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Preventing *European* "Enronitis"

BY KLAUS C. ENGELEN

How European regulators are handling the spillover effects of Sarbanes-Oxley.

Are the international spill-over effects of the U.S. Sarbanes-Oxley legislation becoming another nightmare for European businessmen, investors, and policymakers? Will the outreach of this U.S. legislation and its conflicts with legal and regulatory systems in EU member states escalate into another major strain on transatlantic relations? Most European accountants, financial executives, regulators, and corporate lawyers—haunted by the far-reaching extraterritoriality of the new law—would say "yes." Anger over the new post-Enron U.S. capital market laws is vented in the sarcastic reply given by the spokesman of a leading European industry association to the question: "What does Sarbanes-Oxley mean? That's when two members of U.S. Congress fiddle and half a million accountants in Europe start dancing."

But there is also a less pessimistic scenario from a European perspective for two reasons. First, under mounting pressure from global markets and an increasingly critical general public, most European governments, lawmakers, and regulators are being forced to speed up long-delayed modernizations of oversight structures for accountants as part of a broader overhaul of corporate governance structures. This makes it easier for EU Commissioners such as Frits Bolkestein to push modernization directives in areas such as EU financial market supervision, accounting oversight, and corporate governance standards—reform initiatives that for many years have been blocked by national governments and private sector interests. Second, at both the new U.S. oversight board and at the EU Commission, extremely experienced and skillful negotiators are pulling the strings.

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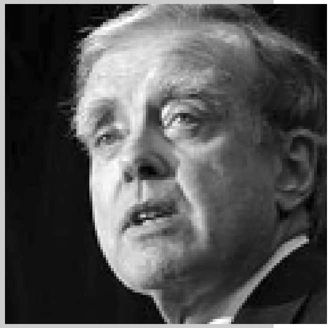
McDonough's Key Backstage Role

Since June 2003, William McDonough, 69, has headed the newly established Public Company Accounting Oversight Board (PCAOB). A former president of the New York Federal Reserve Bank, McDonough became the "super diplomat" on the world financial stage when, in July 1998, as chairman of the Basel Committee on Banking Supervision, he began negotiating the new risk-adjusted bank capital accord called "Basel II," a centerpiece in reforming the international financial architecture. And at the outgoing EU Commission, Frits Bolkestein, Commissioner in charge of Internal Market and thus chief Brussels negotiator on matters such as auditing, accounting, corporate governance, and financial supervision, is a skilled negotiator, having played a key role in adjusting Europe's internal markets to the new challenges of globalization.

The tone between Brussels and Washington improved after William McDonough, in June of last year, took charge of the new U.S. oversight board.

As it turns out, after a bumpy start both McDonough and Bolkestein have been working closely together to dampen the extraterritorial shocks of Sarbanes-Oxley on EU member countries and corporate governance systems. Both are talking about a basic understanding (that might fall apart when both leave office this fall) along this line: That U.S. authorities will cooperate under the Sarbanes-Oxley Act with their European counterparts with a view to the emerging future oversight structures of EU member states. These oversight structures will be established under the Eighth Company Law Directive. In return, the EU Commission promises to speed up the passing and implementation of the new Directive on "statutory audit of annual accounts and consolidated accounts" in order to make sure that the reformed U.S. capital market laws will get their missing EU links in the form of the new oversight structures for EU audit firms. This way, the feared showdown between the post-Enron United States and the post-Parmalat European Union can be avoided.



William McDonough

LUCK IN ADVERSITY: EXPERIENCED NEGOTIATORS

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Since early December 2001—when U.S. energy giant Enron filed for Chapter 11 in what was at the time the largest-ever bankruptcy—U.S. authorities and legislators have responded to the revelations of massive systematic fraud surrounding this corporate failure with great resolve and lightning speed. Enron's collapse was followed by revelations of fraudulent accounting practices, willfully misleading disclosure, and other wrongdoing at major publicly traded corporations including Global Crossing, Tyco, Adelphia Communications, WorldCom, and Xerox.

While U.S. authorities and legislators acted swiftly and forcefully, Europeans needed time to realize how much "Enronitis" was a global disease. When similar excesses and abuses came to light in several prominent European firms—starting with Vivendi Universal, ABB, and Royal Ahold and leading to such spectacular corporate failures as Parmalat—the minds of European policymakers, regulators, companies, investors, and the general public finally focused on the weaknesses of corporate governance systems and the threats posed to the integrity and stability of financial markets. "The Parmalat affair," notes the Bank for International Settlements (BIS) in its 2004 Annual Report, "indicated shortcomings at every possible level: senior management, internal audit, external audit, bank lenders, bond underwriters, rating agencies, investment bank analysts, and the overseers of many of the above."

EUROPEAN UNION'S EXEMPTION CALLS IGNORED IN WASHINGTON

By the time Europeans woke up to the spillover effects of the post-Enron legislation, the comprehensive Sarbanes-Oxley Act—authored by Maryland Democratic Senator Paul Sarbanes and Ohio Republican Representative Michael Oxley—was already on the U.S. statute books.

The legislation, signed by President Bush on July 30, 2002, applies to all publicly held companies, their audit firms, and all actively working auditors. The changes in U.S. capital market laws through Sarbanes-Oxley have far-reaching irreconcilable differences with the laws, regulations, and corporate governance systems of EU member states.

EU finance ministers reacted angrily last year, urging the EU Commission to negotiate with U.S. authorities to obtain exemptions for EU corporations and audit firms. At the top of their list was a full exemption for audit firms from registration with the newly established Public Company Accounting Oversight Board. In addition, while recognizing the importance of audit work papers to effective auditor oversight, the finance ministers raised concerns about U.S. authorities' access to a foreign firm's audit work papers. In some EU member states, the law requires audit firms to keep audit papers confidential.

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But drafting an impressive list of calls for exemptions for EU auditing firms under the Sarbanes-Oxley Act is one thing. For the EU Commission to actually obtain concessions from those U.S. agencies that must implement the new law—the Securities and Exchange Commission and the PCAOB—is quite another.

At the outset, the Commission offered harsh criticism. Considering the potential impact of Sarbanes-Oxley on foreign companies and audit firms, the fact that the SEC only granted a thirty-day comment period "indicates the lack of willingness on the part of the United States to cooperate internationally." The tone between Brussels and Washington improved after William McDonough, in June of last year, took charge of the new U.S. oversight board.

Frits Bolkestein *on Sarbanes-Oxley: "We in the European Union were faced with a simple choice: Either we could oppose tooth-and-nail the Sarbanes-Oxley Act and add yet another fiery dispute to our post-Iraq bilateral relations, or we could try to find a constructive, cooperative way forward, jointly respecting to the maximum degree possible our different legal traditions and cultures. We decided on the latter."*

Yet one could ask: What have the SEC and the PCAOB, as agencies implementing the new law, come up with to soften the Sarbanes-Oxley blow for outside jurisdictions such as Germany? The answer: Not much.

Up to now only two concessions demanded by Germany's justice minister Brigitte Zypries have been made by the SEC. First, labor representatives can be members of supervisory boards, if they are not part of a company's management. (Under the Sarbanes-Oxley Act, members of a company's supervisory board and audit committee must be "independent" from a corporation.) Second, a corporation under German law can continue to have the statutory auditor elected by the general shareholders' meeting, acting as the law states on the proposal of the company's supervisory board.

This means that most of what the EU Commission called for in its 2002 response paper and that were endorsed last year by EU finance ministers fell on deaf ears in Washington.

The registration requirement of EU audit firms with the PCAOB is a dramatic case in point. As the EU Commission criticizes, this subjects all major audit firms in the European Union to double oversight by both the EU member states and the U.S. oversight board. This may result in conflicts between the two oversight mechanisms, and also causes additional administrative and financial burdens for European audit firms. The application of U.S. standards on ethics, auditing, quality assurance, and auditor independence may hinder the EU audit firms from fulfilling EU requirements which are or will be based on internationally accepted standards. Whether the U.S. and EU accounting standards will converge is still an open question.

U.S. access to EU audit working papers is in some respects the biggest bone of contention. Under the Sarbanes-Oxley Act, the SEC and the PCAOB have access to the working papers of EU firms that perform at least material audit services for SEC registrants, including any client document in the audit firm's possession. This, however, violates EU member states' laws and/or professional standards that require statutory auditors to maintain strict confidentiality with respect to audit working papers. Also, it overruns existing Memoranda of Understanding with the SEC. (How much the European Union has been capitulating under the weight of U.S. economic and financial power is shown by the new draft of the Eighth Company Law Directive. In Section 47 it provides for U.S. access to EU firms' audit papers through the forthcoming new national EU auditing oversight boards.)

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There remain many other hotly contested legal issues on the EU Commission's list, including audit committee requirements, auditor independence, loans to directors and executive officers, certification of financial reports, and certification of internal control systems.

EUROPE'S ACCOUNTANT PROFESSION IN REVOLT

So it doesn't come as a surprise that Frits Bolkestein and Alexander Schaub, his Director General, can count on a wave of anger and frustration among European auditors, financial executives, regulators, and politicians when battling with the Americans. Schaub, who had a key role in communicating the European Union's problems with Sarbanes-Oxley to U.S. lawmakers, told the world's leading bankers gathered in London for the International Monetary Conference (IMC) in early June, "The Sarbanes-Oxley Act is the textbook case for regulatory spillovers, when decisions in one country may have direct and immediate consequences on economic operators or regulators operating primarily or even exclusively in another country." Schaub criticized that, "There was no dialogue and no attempt to take account of any extraterritorial consequences. Thanks to an effective mobilization of European interests and the pragmatic and open attitude of relevant U.S. authorities, these tensions have been effectively diffused."

But have they? Schaub continues: "As globalization intensifies, the risk of international financial contagion and regulatory spillovers will grow. There will be a need for a common understanding of the core prudential safeguards, and a clear assignment of responsibilities for oversight and enforcement."

Tom Lawton, senior audit partner at RSM Robson Rhodes, sums up the dominating European view: "Sarbanes-Oxley, enacted in haste, will be quite inhospitable to non-U.S. corporations, financial institutions, and audit firms."

On January 26, of this year, David Devlin, president of the Brussels-based FEE, the Fédération des Experts Comptables Europeéns, responded to the PCAOB rules relating to the oversight of non-U.S. public accounting firms with what some considered a "wake-up call" for the new U.S. oversight board to be more forthcoming and cooperative towards non-U.S. audit professionals.

As head of the European professional association, Devlin can speak for more than half a million accountants in 41 professional institutions from 29 countries in Europe. In his letter to the PCAOB secretary, he warned that "limited co-operation, based only on the PCAOB model, offers a difficult prospect." Said Devlin: "There is a risk of unseemly litigation between European firms or oversight bodies and the PCAOB." This may come about "by the imperatives of some future scandal and conflict between PCAOB rules and national law." There might also, in a particular case, "be the risk of inconsistent findings between a national oversight system and the PCAOB." Overall, limited cooperation offers ineffective solutions. "In such a scenario, the benefits of continuous development of existing systems could well be lost," warns Devlin.

Under the shadow of the spectacular corporate scandals of recent years, audit firms around the globe are negotiating from a position of weakness.

The FEE president was condemning the PCAOB's rules for not supporting "mutual cooperation with other high-quality regulatory systems that respect the cultural and legal differences of the regulatory regimes that exist around the world."

But under the shadow of the spectacular corporate scandals of recent years—in which one of the five big accountant firms, Arthur Anderson, LLP, went under—audit firms around the globe are negotiating from a position of weakness. The process of setting new international standards covering auditor independence and audit quality, says the OECD in its recent "Corporate Governance Survey of OECD Countries," is driven by the realization that "the four large international accounting and audit companies are not in fact a guarantee of uniform quality standards across countries." Thus, the International Organization of Securities Commissions (IOSCO) has worked out principles covering auditor independence and auditor oversight.

As it turns out, the broadsides from Europe's accounting profession and similar highly critical responses from several

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associations of European industry, in particular UNICE, the Union of Industrial and Employers' Confederations of Europe, had some impact. It strengthened the hand of those in Washington and Brussels who opted for cooperation instead of confrontation. In this effort, Bolkestein didn't mince his words. Sarbanes-Oxley's extraterritorial transgressions were leading "to great concern throughout Europe," he told the Americans early on. And he added: "I have been rather critical of this legislation, which I considered to have been prepared in haste, without proper consideration of conflicts of law."

BOLKESTEIN AND MCDONOUGH OPT FOR DETENTE

Bolkestein gives several reasons why—so far—Brussels has been avoiding a showdown on Sarbanes-Oxley's spillover effects and instead has been opting for cooperation with the SEC and the PCAOB.

First, he admits that once Sarbanes-Oxley was adopted, "We in the European Union were faced with a simple choice: Either we could oppose tooth-and-nail the Sarbanes-Oxley Act and add yet another fiery dispute to our post-Iraq bilateral relations, or we could try to find a constructive, cooperative way forward, jointly respecting to the maximum degree possible our different legal traditions and cultures. We decided on the latter."

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Second, he realizes that since the Parmalat disaster, Europe is under even heavier pressure from the public and the markets to quickly strengthen its own corporate governance structures and improve oversight, transparency, and quality of accounting and auditing standards. Addressing the European Parliament in Strasburg on February 11, 2004, Bolkestein called on the financial service industry to "better get its act together, and do so fast." Europe needs "some real industry leadership to stand up and take charge: to clear out the crooks, expose their unscrupulous practices, and curb excessive greed." And he added: "The apparent size of this [Parmalat] fraud is staggering. And the apparent complicity of a number of people from distinguished, liberal professions together with failures of regulatory control—equally so."

Third, Bolkestein's way out of the "hall of shame" connected with such corporate frauds as Royal Ahold and Parmalat is the European Union's new Corporate Governance Action Plan, unveiled in May 2003. It is aimed at strengthening the single market and providing a comprehensive and flexible framework for company law and corporate governance in Europe. Its main features are modernizing the board of directors, increasing disclosure and transparency, and empowering shareholders. A centerpiece will be the Eighth Company Law Directive that will clarify the duties of statutory auditors, their independence and ethics, and introduce the full responsibility of the group auditor for the audit of consolidated accounts of groups of companies. All this will be supported by EU Commission proposals for a framework for cooperation between relevant authorities of third countries.

FOR UNITED STATES AND EUROPEAN UNION, MUCH IS AT STAKE

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Oxley on EU member countries and corporate governance systems. Both are talking about a basic understanding (that might fall apart when both leave office this fall) along this line: That U.S. authorities will cooperate under the Sarbanes-Oxley Act with their European counterparts with a view to the emerging future oversight structures of EU member states. These oversight structures will be established under the Eighth Company Law Directive. In return, the EU Commission promises to speed up the passing and implementation of the new Directive on "statutory audit of annual accounts and consolidated accounts" in order to make sure that the reformed U.S. capital market laws will get their missing EU links in the form of the new oversight structures for EU audit firms. This way, the feared showdown between the post-Enron United States and the post-Parmalat European Union can be avoided. But in case the United States falls back to a more confrontational stance, Brussels could put "Plan B" in action: using the substantial dose of reciprocity requirements in the new Company Law Directive as a lever to get the United States back to the negotiating table.

On both sides of the Atlantic, policymakers and market actors realize that when it comes to controlling the spillover effects of Sarbanes-Oxley, the stakes are high. Bolkestein's Director General Alexander Schaub, in hearings before U.S. congressional committees, reminds Washington lawmakers: "In the modern global economy, the European Union and United States are each other's biggest partner. Capital markets (bonds, equities, and bank assets) amount to over $50,000 billion in both the European Union and United States, equivalent to 6.5 times and 5.5 times GDP respectively. EU and U.S. equity markets together represent 80 percent of global stock market capitalization. Fifteen percent of the total capital raised by EU equity issuers through primary offers was raised in the United States. This interdependence can only intensify as technology expands the possibilities for overseas trading and remote provision of services."

Also, cross-border trade and direct investment flows the numbers are staggering. Schaub notes that in 2000, two-way cross-border trade in goods and services amounted to more than €650 billion (€412 billion in goods and €238 billion in services). Transatlantic trade represents 39 percent of EU and 35 percent of U.S. total cross-border trade in services. EU and U.S. companies invest more in each other's economies than they do in any other area of the world. The European Union and United States accounted in 2001 for 49 percent and 46 percent respectively of each other's outward foreign direct investment flows. The European Union accounted for 54 percent of U.S. inward FDI and the United States for 69 percent of EU inward FDI. These figures will expand even further now that the European Union has enlarged from fifteen member states to twenty-five. "The fact is," said Schaub, "that a large number of EU and U.S. jobs are dependent on developments in the other's economy and regulation."

Nobody can say that there hasn't been a lot of dynamism in expanding transatlantic financial markets, because:

- Annual purchases and sales of foreign securities by U.S. investors grew from US$53 billion in 1980 to US$6.6 trillion in 2003.
- Flows in the opposite direction increased even more dramatically. Non-U.S. investors bought and sold US$198 billion in 1980 compared to $30.9 trillion today
- Fifteen percent of total capital raised by EU equity issuers through primary offer was raised in the United States.
- Some finance fields such as issuance and underwriting, M&A consultancy, and credit ratings, as well as audit and accounting, are dominated by a handful of global players implementing intercontinental strategies.

EUROPEAN UNION IS BUILDING NEW OVERSIGHT STRUCTURES

As PCAOB Chairman McDonough reported to the U.S. Congress on June 24 of this year, Sarbanes-Oxley is directed towards the auditors of 15,000 U.S. public companies that seek to raise capital in

U.S.markets. The securities of about 1,400 non-U.S public companies also trade in U.S. securities markets, and so those companies must also follow many of the requirements of the Sarbanes-Oxley Act, including the requirement to file financial statements audited by a registered public accounting firm with the SEC.

Under Section 106(a), non-U.S. firms are subject to Sarbanes-Oxley and to the rules of the PCAOB "to the same extent as a public accounting firm that is organized and operates under the laws of the United States." At that date, the PCAOB had 164 non-U.S. firms registered. McDonough stated, "At this point, we expect that as many as 400 non-U.S. firms may register with the Board." And McDonough continued: "Last October, we issued a briefing paper that describes a framework for oversight that depends, to the greatest extent possible, on cooperation among regulators. That paper fostered an international dialogue that contributed to the development of a landmark European proposal for an independent auditor oversight regime in Europe and to an unprecedented confluence in Brussels this past March of auditor oversight bodies from every European member state to discuss with us how we can mutually improve the quality of auditing on both sides of the Atlantic."

In spite of the fact that large segments of Europe's internationally active accountants are drowning in the spillovers of Sarbanes-Oxley these days, the most recent assessment by the profession's top spokesman in Brussels seems like a light at the end of a tunnel. "The recent European Commission's proposal to revise the Eighth Company Law Directive, together with the PCAOB's 'Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms,' provide a pragmatic way forward for the oversight and inspection of auditors," says David Devlin, president of FEE. "It is early in the process, the PCAOB is a relatively new organization, hence its inspection programs are still at an early stage, and in Europe, established public oversight arrangements may need to be adapted to conform with the revised Eighth Company Law Directive." Commenting on the coordination of public oversight in Europe, Devlin adds: "The Eighth Company Law Directive proposes that national oversight bodies should cooperate with each other and with foreign counterparts, such as the PCAOB. FEE believes that the Eighth Company Law Directive could be strengthened to provide for a separate body to effect the cooperation between national public oversight systems. This body would work to ensure that public oversight is equally effective in each EU member state." In Devlin's view, the Eighth Company Law Directive provides for a strong element of reciprocity. "Taken together with the PCAOB's final ruling, there is a clear incentive for cooperation on the oversight and inspection of auditors."

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How fast can the European Union get what Devlin calls a "separate body to effect the cooperation between national public oversight systems"? According to Grant Kirkpatrick of the OECD Corporate Affairs Division, sooner rather than later. Kirkpatrick prepared the recently released "Corporate Governance Survey of OECD Countries." In his view, there is no need to load the Eighth Company Law Directive with establishing a new PCAOB structure on the EU level. Instead the European Union should place audit oversight with the "Committee of European Securities Regulators" that has been operating since June 2001. This Paris-based Committee of EU regulators is part of the so-called "Lamfalussy Process." That is the EU framework to make regulatory and supervisory structures more efficient. It was introduced following proposals made by Baron Alexandre Lamfalussy, former Belgian central banker and president of the European Monetary Institute, the forerunner of the European Central Bank.

CESR's mandate, however, is focused on securities market regulation—a realm much narrower than that needed for the supervision of Europe's auditors whose clients are predominantly unlisted. The EU Commission points to the fact that "there are more than a million audits but only about 7,000 listed companies in EU member states. As a result, Kirkpatrick's proposal does not come without problems. "Such a CESR proposal, says Devlin, chief lobbyist for Europe's accountants, "wouldn't be such a good idea. Our alternative is a much better one." ◆