

**The EU Perspective : How Accountants fit in creating a Single  
Capital Market**

**By**

**Michel Petite**

**Director General Legal Service, European Commission**

**Accountancy 2003**

**London Conference**

**July 8 ,2003**

- 1. Your Colleagues of the Institute suggested that I should answer this question: “How accountants fit in creating a Single Capital Market?”. And to deal with this right away, I would answer that accountants fit pretty well in the creation of a Single Capital market.**

2. Now President, ladies and gentlemen, let me say how honoured I feel to have been invited to your Annual Conference, amidst such distinguished speakers and knowledgeable audience, and many old friends.

I say 'old friends', because I would prefer to believe - probably out of nostalgia - , that you invited - not the Director General of the Legal Service - but the once young official who, 20 years ago, was sweating hard with some of you on what was finally passed as the 7<sup>th</sup> Company law directive; at the time considerable amount of energy and expertise were devoted to the vexed question of the scope of consolidation (that is : when is a company a parent company that should consolidate its subsidiaries ? And when is a company a subsidiary ? These issues were once a major cause of non-comparability of account throughout Europe).

Or maybe you invited the same official who, 15 years ago, was in charge of the Internal Market in the Cabinet of Lord Cockfield. These were the days of the Directive on a general Mutual Recognition of Professional qualifications, and at the time each single profession -

from the physiotherapists or the teachers, to the accounting profession – was adamant that theirs was unique, and could certainly not fit in a general system of mutual recognition. But finally, they more or less did; and the accounting profession also did, a little bit reluctant and with some specifics, but I guess feeling that there was more to gain than to lose out of it, in a context of your profession and of your Institute, which export so well.

These were also the days of the Banking directives, in particular the 2<sup>nd</sup> Banking directive on free establishment of Banks under the Home Country Control.

Strangely enough, these texts have remained virtually unchanged. Not that they were particularly well drafted, or drafted to last; or that they were left forgotten; but they were basic texts, on which it has proved possible to build.

3. Now, in case you did invite me as Head of the Commission's Legal Service, I ought to say a word on its function within the European Commission.

**This is a team of 130 lawyers, working very much like a reasonable sized law firm, whose role is two-fold:**

- **first, as the in-house lawyers of the College of Commissioners, we give a legal advice on all the legislative proposals prepared by the other services: on their consistency, on their legal and institutional formulation. And beside proper legislative proposals, we produce on demand legal advice on any question raised by a service or a Commissioner. And they are not shy with asking : In 2002, we were asked for over 12.000 consultations.**
- **and second, we are the Commission's advocate, mostly in the European Court of Justice in Luxembourg, and also at the WTO in Geneva where we act on behalf of the European Union.**

**This action takes several forms: bringing a Member State or another European institution to the Court for infringement to the Treaty, or defending Commission's decision contested by an individual or**

**a company. We also systematically intervene in all the preliminary rulings on interpretation of Community law, which the national Courts raise to the European Court of Justice.**

**Indeed, we are a party in - every case in the European Court. This represents around 600 cases at the Court or 1<sup>st</sup> Instance and 500 with the Court.**

- Finally, yes, there are case where as a Legal Counsellor we have advised the College not to take a decision; but for good political reasons, they nevertheless have taken it; and we have to defend in Court what we advised against. This is good gymnastic for the mind, and help us to remember that truth can be relative.**

- 4. Your profession has always been at the heart of our efforts for the completion of the single internal market . Accounting is at the core of a series of internal market directives: the company law directives (4<sup>th</sup> 7<sup>th</sup> , 8<sup>th</sup> ), the financial services, accounting directives for banks and insurances, and in taxation . Yes, taxation: I know that in**

**UK the secret has been well kept, and accordingly this should remain between us. But we know that harmonisation of taxation has been achieved in the European Union, and that indeed for indirect taxes, not the rates - left to the Member States, but almost everything else has been harmonised. Otherwise, VAT borders would have remained and products could not circulate freely.**

**I should congratulate your Institute for playing a very significant and active role with its contributions and feedback during all the consultation processes. These bring the mark of your large experience which helps my colleagues to shape legislative proposals.**

- 5. Now once more you are at the frontline of our efforts for the completion of the European Capital Market whose rules of the game should guarantee integrity, transparency, disclosure and level playing field. The Enron crisis and some accounting problems closer to us have shaken the foundations of the world capital markets, and have eroded the investors' confidence on a global scale. In substance, they have questioned the premises on**

**which rely the legal, institutional, accounting, auditing and supervisory structures of the US and other capital markets. They have highlighted the need for high degree of integrity, transparency and enforcement for all the institutions which intervene, as gatekeepers, in the chain of capital raising. This includes such companies as issuers, accountants, auditors, investment banks, stock exchanges, analysts, lawyers, rating agencies, regulators and supervisors.**

- 6. And now we must recover speedily the confidence of European and international investors that has been shaken. Your profession as accountants and auditors is the backbone of financial regulation, financial stability, and corporate governance and should beyond any doubt inspire public confidence. In order to help in this difficult crisis, the European Commission has developed a post – Enron audit strategy which addresses many of these issues.**
- 7. A European Financial Services market has taken some good steps when the Internal Market as a whole was the main subject of the Delors days. However, new challenges**

now lay ahead following the advent of the Euro, the imminent enlargement and the European Convention which has just delivered a draft European Constitution. These are reflected in a broad Commission's Financial Services Action Plan for the years to come.

8. At the European level, we seem to be facing at present three major challenges, which I will briefly address in turn  
first the completion of the legal and regulatory framework of the European capital market by 2005,  
second the successful task of the Enlargement of the EU to 25 Members,  
third the challenge of the global capital market place.

- I. European Financial Services Market and its regulatory frameworks

9. The objective is the creation of a single financial market based on the fundamental Treaty freedoms of establishment for banks and other financial institutions, the cross-border provision of financial services and the free movement of capital. The prospect is a stable, sound



**and efficient European financial system, and the method is the mutual recognition of authorisations and supervisory systems based on the harmonisation of the essential elements of financial regulations. This allows for the single financial passport throughout the EU.**

- 10. The classical achievement of this method has been the Second Banking Directive, which remains the cornerstone of the European banking markets. But until recently, for all sorts of reasons, the securities regulation had not registered the same progress. As you know well, one of the greatest challenges in this field is to achieve a level playing field by creating a regulatory framework capable of accommodating the different securities market structures.**
- 11. The real test case of mutual recognition is now the revised Investment Services Directive which is currently under negotiation. The ISD aims at achieving the mutual recognition based on the harmonisation of essential rules, which guarantee the protection of the European investors and the integrity and transparency of the securities markets.**

- 12. These rules –which were not harmonised in the 90' - include the conduct of business rules, the best execution, the handling of client's monies, transparency etc.. These rules are closely interlinked with the companion directives on market abuse, prospectus, and transparency. The Commission takes the view that in principle professional and sophisticated investors do not need the same degree of protection as provided for the average investor. Thus the Investment Services directive will eliminate some costly and bureaucratic duplications that the investment firms face when they are conducting their business on a cross-border basis.**
- 13. We believe that this balanced approach of mutual recognition and single passport will significantly restrict the practices of some structurally defensive administrations, which in the past have invoked unjustifiably the so –called “general good” clause, in order to protect their national markets.**

**14. This will not be done without a degree of harmonisation.**

Once more the philosophical debate on harmonisation, with all its practical implications, is on the agenda of policy makers, regulators and supervisors. Though this discussion is a *déjà vu*, it takes new directions. The harmonisation debate in Europe frequently reflects the conflicting visions and entrenched national interests on the completion of the financial services market. We should remain agnostic about market structures, but try to lay down a level playing field.

**15. I need to say that harmonization was never a Brussels religious dogma as some have tried to portrayed it. It has always been a legal instrument for the completion of the internal market.**

Some harmonization is necessary in order to provide the central elements of confidence and recognition of our different structures. In Financial Services, it will provide the “public goods” of stability, integrity, transparency of financial markets. Without this groundbase of mutual trust, there is no point claiming for mutual recognition. It

**will simply not take place. This is what the history of 40 years of internal market for goods and services have taught us. And this, by the way, does not always and necessarily coincides with the so-called cost-and benefit economic analysis, sometimes called for as the ultimate test for do-ability. Harmonization lays down basic rules which are necessary, and which are legally binding and enforceable throughout the EU, bearing the same consequences for each individual. Without them, room is left wide open to discrepancies and varying degree of implementation by Member States, and indeed inexorable failure of a level playing field.**

**In conclusion to this point, the art of the present time is :  
how much or how little to harmonize.**

- 16. Viewed with the hindsight of the last twenty years the landscape of the European Financial Markets has changed dramatically. The EU's legislative action, the operators financial innovation, and very much the advent of the *Euro*, had a major impact on the further integration of the Europe an capital markets. Today we**

can safely say that the *wholesale financial markets* are highly integrated.

17. However this is not the case with *retail markets* where multiple, legal, regulatory, supervisory, tax, accounting, linguistic and cultural impediments are still fragmenting the European financial markets and generate high transaction costs for the investors and the firms. In fact, in contrast with their official liberal stance, the majority of supervisors perceive themselves as the “guardians of their national markets” and not necessarily as promoters of the home European market which should be at the heart of the interest of their investors and their companies.

18. The fact is that despite the liberalisation of branching and cross-border provision of financial services, retail financial markets remain to a great extent domestic.

The retail mortgage market is a good example where obtaining a secure title to collateral in other Member State shies away the banks from granting a mortgage. The different tax systems still play a significant role in

**discouraging the cross border provision of services and of branching.**

- 19. It is also typical that despite our consistent efforts, delays in the adoption of the take-over bids directive is a significant stumbling block for an integrated financial market. Because mergers and acquisitions are one of the most important means of penetrating markets. The risk now is that the end product could be of little use.**
- 20. Another cause of the fragmentation of the financial market has been the implementation of the directives and the highly diverging methods of national regulatory enforcement. The investment Service Directive of 1993 left a large margin of discretion to the national regulatory authorities, and they have indeed implemented and interpreted it in very differentiated ways.**
- 21. The Commission has taken action in some blatant cases of incorrect implementation through its infringement procedures. However, on such issues, we rely almost entirely on the industry and the operators, to complain**

**and help us identify potential violations of Community law.**

- 22. Finally, the Commission is consistently applying competition rules throughout the financial sector. I am sure all of you are well aware of the theoretical case of a profession which market structure includes an oligopoly of a few mega-firms, (say "the Big any number"), in a situation where for varying reasons, this number tends to shrink...**
- 23. The frequent criticism of the industry is that the EU legislative process is slow, complicated and delivers mixed quality results. In general it is difficult to adjust to galloping financial market developments and has not been subject to sufficient consultation . A Group of Experts chaired by Baron Lamfalussy identified some of the problems in the securities markets area and tried to propose some institutional and legal arrangements for speeding up the legislative process in the area of securities law securities.**

**24. The proposals of this Committee were designed particularly for the securities sector where limited harmonized regulation existed, and thus host country authority regulation played an important role.**

**Mr. Lamfalussy's main proposal was that the legislative process will be accelerated if**

- a) the essential principles were to be adopted in framework directives by the European legislator (long process) (level 1) and**
- b) implementing measures were to be adopted by the Commission which should include the detailed and technical aspects (level 2)**
- c) national supervisors would contribute more actively and strive to achieve convergence of their practices .**

**This method is nothing really very new, but certainly had the merit of focusing the attention on the need for our Ministers to take decisions.**



**25. The difficulties of the exercise are also well known :**

**First, not always easy to identify precisely what is an essential measure that should be included in the framework directive, and what is technical and should be adopted at the implementing level by the Commission. A constant risk is that either the Council of Ministers and the European Parliament, the 2 co-legislators, will insist on having a too detailed "framework directive", sometimes in order to make sure that some particular national provisions are engraved in the marble and protected by the primary legislation.**

**26. Second, when it comes to adopting the implementing measures, the Commission takes into account the proposals produced by the Committee of Supervisors. However, one task of the Commission is to turn these measures in concrete and binding legal effects, and for this we have to choose the appropriate legal instrument:**

- if the "implementing" measures take the form of a directive, then the Member States will have to further**

**implement it , with the risk of divergences mentioned a moment ago;**

**- if the "implementing" measures take the form of a regulation, then this risk is avoided, but the text has to be precise enough to be directly applicable by all national authorities.**

- 27. Third, it is important to define the demarcation line between implementing measures adopted by the Commission taking into account the Committee of representatives of Member States, and the supervisory convergence (level 3), where national supervisors are streamlining their practices . The difference is that while the implementing measures of the Commission are legally binding, the supervisors are supposed to make their practices converge, without any binding effect . Will they be able to do so, on a voluntary basis? Or will they tend to make their difference, or protect their national markets? Future will soon tell.**

## **II The Enlargement and the Enforcement Challenges**

28. The target date for this scheme is 2005. In fact however, the Commission tries to have all the program adopted by April 2004, before the election of a new Parliament, because the legislatives which have not been adopted would fall; and before the Enlargement takes place on 1 May 2004 takes place.
29. The real challenge for the Enlarged Union will be the consistent and effective enforcement of its legislation for financial services and accounting rules by national regulatory and supervisory authorities. This is essential because the mutual recognition and the free establishment, fully applied, means that. a host country assumes that the financial institutions of the home country providing cross-border financial services in its jurisdiction, are subject to adequate prudential supervision; and that the issuers listed in its exchange have fulfilled the appropriate accounting, auditing and all disclosure and transparency requirements that foresees the Community legislation. All this requires full

**confidence between the regulatory and supervisory authorities of the Member States; and this is not to be taken for granted, for good or bad reasons.**

- 30. Together with the present Member States, the acceding countries will have to implement effectively and in a very short period of time, the new financial services, and accounting legislation, into their national laws. This process requires, amongst other things, a high level of administrative, institutional and legal capacity within the competent regulatory and supervisory authorities and close co-operation with their EU counterparts, which is far from obvious.**
- 31. For this reason, during the pre-accession period, several programs - in which many of your profession participated, were designed to support the institution building of national regulatory, and judicial authorities. These fundings supported the reinforcement of their human resources, their administrative capacities and the adoption of the best practices. But there is something of a jump in the unknown, both for our countries and for the new comers. All we can say for the time being is that it**

**will be very important after the accession of these countries, to ensure efficient enforcement in the transposition and implementation of the legislation.**

- 32. For the stability of the European financial system will be at stake, and will largely depend on the real and effective implementation of all the Community prudential supervision rules.**
- 33. Recent History tells what we knew already: that accounting, audit and disclosure standards, is the backbone of the financial system. A Community Regulation will require European firms listed on a regulated market (including banks and insurance companies) to adopt the International Accounting Standards (IAS) for their consolidated accounts by the end of 2005. Member States may extend this obligation to non-listed firms and individual accounts And recent amendments of the 4 and the 7 Company law directives will facilitate the gradual and smooth extension of the IAS by Member States to non listed companies**

- 34. Who would deny the extraordinary input of your Institute in this bold move, which has finally promoted the IAS to a compulsory standard. And if the slogan is right that "the standard leads to the product", it can only mean good prospects and good business for the best experts in IAS standards.**
- 35 Financial reporting standards require that all the member of the Enlarged EU have in place the appropriate institutional oversight for their enforcement. But the current structure of enforcement varies widely between member states, because the enforcement is entrusted to securities regulators. In some member states, securities regulators are the accounting enforcers (like in France and Italy); in others, that function is exercised by a review panel (like in the UK with the Financial Reporting Review Panel); in others stock exchanges have some responsibility in this respect. A new feature is that these regulators now regularly meet within the "Committee of European Securities Regulators (CESR)", and begin to produce guidelines . The hope is that all accounting enforcers, whatever their structure, work in**

**the same direction in order to progressively converge their practices.**

### **III. Finally, a word on The Global Capital Market Place**

**36. The European Union must create an internationally competitive, and attractive, regulatory environment within the context of increasingly global marketplace. EU accounting, auditing, disclosure and supervision standards are gradually converging with internationally accepted standards. This process grants an important competitive advantage to the EU, because it makes the European capital market more attractive to foreign investors and facilitates the issuers.**

**37. One might want to think that at this period in time, there is considerable scope for greater convergence between the EU and the US, as both could be getting closer to adopt equivalent standards. However the recent adoption of the Sarbanes –Oxley Act, with its extraterritorial effects on audit, creates some significant problems. No doubt that the broad terms of the Act should be supported. However the Commission, and the European Finance Ministers have recently voiced their serious concerns, in particular**

about the draft US Public Company Accounting Oversight Board which would require all EU auditors to register with the PCAOB, and be allowed to conduct on spot investigations. We can all share the view that it is important to have in place effective audit systems. At the Commission, we also believe that there are already equivalent systems in place, laid down by the 8th Company Law Directive which deals with the registration, the oversight and external quality assurance of auditors. I should probably emphasise that this directive has set an obligatory registration system for auditors in all EU. The recent Commission Communication on statutory audit, highlights the further improvements that could take place to reinforce corporate governance, financial reporting and statutory auditors.

37. While we are at this important turning point, we need to draw some lessons from our past and recent experience. It is absurd for any country, region or continent to want to impose unilaterally its financial or accounting regulation on a global scale. In this case there is a clear need for a co-operation between US and the EU, in order



**to work out a mutual recognition of their regulatory standards. As to the Member States and the accounting profession in the EU, the message is clear : they must stick together to promote their interests, and resist the pressure to be divided. Any deviation from this rule could have far reaching implications, which might seriously distort and fragment the single financial market.**

**In conclusion,**

**38. I think in Europe there is a political awareness and consensus that growth and job creation depend crucially on the success of its financial integration. The 80's and the 90's showed major steps for the completion of a financial services market, but now this market has to be a global financial player. The strategy for this must aim both at the protection of investors, and at the increased stability and competitive advantages of its financial centres.**

**39. As for the accounting and auditing agenda of the Commission, I would say it is a "going concern": the process set up takes a pragmatic approach and makes the**

**best use of the consultation and expertise of the profession, and of the regulators. We all hope that this network will prove efficient and forward looking, and I am confident that your profession which has been at the origin of the most important initiatives for the completion of the Single Financial Services Market, will be the usual pragmatic and constructive contributor to our common undertaking.**

**=====**