's statutory responsibilities include (1) registration of accounting firms that audit public companies trading in U.S. securities markets, (2) inspection of registered accounting firms, (3) establishment of standards for auditing, quality control, ethics, and independence, as well as attestation, for registered accounting firms, and (4) investigation and discipline of registered accounting firms and associated persons for violations of law or professional standards. The PCAOB is supervised by the SEC, who must approve the PCAOB's budget and rules and may remove members of the PCAOB Board for cause.⁵⁷

Under Sarbanes-Oxley, accounting firms must register with the PCAOB if they prepare or issue audit reports on financial statements filed in the U.S. This affects foreign accounting firms as well as domestic accounting firms. Many U.S. public companies have significant operations in other countries and hire foreign auditors to audit their foreign operations. These foreign auditors must register with the PCAOB.

⁵⁷ PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD ANN. REP. (2003), *available at* http://www.pcaobus.org/About_the_PCAOB/Annual_Reports/2003.pdf (last visited Feb. 19, 2006).

Separately, about 1,200 public companies based outside of the United States trade in U.S. securities markets. These companies also have reporting requirements in the U.S., and their foreign auditors must also register with the PCAOB. As of November 21, 2005, 640 non-U.S. accounting firms based in 81 countries were registered with the PCAOB.⁵⁸ Theoretically, the PCAOB could assert authority to inspect any and all of these foreign firms.⁵⁹

Foreign regulators expressed concern over this perceived attempt by the U.S. to exercise extraterritorial jurisdiction. Commenting on PCAOB proposed rules relating to the oversight of non-U.S. accounting firms, the Director General for the Internal Market at the European Commission stressed the need for “a true EU-US cooperative approach on auditor oversight based on effective equivalence of regulation and oversight.” He pointed out that direct inspections of European companies by PCAOB officials may cause legal or even constitutional difficulties in some European countries, and the Director General favored limiting the participation of PCAOB personnel to cases where knowledge of U.S. standards cannot be secured by other means.⁶⁰ Similarly, Director for International Financial Markets of the Financial Services Agency of Japan beseeched the PCAOB to heed the principles of mutual respect for each jurisdiction's sovereignty, and the Director also warned that the Japanese Government would not give consent to the

⁵⁸ PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD BUDGET (2006), *available at* http://www.pcaobus.org/About_the_PCAOB/Budget_Presentations/2006.pdf (last visited Feb. 25, 1006).

⁵⁹ PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD ANN. REP. (2004), *available at* http://www.pcaobus.org/About_the_PCAOB/Annual_Reports/2004.pdf (last visited Feb. 19, 2006).

⁶⁰ PCAOB-2004-04: International Rules, Comment by Alexander Schaub, Director-General (January 26, 2004), *available at* http://www.pcaobus.org/Rules/Docket_013/Form_19b-4_%20International%20Rules.pdf (last visited Feb 20, 2006).

exercise of public authority by the PCAOB, including inspection and investigation, on Japanese territory.⁶¹

Eventually, the PCAOB conceded to some extent to the views of foreign regulators and to the practical difficulties of sending inspectors to foreign countries. In June 2004, the Board issued rules providing that a foreign, registered public accounting firm may request the Board to rely on inspections conducted by a foreign, home-country supervisor instead of administering its own investigations.⁶² In response to such a request, the Board will decide how much reliance to place on the home supervisor by examining the quality of the foreign supervisory system. The more independent and rigorous the foreign system, the more the Board will rely on the home supervisor and the less directly involved the Board needs to be. Reliance may also depend on the home supervisor's willingness to update the Board on a regular basis and its willingness to share relevant findings with the Board. While the PCAOB rules do not make explicit reference to the term "equivalence," the decision whether to rely on a foreign supervisor amounts to an equivalence determination, in which the PCAOB decides whether the foreign supervisory system is as independent and rigorous as the U.S. regime.

A number of countries have instituted or revised their own auditor oversight systems with the hope and expectation that the PCAOB will find home country supervision to be adequate. In April 2004, Japan established the Certified Public

⁶¹ PCAOB-2004-04: International Rules, Comment by Naohiko MATSUO, Director for International Financial Markets of Financial Services Agency of Japan (January 26, 2004), *available at* http://www.pcaobus.org/Rules/Docket_013/Form_19b-4_%20International%20Rules.pdf (last visited Feb. 20, 2006).

⁶² PCAOB Release No. 2004-005: Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms (June 9, 2004), *available at* http://www.pcaobus.org/Rules/Docket_013/index.aspx (last visited Feb. 20, 2006).

Accountants and Auditing Oversight Board, a Japanese counterpart to the PCAOB.⁶³ And in the E.U., while there is already auditor oversight at the level of individual member states, the E.U. is considering a new Directive that seeks to ensure more robust public oversight over European auditors and would require the registration of audit firms.⁶⁴ The PCAOB has praised these efforts⁶⁵, and is currently in the midst of negotiating with foreign regulators over how to conduct inspections. These negotiations are still preliminary and are subject to change – the PCAOB is only just beginning to inspect foreign accounting firms. But already, some observers worry about the lack of transparency. The Board has not publicly announced a list of countries for which it is willing to rely on foreign inspections. Critics fear that the PCAOB is trying to shield itself from public scrutiny, hiding the fact that it is making determinations on an *ad hoc*, unprincipled basis.

D. U.S.-Canada Multi-Jurisdictional Disclosure System

In place since 1991, the Multi-Jurisdictional Disclosure System (MJDS) is a joint initiative by the SEC and the Canadian Securities Administrators designed to facilitate U.S. and Canadian companies in cross-border transactions by subjecting them only to home country regulation.⁶⁶ Prior to the MJDS, companies had to prepare two sets of

⁶³ Establishment of Certified Public Accountants and Auditing Oversight Board, *available at* <http://www.fsa.go.jp/cpaob/english/circumstances.pdf> (last visited Feb. 20, 2006).

⁶⁴ Proposal for a Directive on statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC, *available at* http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=COMfi nal&an_doc=2004&nu_doc=177 (last visited Feb. 20, 2006).

⁶⁵ Samantha Ross, Chief of Staff of Public Company Accounting Oversight Board, The Regulatory Dialogue Between the PCAOB & the European Commission, Testimony before the Committee on Financial Services United States House of Representatives (May 13, 2004), *available at* http://www.pcaobus.org/News_and_Events/Events/2004/Testimony/05-13_Ross.aspx (last visited Apr. 23, 2006).

⁶⁶ 56 Fed. Reg. 30036 (1991).

disclosure documents, one according to U.S. securities laws and the other according to Canadian laws. The MJDS allows companies to use disclosure documents filed in their home jurisdiction in the host jurisdiction. Additionally, the host country will defer to the home country's review process. Home country regulators have primary responsibility for reviewing disclosure documents, and host country regulators generally forgo review.⁶⁷ The MJDS covers cross-border offerings, issuer bids, take-over bids, business combinations and continuous disclosure and other filings.

One might plausibly view the MJDS as a regime that draws upon the principle of equivalence. Essentially, each country agrees that despite some differences, the other country's securities regulation regime is "close enough." Hence, when a Canadian company issues securities under MJDS, the company need only comply with Canadian disclosure requirements and need not worry about U.S. requirements. The SEC explains:

By adopting the MJDS, the Commission in essence is adopting as its own requirements the disclosure requirements of Canadian forms. The effect is the same as if the Commission had set forth each Canadian requirement within the MJDS forms Accordingly, good faith compliance with the disclosure requirements of the home jurisdiction will constitute compliance with the applicable U.S. federal securities disclosure requirements, *even if such compliance results in the omission of information which might otherwise have been required as a line item in registration statements filed by U.S. issuers on the Commission's other registration forms.* [emphasis added]⁶⁸

The SEC acknowledges persistent differences between U.S. and Canadian disclosure requirements, but nevertheless judges the two to be functionally substitutable.

Concededly, while the MJDS bears some characteristics similar to equivalence, to call the MJDS "an example of equivalence" would strain what we mean by the term

⁶⁷ See HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION, 79-84 ((Foundation Press, 13th ed., Forthcoming 2006) (on file with author); 71-101CP The Multijurisdictional Disclosure System, available at <http://www.bcsc.bc.ca/policy.asp?id=1299> (last visited Apr. 13, 2006).

⁶⁸ 56 Fed. Reg. 30036 fn. 130 (1991).

“equivalence.” The MJDS example differs from the previous three examples in a couple ways. First, the U.S., rather than accepting Canadian securities law in a wholesale manner, instead imposes certain additional requirements on Canadian companies. Most significantly, while Canadian regulators require companies to use Canadian GAAP, the SEC determined in 1993 that there were “significant differences in accounting principles and practices ... between Canadian GAAP and U.S. GAAP” and has since required Canadian companies to reconcile financial statements to U.S. GAAP.⁶⁹ Additionally, MJDS issuers must supplement their registration with certain additional disclosures that are not required under Canadian law, such as disclosure of indemnification provisions regarding directors, officers, and controlling persons. Moreover, U.S. fraud liability rules – and in particular, Rule 10b-5 – continue to apply.⁷⁰ In light of these additional requirements, the MJDS might be more fairly viewed as a type of “equivalence-plus” regime.

Second, the MJDS is a bilateral agreement. The U.S. and Canada mutually agree to allow companies from the other country to be governed by home country regulation. The SEC rule adopting the MJDS expressly acknowledges this notion of reciprocity:

Concurrently with the publication of this Release, the Canadian Securities Administrators are publishing a National Policy Statement that adopts a largely parallel multijurisdictional disclosure system in Canada. That system permits U.S. issuers to satisfy certain securities registration and reporting requirements in Canada using disclosure documents prepared in accordance with Commission requirements. That National Policy Statement is published as an appendix to this Release.⁷¹

⁶⁹ 58 Fed. Reg. 35367 (1993).

⁷⁰ HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION, 81 (Foundation Press, 13th ed., Forthcoming 2006) (on file with author); Hal Scott, *An Overview of International Finance: Law and Regulation*, in HANDBOOK OF INTERNATIONAL ECONOMIC LAW, (Andrew T. Guzman and Alan O. Sykes eds., forthcoming 2006).

⁷¹ 56 Fed. Reg. 30036 n.130 (1991).

Here, the SEC emphasizes that the Canadian Policy Statement and the SEC release were published *concurrently*, and that the two systems are largely *parallel*. Canadian issuers coming to the U.S. benefit from the agreement, just as U.S. issuers going to Canada benefit. To further emphasize the point of reciprocity, the SEC even attaches the Canadian Statement as an appendix. Some commentators have thus categorized the MJDS as an example of “mutual recognition” rather than equivalence.⁷² Mutual recognition is the policy under which a country offers favorable treatment to companies from a foreign country in return for favorable treatment of its own companies by the foreign country. It rests on the principles of mutual benefit and reciprocity. As we shall see, these principles are largely absent from conventional notions of equivalence, although the current trend is that equivalence is slowly incorporating these ideas and grappling towards something akin to mutual recognition.

IV. Evaluating Equivalence

A. Potential Benefits

1. Reducing Transaction Costs

The primary justification for equivalence is that it reduces transaction costs. Absent equivalence, a company seeking to expand its operations into a foreign country must continue to comply with home country regulations, and additionally, undertake certain actions to comply with host country regulations. This may require that the

⁷² Hal Scott, *An Overview of International Finance: Law and Regulation*, in HANDBOOK OF INTERNATIONAL ECONOMIC LAW, (Andrew T. Guzman and Alan O. Sykes eds., forthcoming 2006).

company incur significant financial costs. Furthermore, if home and host country regulations are comparable, to insist that the company comply with host country regulation will not significantly increase protection for investors. The better approach is to subject the company only to the home country regulatory regime, thus making it less costly for the company to operate in the host country.

Such is the argument for equivalence in the case of accounting standards. Absent a finding of equivalence, U.S. companies conducting public offerings in Europe must prepare IAS financial statements in addition to U.S. GAAP financial statements. Similarly, a European company that is listed in the U.S. must prepare IAS statements for its home country regulators and U.S. GAAP statements (or statements reconciled to U.S. GAAP) for the SEC. The resulting costs can be substantial, thus explaining why financial industries are pushing for equivalence. In 2002, the Chief Financial Officer of Nokia estimated an annual savings of approximately \$500,000 if the SEC would allow Nokia to maintain its NYSE listing on the basis of IAS disclosure statements alone.⁷³ More recently, in 2005, an E.U. regulator indicated that he believed that among the approximately 250 EU issuers listed in the U.S., the largest companies spend between 1 and as much as 10 million dollars per year to reconcile IAS to U.S. GAAP.⁷⁴

Equivalence may also yield significant cost savings in the context of the Financial Conglomerates Directive. As discussed earlier, pursuant the Directive, if a non-E.U. financial conglomerate is not subject to equivalent home supervision, an E.U. regulator

⁷³ Benn Steil, *Building a Transatlantic Securities Market*, Published by the International Securities Market Association in cooperation with the Council on Foreign Relations (2002), available at http://www.fese.be/initiatives/other_reports (last visited Feb. 25, 2006).

⁷⁴ Charlie McCreevy, EC Strategy on Financial Reporting: Progress on Convergence and Consistency, Speech at European Federation of Accountants' (FEE) Seminar on International Financial Reporting Standards (IFRS), Brussels (December 1, 2005), available at <http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/05/750&format=HTML&aged=0&language=EN&guiLanguage=en> (last visited Mar. 02, 2006).

may require the conglomerate to establish a European holding company for supervisory purposes. The SEC calculated that the cost for a U.S. company to establish a holding company in Europe would be approximately \$8 million.⁷⁵ The U.S. company can avoid this expenditure if E.U. regulators finds SEC supervision to be equivalent to E.U. supervision.

In addition to cost savings for firms, equivalence may also produce cost savings for regulators. For example, the PCAOB's 2006 budget provides \$128.4 million, net of interest, in outlays for the calendar year. The majority of the outlays are for salaries and other expenses related to the hiring of the experienced auditors needed to conduct inspections. Firms with more than 100 public company clients must be inspected annually; firms with one to 100 public company clients must be inspected every three years. Many of these inspections will occur abroad; as of Nov. 21, 2005, 640 out of 1,586 public accounting firms registered with the Board (approximately forty percent) were based outside the United States.⁷⁶ From this statistic, it seems clear that the PCAOB can significantly reduce its expenditures if the Board is willing to deem foreign oversight equivalent to domestic oversight and rely on inspections by foreign counterparts.

Equivalence skeptics would respond that there are other ways to reduce transactions costs. In particular, those who favor harmonization over equivalence may argue that harmonization yields even lower transaction costs. Why not pursue

⁷⁵ SEC Release No. 34-49831 (Jun. 8, 2004).

⁷⁶ *Board Approves 2006 Budget, Amendments to Tax Rules*, News and Events (PCAOB), November 22, 2005, available at http://www.pcaobus.org/News_and_Events/News/2005/11-22.aspx (last visited Feb. 25, 2006).

harmonization instead of equivalence? The follow subsections list some of the advantages of equivalence over harmonization.

2. Feasibility

In many situations, full harmonization is not feasible, and equivalence is a second-best solution. Harmonization may be difficult for a variety of reasons.

First, harmonization requires broad consensus across countries – countries must agree to single set of harmonized regulations. However, it may be difficult to forge such consensus; invariably, countries will disagree on matters of policy. This is especially problematic outside the European Union. The E.U. at least provides a forum in which disagreements can be sorted out. But even within Europe, harmonization has not been easy, and E.U. regulators have been forced to turn to equivalence. During the 1970s, the E.U. made several attempts to harmonize regulations with the aim of creating a single, integrated internal market – for example, by abolishing custom duties and other trade restrictions between European states. But these attempts were largely unsuccessful, and the E.U. was forced to retreat from full harmonization and focus instead on instituting some common minimum standards. This was the approach in the E.U. Commission’s 1985 White Paper⁷⁷, which sought to reduce certain barriers to the movement of goods, services, and capital within Europe. The White Paper acknowledged that “experience has shown that ... a strategy based totally on harmonization would be over-regulatory, would take too long to implement, would be inflexible and could stifle innovation,” and “a clear distinction needs to be drawn in future internal market initiatives between what is essential to harmonize, and what may be left to mutual recognition of national regulations

⁷⁷ Completing the Internal Market: White Paper from the Commission to the European Council, COM (85)310 final (1985), available at http://europa.eu.int/comm/off/white/index_en.htm (Feb. 27, 2006).

and standards.”⁷⁸ Under the White Paper approach, European states agree not to put up certain barriers to trade, but are free to enact other types of regulations. European states also agree to recognize the regulations of other member states. Some commentators have described this intra-E.U. regulatory regime as one based on “equivalence.”⁷⁹

Second, regulatory agencies can only act pursuant to legislative authorization – full harmonization may be outside their statutory authority. Such is the situation in the case of accounting standards. As discussed previously, the SEC currently requires foreign companies to reconcile foreign financial statements to U.S. GAAP, a very costly process. If the SEC chooses an equivalence solution, the agency may do so simply by eliminating the reconciliation requirement.⁸⁰ This is clearly within its statutory authority. In fact, the SEC has already waived reconciliation with respect to a few IAS standards. In contrast, if the SEC wishes to pursue full harmonization, the agency may face certain statutory restrictions. For example, the SEC’s roadmap acknowledges as a future possibility the replacement of FASB with IASB as the official standard setter of U.S. accounting rules.⁸¹ This is one way to achieve full harmonization. But even assuming

⁷⁸ *Id.*

⁷⁹ See, e.g. Douglas W. Arner, *Globalization of Financial Markets: An International Passport for Securities Offerings?*, 35 *Int'l Law.* 1543, 1553 (2001) (“The EU legislative framework for financial markets seems to be grounded in a concept that can be thought of as a search for *equivalence* among disparate regulatory and legal systems, while taking into account the continuing reality of separate and distinct national legal and regulatory regimes as the basis of any overall EU initiatives.” [emphasis added]); Roel C. Campos, SEC Commissioner, *Convergence and Beyond*, Speech at the U.S. - Europe Symposium: Program on International Financial Systems, Armonk, N.Y. (November 15, 2003), available at <http://www.sec.gov/news/speech/spch111503rcc.htm> (last visited Feb. 23, 2006) (“Alex [Schaub, Director-General, DG Internal Market of the European Commission], I think you said that what now exists in the EU is best described as a determination of ‘equivalence’ and, where equivalence cannot be achieved, an acceptance of ‘diversity in the standards of member states.’”).

⁸⁰ Congress did not pass a statute mandating reconciliation. The reconciliation requirement is an agency rule, which the SEC may amend the rule at its own initiative. See Rule 4-01(a)(2) of Regulation S-X, 17 CFR 210.4-01(a)(2).

⁸¹ See Donald T. Nicolaisen, *A Securities Regulator Looks at Convergence*, (Address at the Symposium on the Convergence of Accounting Standards), 25 *Nw. J. Int'l L. & Bus.* 661(2005) (“For purposes of this article I have assumed that the FASB will continue as our country’s GAAP standard setter, although I recognize that over time it is possible to imagine that various other scenarios could develop.”).

that the SEC wants to switch to IASB, Congress has limited the SEC's authority to appoint a new standard setter. In particular, Sarbanes-Oxley requires that the standard setter must meet several statutory requirements. Currently, FASB is the only organization that meets the requirements of Sarbanes-Oxley⁸², and the SEC has no choice but to recognize FASB as the official standard setter. The alternative is to lobby Congress to amend Sarbanes-Oxley.

Third, harmonization may be infeasible if it is perceived as violating national regulatory prerogatives; again, in this case, equivalence may serve as a second-best alternative. This is potentially an issue in the case of IAS-U.S. GAAP convergence. There has been at least one incident in the recent past when nationalism stood in the way of accounting reform. When deciding whether to adopt IAS 39, the European Commission received a letter from French President Jacques Chirac warning that the adoption of certain IAS standards would have "nefarious consequences for financial stability."⁸³ President Chirac's letter was widely interpreted as continental Europe proclaiming independence from the U.K. and the U.S. in accounting matters, and the IASB Chairman observed that, "France ... has a different culture of accounting.... It is a proud and independent country and they saw what to them was an alien culture being rammed down their throat."⁸⁴ One can imagine similar resistance to future attempts to converge IAS and U.S. GAAP. If full convergence is infeasible, one view is that regulators should switch to equivalence as a substitute for convergence.

⁸² Andreas M. Fleckner, *FASB and IASB: Organization and Influence* 11 (2005) (on file with author).

⁸³ Daniel Dombey, *France Isolated on IAS Concerns*, FINANCIAL TIMES, July 16, 2003, p. 26.

⁸⁴ Robert Bruce, *Setting a New Standard*, FINANCIAL TIMES, September 29, 2004, at 5. For further discussion of these events, see Andreas M. Fleckner, *FASB and IASB: Organization and Influence* 19-21 (2005) (on file with author).

Similarly, in the case of auditor oversight, equivalence may be the only feasible option in light of sovereignty concerns. When the PCAOB asserted jurisdiction over foreign auditors, it was accused of violating the national sovereignty of foreign nations. Foreign regulators protested fiercely to the PCAOB assertion that it had authority to inspect and investigate foreign audit firms. One European regulator declared that direct inspections by PCAOB officials would cause legal and constitutional difficulties in European countries, and a Japanese regulator warned that the Japanese government would not allow the PCAOB to exercise public authority in Japan.⁸⁵ If barred from entering these jurisdictions, the Board will have no choice but to rely on foreign regulators. This would be *de facto* recognition that foreign inspections are equivalent to PCAOB inspections.

3. Flexibility to Address Real Differences

When there are real differences between countries, it may be unwise to force countries to adopt the same regulations. Harmonization may be undesirable. Equivalence may be the preferred alternative, one which allows countries to pursue different rules to accommodate real differences.

In the case of accounting, it may be preferable that Europe and the U.S. employ differing accounting standards to accommodate real differences. In continental Europe, such as in France and Germany, accounting and taxation are closely integrated. These countries sometimes use accounting rules as an instrument of tax policy, for example, by offering tax breaks for businesses by allowing generous measurements of expenses and modest measurements of revenues. In contrast, the U.S. separates accounting and

⁸⁵ See *supra* notes 60-61 and accompanying text.

taxation. Tax breaks can be enjoyed independently of the way results are reported to shareholders.⁸⁶

There are other real differences. The U.S. has stricter legal liability standards. Also, class action suits are available as a means of enforcement. For these reasons, it makes sense for the U.S. to use a rule-based accounting regime rather than a principle-based accounting regime. The rule-based approach provides certainty to U.S. companies, who may follow the rules to avoid liability. In Europe, there is not the same need for a rule-based approach.⁸⁷ As an aside, the fact that accounting rules are enforced differently in the U.S. and Europe raises the issue of whether U.S. accounting standards and European accounting standards can ever be “truly” equivalent. We will revisit this. For now, the point is simply that there are reasons for having different accounting standards in Europe and the U.S.

These real differences between Europe and the U.S. push in favor of equivalence over harmonization. Equivalence allows regulators to pursue different rules to accommodate real differences. In its Concept paper, the CESR emphasized that “equivalent” accounting rules should not mean “identical” accounting rules; equivalence only means that the rules are sufficiently alike to enable investors to take similar investment decisions. “For example,” the CESR explains, “some differences in accounting treatment may not be significant in terms of equivalence because they arise from differing legal elements, for instance accounting for tax purposes.”⁸⁸

⁸⁶ Brian Carlsberg, *Harmonizing Accounts Worldwide*, FINANCIAL TIMES, January 12, 1996, at XII.

⁸⁷ Hal S. Scott, *An Overview of International Finance: Law and Regulation* 20 (Sept. 1, 2005) (unpublished manuscript, on file with author).

⁸⁸ CESR, “Concept Paper on Equivalence of Certain Third Country GAAP and on Description of Certain Third Countries Mechanisms of Enforcement of Financial Information,” Ref:CESR/04-509C (February 2005), available at http://www.cesr-eu.org/data/document/04_509c.pdf (last visited Apr. 30, 2006).

4. Competition of Rules

There is a well-developed line of literature advocating regulatory competition. Not only does regulatory competition accommodate real differences, but more importantly, regulatory competition fosters innovation. It allows regulators to experiment and to learn through trial and error. In this manner, regulators can develop more efficient regulatory regimes.

Equivalence, to a lesser degree, shares these same benefits. In a speech quoted in part earlier, European regulator Alexander Schaub notes that equivalence incorporates some aspects of regulatory competition.

Working on the basis of equivalence is not an admission of defeat: it is a healthy recognition by both sides that there can be more than one way to achieve a common objective. In many cases, there is no perfect solution to a regulatory problem. In some cases, the regulatory solution used in one jurisdiction might not work in the other. We need an organized and cooperative coexistence: a managed competition of equivalent systems based on common underpinnings.⁸⁹

Schaub asserts that equivalence, like regulatory competition, allows countries some flexibility to pursue similar objections through different means. Furthermore, Schaub encourages “managed competition” of regulatory systems, implying that, over time, competition leads to improvement.

Admittedly, there is more opportunity for innovation under regulatory competition than under equivalence, because equivalence is more restrictive than regulatory competition. Under equivalence, regulators are free to experiment to some extent, but they are not given *carte blanche*. Instead, regulators must stay within the

⁸⁹ Alexander Schaub, Director-General, DG Internal Market of the European Commission, Testimony before the Committee on Financial Services, U.S. House of Representatives (May 13, 2004), *available at* <http://financialservices.house.gov/media/pdf/051304as.pdf> (last visited Feb. 23, 2006).

bounds of what is “functionally substitutable.” This illustrates a basic tension of equivalence. On the one hand, equivalence requires that two regulations are “sufficiently similar,” or “close enough.” On the other hand, equivalence recognizes that it is often important for different countries regulate in different ways. Another way of expressing the same point is that equivalence represents an uneasy compromise between harmonization and regulatory competition.

B. Potential Pitfalls

1. Insufficient Protection for Host Country Investors

This section lists four warnings regarding equivalence. All relate to investor protection. First, home country substantive law may offer less investor protection than host country substantive law. Second, home country laws may be under-enforced. Third, home country regulators may be unwilling to cooperate with host country regulators. Fourth, if the law, as applied, is inconsistent across jurisdictions, this creates uncertainty among investors.

Critics of equivalence worry that if regulators import foreign substantive laws that are less rigorous than domestic laws, this will harm domestic investors. This may explain why some U.S. regulators have been reluctant to embrace the concept of equivalence; frankly, they fear that foreign regulation is too lax and thus not comparable to U.S. regulation. This concern is most apparent in the accounting context, where despite pressure from Europe, the SEC remains cautious and hesitant toward accepting IAS as an alternative to U.S. GAAP. In a recent speech before the Federation of European Accountants, the SEC Director of the Office of International Affairs drew attention to the

fact that “accounting standards in the United States have a long and unique history,” that “U.S. GAAP has been used extensively in the United States since the 1930s,” and that today U.S. GAAP “is widely-used, comprehensive, well-understood, and well-regarded both at home and internationally.”⁹⁰ In contrast, “IFRS have only existed ... just a few years,” and unlike U.S. GAAP, “it has little to no history of application and interpretation.”⁹¹ In other words, the Director is worried that IAS does not offer sufficient investor protection, at least in its current form. The SEC will eliminate the reconciliation requirement only when it is satisfied that the quality of IAS is on par with U.S. GAAP.

Even if two sets of regulations are substantively similar, there is still the problem of enforcement. This is a concern anytime a host country regulator relies on the home country regulator to execute laws – for example, by reviewing disclosure documents or by conducting on-site inspections. Even if on the books, home country regulation appears identical to host country regulation, there is still the danger that home country regulation might be under-enforced. Research suggests that countries vary widely in their actual enforcement of financial regulations, and consequently similar, or even identical substantive regulations, may yield different results.⁹²

The enforcement problem is one that PCAOB struggles with on a recurring basis. When the Board decides whether to rely on foreign inspections, the most pressing issue is the effectiveness of the foreign enforcement:

⁹⁰ Ethiopis Tafara, Director, Office of International Affairs, SEC, International Financial Reporting Standards and the US Capital Market, Remarks before the Federation of European Accountants (December 1, 2005), available at <http://www.sec.gov/news/speech/spch120105et.htm> (last visited Feb. 26, 2006).

⁹¹ *Id.*

⁹² See, e.g., Howell E. Jackson, *Variation in the Intensity of Financial Regulations: Preliminary Evidence and Potential Implications*, THE HARVARD JOHN M. OLIN DISCUSSION PAPER SERIES No. 521 (2005).

Under the Board's rules, a firm would first provide the Board with a one-time statement asking the Board to rely on a non-U.S. inspection. At an appropriate time before each inspection of a non-U.S. firm that has submitted such a statement, the Board would determine the appropriate degree of reliance based on information about the non-U.S. system obtained primarily from the non-U.S. regulator regarding the independence and rigor of the non-U.S. system. The Board would also base its decision on its discussions with the appropriate entity or entities within the oversight system concerning the specific inspection work program for the non-U.S. firm's inspection at hand. The more independent and rigorous a home country system, the higher the Board's reliance on that system. A higher level of reliance translates into less direct involvement by the Board in the inspection of the non-U.S. registered public accounting firm.

The Board's rule on investigations ... provides that the Board may, in appropriate circumstances, rely upon the investigation or sanction, if any, of a foreign registered public accounting firm by a non-U.S. authority. The Board's reliance would depend, in part, on the independence and rigor of the non-U.S. authority. Reliance also may depend on the non-U.S. authority's willingness to update the Board regarding the investigation on a regular basis and its willingness and authority to share the relevant evidence gathered with the Board.⁹³

The Board emphasizes that in order for foreign enforcement to be effective, the foreign regulatory authority must be “independent” and “rigorous.” Before making its decision, the Board will inquire into the type and quality of inspections performed by the foreign authority. If the foreign authority proves to be particularly dependable, the Board may even rely upon the foreign agency to investigate misconducts by foreign accounting firms and will honor any sanctions imposed by the foreign agency. But strong enforcement, by itself, is not sufficient. Importantly, even if the foreign authority is very capable of enforcing the laws, the PCAOB will hesitate to rely on the agency, unless the agency shows willingness to cooperate with the Board. Hence, while cooperation and

⁹³ PCAOB Release No. 2004-005: Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms, June 9, 2004, available at http://www.pcaobus.org/Rules/Docket_013/index.aspx (last visited Feb. 20, 2006).

enforcement are conceptually distinct, it seems that at least in this context they must go hand-in-hand.

Similarly, the drafters of the E.U. Financial Conglomerate Directive also recognized the importance of enforcement and cooperation. The Directive instructs that in order to determine whether third-country supervision is equivalent to European supervision, E.U. regulators must consider not just whether the third-country provides group-wide supervision on the books, but also whether *in practice*, the third-country “achieves objectives and results similar to those pursued by the provisions of this Directive.”⁹⁴ But again, good enforcement by itself is not sufficient. The provision that immediately follows instructs E.U. regulators to ask whether “the third-country supervisory authorities have agreed to cooperate with the competent [E.U.] authorities.”⁹⁵ As in the previous example, the Directive links enforcement with cooperation, on the theory that while the quality of third-country enforcement is important, also important is open communications between the third-country regulator and the E.U. regulator so that the E.U. regulator can confirm that there is adequate enforcement.

The preceding examples illustrate the importance of enforcement, but one may ask whether sometimes, equivalence may be possible even *without* strong enforcement on both sides. What if the host country does not need to rely on the home country for enforcement? Let us assume, as is sometimes alleged, that the E.U. enforces accounting standards less rigorously than the U.S.? Can IAS and U.S. GAAP nevertheless be equivalent?

⁹⁴ Recital 13, Directive 2002/87/EC of the European Parliament and of the Council, December 16, 2002.

⁹⁵ Recital 14, Directive 2002/87/EC of the European Parliament and of the Council, December 16, 2002.

One view is: yes. In this context, perhaps the SEC should not care whether there is adequate enforcement Europe, because the SEC can enforce IAS itself. Unlike the PCAOB case and the E.U. Financial Conglomerates case, the SEC need not depend on foreign regulators for enforcement. The SEC only needs to hire some IAS accountants, and it will be able to interpret and enforce IAS the same way it interprets and enforces U.S. GAAP.

On the other hand, while there may not be an enforcement problem, there is an inconsistency problem. The SEC may enforce IAS in the U.S. without regard for enforcement in Europe, but the effect is to establish two IAS regimes – a U.S. IAS regime, and a European IAS regime. An investor, upon receiving an IAS financial statement, is uncertain about how to interpret the statement. Should she treat the statement as if it had been scrutinized under the (hypothetically) stronger U.S. enforcement regime? Or should she assume that the statement was filed in the E.U. (hypothetically, the weaker regime), and discount the numbers according? Recognizing this problem, the SEC has announced that before it accepts IAS in the U.S., it will require evidence showing that “IFRS are applied and interpreted faithfully, consistently and thoroughly across different jurisdictions and across different industrial sectors,” and that “IFRS are indeed a single set of international accounting standards and not a multiplicity of standards going by the same name.”⁹⁶ If there are significant disparities in the way foreign regulators interpret and enforce IAS standards, the SEC will not recognize IAS as equivalent to U.S. GAAP.

⁹⁶ Ethiopis Tafara, Director, Office of International Affairs, SEC, International Financial Reporting Standards and the US Capital Market, Remarks before the Federation of European Accountants (December 1, 2005), available at <http://www.sec.gov/news/speech/spch120105et.htm> (last visited Feb. 26, 2006).

In the case of the E.U. Financial Conglomerate Directive, there remains a danger of inconsistency in a different sense. Pursuant to the Directive, the decision of whether third-country supervision is equivalent to E.U. supervision is left to national regulators, as opposed to E.U. officials. This opens the possibility that different regulators may reach different conclusions, creating the odd situation that third-country supervision may be equivalent to E.U. supervision in one E.U. country, but not in another. The E.U. has tried to address this concern by issuing “general guidance” documents, which make recommendations about whether supervision by certain third-countries is equivalent, but these recommendations are merely advisory and not binding.⁹⁷

2. Lack of Transparency

A second potential pitfall is the problem of non-transparency. Two examples illustrate this. First, when the PCAOB decides whether to rely on foreign supervisors, its determination is not made public. This is a lack of transparency. Full transparency would require that the PCAOB announce a list of countries for which it will substitute foreign inspections for PCAOB inspections. Second, when the FSA decides whether a foreign financial conglomerate is subject to equivalence home supervision, its decision is also not made public – instead, the FSA notifies firms through private letters. Not only is this an example of non-transparency, but what is additionally puzzling is that the FSA makes equivalence decisions on a firm-by-firm basis rather than a country-by-country basis.

⁹⁷ Thus far, there are two general guidance documents. *See* Third Country Supervision and Equivalence: European Financial Conglomerates Committee Issues General Guidance to EU Supervisors on Supervision in Switzerland, 06.07.2004; Third Country Supervision and Equivalence: European Financial Conglomerates Committee Issues General Guidance to EU Supervisors on Supervision in the United States of America, 06.07.2004, available at http://europa.eu.int/comm/internal_market/financial-conglomerates/supervision_en.htm (last visited Feb. 28, 2006).

Why not more transparency? Why not make equivalence determinations public? One view is that the PCAOB and the FSA fear public scrutiny. Perhaps public scrutiny would reveal that the FSA and the PCAOB make equivalence determinations in an arbitrary, unprincipled manner. After all, to determine equivalence, a regulator weighs several considerations – e.g. whether home country laws are adequate, whether there is sufficient enforcement, whether the home country regulator is cooperative – in other words, there is no bright line rule. In practice, perhaps this reduces equivalence to an *ad hoc* determination. This suggests that we should be wary of equivalence. But the difficulty with this explanation is that both the FSA and the PCAOB have promulgated detailed rules explaining the criteria used to determine equivalence.⁹⁸ If the sole concern of the FSA and the PCAOB is to avoid public scrutiny, perhaps they would not have bound themselves to these self-promulgated rules.

Another explanation recognizes that equivalence sometimes involves complex negotiations, specifically negotiations among the host country regulator, the home country regulator, and the firm being regulated. For example, in the financial conglomerate context, the FSA may accept SEC supervision as basically equivalent, but may nevertheless request that the SEC grant it access to certain information pertaining to the firm, or require that the firm make additional disclosure directly to the FSA. During negotiations, all three parties may wish to keep communications private, because negotiations are more likely to succeed when parties can communicate in confidence. Once negotiations conclude, the FSA may continue to keep the negotiation details private

⁹⁸ See PCAOB Release No. 2004-005: Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms, June 9, 2004, available at http://www.pcaobus.org/Rules/Docket_013/index.aspx (last visited Feb. 20, 2006); Policy Statement 04/20: Financial groups - Feedback on CP204 and Made Text, available at http://www.fsa.gov.uk/Pages/Library/Policy/Policy/2004/04_20.shtml (last visited Apr. 23, 2006).

in order not to jeopardize future negotiations. Otherwise, if the final terms are made public, future firms and regulators may demand terms from the FSA that are at least as favorable, putting the FSA in a successively weaker bargaining position. While this second explanation has some merit, it is not completely satisfactory either, because it begs the question: why is the FSA making determinations on a firm-by-firm basis in the first place? Shouldn't equivalence focus on the home country supervisory regime rather than the firm? The FSA would likely respond that there are significant differences between financial conglomerates, even financial conglomerates from the same country. For example, financial conglomerates in the U.S. may be regulated by different regulators – banks are regulated by the Federal Reserve and securities firms are regulated by the SEC. Hence, the FSA cannot make a general equivalence determination for each country, and instead, must independently examine each individual firm.⁹⁹

A similar rationale may apply to the PCAOB case. The PCAOB may wish to rely more heavily on some foreign supervisors and less on others. To avoid offending the latter group, the PCAOB may wish not to disclose its evaluations of foreign regulators. Otherwise, all foreign regulators will demand most-favored status.

3. Competitive Advantage and Competitive Disadvantage

As discussed previously, “equivalent” does not mean “identical.” What if there are significant differences between home country regulation and host country regulation, but the host country nevertheless deems home country regulation to be equivalent? If home country regulation is less restrictive than host country regulation, then host country companies may be at a competitive disadvantage. If on the other hand, home country

⁹⁹ These ideas emerged from discussions with Prof. Scott, Prof. Jackson, and other members of the International Finance Seminar.

regulation is more restrictive than host country regulation, and the host country does not allow foreign companies to avail themselves of less restrictive host country laws, this may be seen as protectionism. Protectionism gives host country companies an unfair competitive advantage.

These are not merely theoretical concerns. In the past, the SEC has justified its hesitancy to eliminate the reconciliation requirement on the grounds that the agency does not want to place domestic companies at a competitive disadvantage vis-à-vis foreign companies. In a 1997 report, the SEC explained that if IAS standards are not of comparable quality to U.S. standards, “domestic registrants would be put at a competitive disadvantage because application of U.S. accounting and reporting requirements would impose higher disclosure requirements on them than on foreign enterprises competing for capital in the same markets.”¹⁰⁰ One fear is that upon finding themselves at a comparative disadvantage, U.S. companies may leave the U.S. to reincorporate abroad. They may then reenter U.S. capital markets as foreign firms filing IAS financial statements.¹⁰¹

4. The Dilemma of Mutual Benefit and Reciprocity

Another problem with the equivalence approach is that equivalence does not guarantee mutual benefit or reciprocity. Equivalence does not guarantee mutual benefit, because when a host country decides that home country regulation is equivalent, most of the immediate benefits accrue to the home country. To illustrate with a hypothetical, suppose that the E.U. decides to recognize U.S. GAAP as equivalent to IAS. U.S.

¹⁰⁰ Securities and Exchange Commission, Report on Promoting Global Preeminence of American Securities Markets (October 1997), available at <http://www.sec.gov/news/studies/acctgsp.htm> (last visited Mar. 11, 2006).

¹⁰¹ MARC I. STEINBERG, INTERNATIONAL SECURITIES LAW, 173 (1999).

companies may now raise capital in Europe without the added cost of preparing IAS financial statements. European companies receive no direct benefit. In fact, they may be slightly worse off than before due to increased competition for capital. Concededly, European investors benefit from being able to invest in U.S. securities. Nevertheless, the E.U. would undoubtedly prefer that the U.S. extend the same courtesy to E.U. firms as the E.U. has to U.S. firms.

But equivalence also does not guarantee reciprocity. Whatever the E.U. decides about U.S. GAAP-IAS equivalence, the U.S. does not have to accept the E.U.'s findings. It is entirely possible to have one-way equivalence – the U.S. may choose not to accept IAS as equivalent to U.S. GAAP, even if the E.U. accepts U.S. GAAP as equivalent to IAS.

This poses a problem. The principles of mutual benefit and reciprocity often form the basis for international cooperation – a country is unlikely to voluntarily yield to the demands of another country without assurance that it will receive some benefit in return. In the case of equivalence, it is reasonable to think that a country may be unlikely to recognize another country's regulations as equivalent without assurance that the other country will also recognize the first country's regulations as equivalent.

If this line of reasoning is correct, for equivalence to have continued success in the future, the concept of "equivalence" must be reformulated to incorporate the idea of "reciprocity." Under the equivalence-plus-reciprocity approach, one country agrees to accept a second country's regulations as equivalent on the condition that the second country also accepts the first country's regulations as equivalent. To preventing cheating,

the first country threatens to withhold its equivalences finding if the second country renegades.

In actuality, equivalence has already begun to evolve into equivalence-plus-reciprocity. This is apparent in the case of accounting standards. One early articulation of equivalence-plus-reciprocity was in an April 2004 speech by E.U. Commissioner McCreevy, who declared that equivalence “is not a one-way street – it is only reasonable for European companies to expect that US regulators will make similar efforts to judge the equivalence of our international standards with US GAAP, and once this is done, to release companies from the costly burdens of converting standards.”¹⁰² In this statement, Commissioner McCreevy blurs the line between equivalence and mutual recognition. Equivalence no longer means unilateral action; instead, like mutual recognition, it is conditioned on reciprocity – the E.U. will recognize U.S. GAAP, only if the U.S. also recognizes IAS.

One difference between mutual recognition and equivalence-plus-reciprocity is that the former implies that countries will cooperate with one another, while latter suggests that countries may be at odds with one another. After Commissioner McCreevy’s speech, European regulators continued to urge U.S. counterparts to accept IAS, but in 2005, the SEC announced in its “roadmap” that it will postpone the decision on eliminating the reconciliation requirement until 2009. Rebuffed, European regulators threatened the U.S. with what one U.S. regulator disparagingly labeled “reverse

¹⁰² Charlie McCreevy, European Commissioner for Internal Market and Services, Competitiveness and Growth in the EU through the Development of an Integrated Capital Market and Banking System, Speech at the Institute of International Finance, Panel on “Regulation and Consolidation in the Financial Industry”, Madrid (April 1, 2004), *available at* <http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/05/194&format=HTML&aged=1&language=EN&guiLanguage=en> (last visited March 02, 2006).

reconciliation,”¹⁰³ but what European regulators might characterize as equivalence-plus-additional-requirements. The European CESR recommended that even though U.S. GAAP is broadly equivalent to IAS, with respect to certain IAS standards that are significantly different from U.S. GAAP, U.S. companies should make certain additional disclosures. Only after U.S. GAAP statements are supplemented with these disclosure statements will they be deemed equivalent to IAS statements.¹⁰⁴ As indicated earlier, U.S. regulators reacted negatively. One regulator called this development a “potential speedbump.”¹⁰⁵ Another expressed “bafflement:”

I am baffled at the suggestion by some that Europeans should begin to require U.S. companies to reconcile their U.S. GAAP financial statements to IFRS. This runs against the direction that we are taking in the United States and undermines our efforts towards mutual recognition. Some may assert that this is a useful bargaining chip to ensure that we Americans will recognize IFRS. But, I believe that it is counter-productive, ignores historical precedent and market practice, and diverts attention and energy from solving the real challenges before us. IFRS will stand or fall on its own merits. Our efforts should be focused on making sure that it succeeds.¹⁰⁶

This last statement demonstrates how equivalence-plus-reciprocity can feel less like cooperation and more like strategic interaction.

In the end, the E.U. will likely not carry out its threat of requiring U.S. companies to make additional disclosures. At least for the short-term, Commissioner McCreevy has

¹⁰³ Cynthia A. Glassman, SEC commissioner, The SEC in a Global Marketplace: Current Issues, Remarks before the Center for the Study of International Business Law Breakfast Roundtable Series (October 7, 2005), available at <http://www.sec.gov/news/speech/spch100705cag.htm> (last visited Mar. 02, 2006).

¹⁰⁴ CESR, “Technical Advice on Equivalence of Certain Third Country GAAP and on Description of Certain Third Countries Mechanisms of Enforcement of Financial Information,” Ref:CESR/05-230b (June 2005). Available at http://europa.eu.int/comm/internal_market/securities/docs/prospectus/cesr-05-230b_en.pdf (last visited Apr. 30, 2006).

¹⁰⁵ Cynthia A. Glassman, SEC Commissioner, The SEC in a Global Marketplace: Current Issues, Remarks before the Center for the Study of International Business Law Breakfast Roundtable Series (October 7, 2005), available at <http://www.sec.gov/news/speech/spch100705cag.htm> (last visited Mar. 02, 2006).

¹⁰⁶ Paul S. Atkins, SEC Commissioner, Remarks before the European Parliamentary Financial Services Forum (October 26, 2005), available at <http://www.sec.gov/news/speech/spch102605psa.htm> (last visited Mar. 02, 2006).

indicated that he favors extending the status quo by continuing to permit U.S. companies to continue to use U.S.GAAP.¹⁰⁷ For the long-term, the solution is still equivalence, but there is strong consensus that equivalence will be a bilateral process. Commissioner McCreevy plans to recommend to E.U. Member States and the European Parliament to postpone the decision on the possible equivalence of US GAAP with IFRS for two years. "Such a postponement," he believes, "would align the two timetables for equivalence and would give both of us the possibility to monitor closely developments in the other jurisdiction."¹⁰⁸ The suggestion is that any European finding of equivalence will be conditioned on U.S. reciprocity.

The transformation of equivalence into equivalence-plus-reciprocity is still more evident in the case of auditor regulation. As discussed previously, under Sarbanes-Oxley, foreign accounting firms that prepare or issue audit reports on financial statements that are filed in the U.S. must register with the PCAOB. Additionally, the PCAOB threatens to conduct foreign inspections unless foreign auditors are subject to adequate home supervision. In response, the E.U. is considering a new Directive to improve European public oversight over the audit firms.¹⁰⁹ The proposed Directive purports to "provid[e] a basis for effective and balanced international regulatory co-operation with oversight

¹⁰⁷ Charlie McCreevy, EC Strategy on Financial Reporting: Progress on Convergence and Consistency, Speech at European Federation of Accountants' (FEE) Seminar on International Financial Reporting Standards (IFRS) (December 1, 2005), *available at* <http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/05/750&format=HTML&aged=0&language=EN&guiLanguage=en> (last visited Mar. 02, 2006).

¹⁰⁸ Press Release, European Commission, Accounting Standards: EU Commissioner McCreevy and SEC Chairman Cox affirm commitment to elimination of the need for reconciliation requirements (Feb. 9, 2006), *available at* <http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/06/142&format=HTML&aged=0&language=EN&guiLanguage=en> (last visited Mar. 02, 2006).

¹⁰⁹ Proposal for a Directive on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC, *available at* http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=COMfi nal&an_doc=2004&nu_doc=177 (last visited Feb. 20, 2006).

bodies of third countries such as the US Public Company Accounting Oversight Board.”¹¹⁰ Furthermore, the Directive requires the following:

Auditors and/or audit firms from third countries that issue audit reports in relation to securities traded in the EU, need to be registered in the EU ... and be subject to Member State systems of oversight, quality assurance and investigations and sanctions.... In order to prevent unnecessary international regulatory overlap Article 46 allows for exemption from registration, oversight, quality assurance and investigations and sanctions if audit firms from third countries are subject to *equivalent* systems of registration and oversight Another important obligation is *reciprocal treatment* of Member States by the third country. To have a common EU assessment and, thus, secure equal treatment of third countries throughout the EU, the Commission will perform this assessment at EU level in cooperation with Member States.¹¹¹

There are several points to notice about the proposed Directive. First, the E.U. adopts an equivalence approach. The E.U. will require foreign auditors to be subject to domestic oversight, unless the foreign auditors are already subject to *equivalent* oversight. Second, the E.U. is protesting what it perceives to be an improper attempt by the U.S. to assert extraterritorial jurisdiction over European firms. In response, the E.U. threatens to assert European jurisdiction over U.S. firms. This explains why Europe will make its equivalence determination at the E.U. level rather than at the national level – separately, individual European member states are at a size disadvantage vis-à-vis the U.S.; united, the threat of European jurisdiction carries more force.

The third point is that E.U. regulators have formally incorporated the idea of reciprocity into the concept of “equivalence.” The proposed Directive explicitly states that the E.U. will not exempt third country auditors unless there is reciprocal treatment of European auditors by the third country. This is a novel and important development. There is no comparable E.U. statutory or regulatory provision in the accounting standards

¹¹⁰ *Id.*

¹¹¹ *Id.*

context or in the financial conglomerates context; those Directives were passed a few years earlier, when the concept of equivalence was not as well understood. The proposed E.U. auditor oversight Directive signals a formal shift from a pure equivalence approach to an equivalence-plus-reciprocity approach.

V. Conclusion

In an earlier era, harmonization appeared the only option for those who advocated international financial integration. More recently, equivalence has emerged as a viable alternative. This paper gave four examples: (1) U.S. and E.U. accounting standards, (2) E.U. regulation of financial conglomerates, (3) U.S. regulation of auditors, and (4) the U.S.-Canada Multi-Jurisdictional Disclosure System. Most of these examples involve the U.S. and the E.U., but equivalence is not limited to the trans-Atlantic context. Equivalence is currently being applied between the E.U. and Switzerland (for financial conglomerates), the E.U. and Canada (for accounting standards), and the E.U. and Japan (for accounting standards). In the future, as the U.S. and Japan pursue closer regulatory cooperation¹¹², equivalence may be used there as well.

Even as equivalence has become more common, the precise relationship between equivalence and harmonization remains a matter of considerable debate. The dominant understanding is that harmonization and equivalence are two distinct concepts.

Harmonization pushes for rules to become similar; equivalence allows differences to persist. A counterpoint understanding is that harmonization and equivalence are more

¹¹² See, e.g., Speech by SEC Commissioner: Remarks before the Center for the Study of International Business Law Breakfast Roundtable Series, by Commissioner Cynthia A. Glassman, U.S. Securities and Exchange Commission, October 7, 2005, “The SEC in a Global Marketplace: Current Issues”. Available at <http://www.sec.gov/news/speech/spch100705cag.htm> (last checked Apr. 30, 2006).

alike than distinct – like harmonization, equivalence should focus on making rules more similar rather than acknowledging persistent differences. There is a third understanding of equivalence, one which rejects altogether the notion that we should focus on legal similarities and differences; instead, the market-based test suggests that two regulatory regimes that have different legal characteristics may nevertheless be “equivalent” if they produce the same economic effects.

This paper takes the view that equivalence and harmonization are not mutually exclusive; instead, they can and ought to be used in combination with one another. Nevertheless, there are some situations in which we will want more harmonization, and others in which we will want more equivalence. In general, where there is no overarching, international political structure such as the E.U., equivalence has the advantage of feasibility, flexibility, and being conducive to healthy regulatory competition.

On the other hand, proponents of equivalence should recognize and avoid potential pitfalls. Regulators should be careful not to jeopardize investor protection, which is the primary reason for having securities regulations in the first place. Also, regulators should disclose their equivalence findings to the public, or alternatively, offer reasons for non-disclosure. They should also take care that equivalence does not distort the market, giving some companies an unfair competitive advantage over other companies. Most importantly, regulators must not overlook the importance of mutual benefit and reciprocity; otherwise, they risk impasse and stalemate.