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REGULATORY CONVERGENCE: CORPORATE-PENSION SECTOR

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This paper reviews four key aspects of regulatory convergence between the U.S. and E.U. in the corporate-pension sector. Two of these aspects involve areas where actions or potential actions by the U.S. are impacting the E.U. One is the possible accommodation of U.S. GAAP to international accounting standards (IAS); the second is the extra-territorial reach of the Sarbanes-Oxley Act ("SOX"). The other two aspects of U.S.-E.U. regulatory convergence involve situations where the E.U. may move toward U.S. norms. One is the proposed liberalization of the E.U. rules on investing pension assets; the other is the proposed revision of E.U. rules on takeover defenses.

In each of these four areas, the paper will outline the background on the relevant issues and suggest policy alternatives for the Bertelsmann Group ("Group") to consider.

1. Global Accounting Standards

For most European companies, conversion to U.S. GAAP is the single biggest barrier to making a public securities offering in the U.S. or registering securities to trade on a U.S. stock exchange. The SEC has already accommodated European issuers by allowing them to use home country disclosure requirements on management compensation and affiliated transactions. But the requirements of U.S. GAAP in areas such as segment reporting are difficult to meet for many European companies, especially German companies that have historically relied on "hidden" reserves. For this reason, only a handful of companies based in Continental Europe have registered their shares with the SEC.

Most multinational companies would agree on the need to establish a uniform set of accounting standards that could be utilized on a global basis. Such standards would substantially reduce accounting costs of multinational companies, and would allow them to more easily access capital markets throughout the world. In turn, such standards would allow investors to compare company performance more accurately, and to allocate capital more efficiently among competing claimants.

Although the SEC has historically taken the position that U.S. GAAP is the best accounting system in the world, Enron and other corporate scandals in the U.S. has raised serious questions about this position. On specific issues of significance to Enron, for example, accounting for special purpose entities would have been stricter under IAS than under U.S. GAAP. Enron also illustrates that compliance with detailed rules embodied in U.S. GAAP may nevertheless mislead investors in situations where the principles-based approach of IAS would not have allowed companies to hide behind the screen of technical compliance. In addition, the Bush administration and the current SEC are less locked into U.S. GAAP than was the Clinton administration and the previous SEC.

At the same time, the European Parliament announced earlier this year that all E.U. companies listed for trading on a European market must adopt IAS by December 31, 2005. This announcement applies to approximately 7,000 companies currently using their home country GAAP. Only a few companies and countries in the E.U. now use IAS on a consistent basis.

Thus, this is a good time for the Group to announce a U.S.-European consensus in the area of corporate accounting. One modest alternative would be to urge the Financial Accounting Standards Board ("FASB") in the U.S. to move away from an approach based on detailed rules and more to an approach based on accounting principles. This movement would be consistent with the general direction of the new head of the FASB, who is constraining the role of the Emerging Issues Task Force that used to issue many of the detailed rules.

A more ambitious alternative would be for the Group to advocate a set of global accounting standards (GAS) incorporating the best elements of U.S. GAAP and IAS. The Group could proceed by analyzing a few of the key differences between these two sets of accounting standards, and showing how they could be reconciled or modified in a sensible manner. At present, there are at least fourteen significant accounting differences between U.S. GAAP and IAS according to Deloitte Touche Tohmatsu. In some areas, the International Accounting Standards Board ("IASB") is currently working on a project that is likely to lead to convergence with U.S. GAAP. For example, the IASB is proposing to move from pooling to purchase accounting for business combinations as U.S. GAAP recently did (though with stricter rules on restructuring charges).

However, the IASB and the FASB are moving in different directions in other important areas of accounting. One of the most controversial areas is requiring that estimated expenses associated with stock options be shown on a company's income statement. Under a new draft rule, the IASB has proposed the mandatory expensing of all stock options at the date of grant. Although some U.S. companies have decided to expense stock options, this is likely to remain a voluntary decision. At most, FASB may establish an uniform valuation methodology for those companies choosing to expense stock options on their income statements.

Assuming that significant differences will remain between IAS and U.S. GAAP, the Group would have to address the arguments typically made against the use of IAS by European companies in the U.S. capital markets;

a) U.S. companies have complained that European companies will have a competitive advantage if they may use IAS, while U.S. companies may not. Our response should be that all companies should be permitted to use IAS.

b) There have been different interpretations of IAS among national regulators within the E. U. Our response should be to support a body like the new IASB that will promulgate consistent interpretations of IAS throughout the E.U.

c) Enforcement of IAS has been hampered by uneven auditing procedures and the absence of an international enforcement mechanism. This will probably be the most challenging concern for the Group to satisfy.

2. Extra-Territorial Application of SOX

When Congress enacted SOX during the summer of 2002, it applied many provisions of the new statute to foreign companies listed for trading in the U.S. as well as accountants and lawyers providing service to these companies. According to the U.S. Chamber of Commerce, there are 185 companies based in the E.U. listed on the NYSE, and 149 companies based on the E.U. listed on NASDAQ. All these companies (including those with Levels II and III ADRs) generally file annual reports on Form 20-F with the SEC, but SOX does not apply to foreign companies that submit information to the SEC under Rule 12g3-2(b) or that have only a Level I ADR program.

Most dramatically, SOX requires an issuer's CEO and CFO to personally certify reports filed with the SEC, including Form 20-F by foreign issuers. This civil liability section encompasses an officer's certification, based on his or her knowledge, that the report does not contain any material misstatement or omission; that the financial statements of the company fairly present in all material respects the financial condition of the issuer; and that the internal controls of the company are effective for generating accurate financial statements. SOX also mandates similar certifications in another section, involving criminal penalties for knowing or willful violations.

Other provisions of SOX give the SEC broad authority to bring enforcement actions based on specific types of conduct by executives of registered foreign companies. These include forfeiture of equity-related compensation in the event of a company's financial restatements involving misconduct by an executive of that company; prohibitions on most loans from companies to their officers and directors;

and permanent bars against "unfit" individuals from serving on any boards of publicly traded companies.

Additional disclosures required by SOX are indirectly intrusive into the internal procedures utilized by many foreign issuers listed for trading in the U.S. For example, SOX mandates disclosure of whether foreign issuers have adopted a Code of Ethics and, if so, whether waivers have been granted from the Code. SOX mandates that a foreign company publicly releasing any non-GAAP financial measures disclose the most comparable GAAP measures unless certain conditions are met, including release of the non-GAAP financial measures only outside the U.S. SOX also mandates disclosure of whether the audit committee of a foreign issuer includes a "financial expert" meeting an extensive list of qualifications, including knowledge of reconciliation of local accounting principles with U.S. GAAP.

Beyond these disclosures on financial experts, SOX establishes a regime for audit committees, which may be inconsistent with the normal governance procedures of many foreign issuers. SOX requires that an audit committee, composed entirely of independent directors, set the work agenda and compensation of the company's external auditors. The external auditors may not provide any of nine enumerated non-audit services to the company, and may provide other types of non-audit services to the company only if approved by the audit committee. The audit committee must also establish procedures for handling complaints from whistleblowers.

SOX is particularly onerous on foreign firms that are engaged to audit foreign issuers listed in the U.S., or that substantially participate in such audits. Such foreign auditing firms must register with the newly formed Public Company Accounting Oversight Board (PAB), and become subject to inspections, investigations and potentially disciplinary actions by the PAB. Similarly, lawyers appearing before the SEC to represent any registered issuer, including a foreign issuer, must promptly report "evidence" of a material violation of U.S. securities laws or fiduciary breaches to the issuer's chief legal officer and CEO.

In response to this substantial extension of American law to foreign issuers registered with the SEC, the Group could take one of several positions. First, it could ask the U.S. Congress to limit the application of all provisions of SOX to U.S. issuers. This would require a broad exemption to SOX, which would definitely not pass. Second, it could ask the U.S. Congress to exempt foreign firms from particularly intrusive aspects of SOX, such as the requirements for audit committees and the PAB's jurisdiction over foreign auditors. While good arguments can be that these aspects of SOX conflict with foreign practice, Congress is, at most, likely to provide the SEC with broader exemptive authority for foreign issuers. Third, the group could urge the SEC to utilize its existing exemptive authority, albeit somewhat constrained by Congress, in a more flexible manner for foreign issuers. So far, the SEC has broadly applied SOX to foreign issuers.

3. Open Entry to E.U. Pension Management

In the E.U., the provision of retirement benefits has operated under various national laws and practices. With a few exceptions, these national laws and practices have created barriers to entry for U.S. financial firms skilled in the management of pension funds. This area is particularly significant because many of the E.U.'s largest countries (e.g., Italy, France and Germany) are facing an imminent pension crisis. In response, most are considering a shift in their emphasis from defined benefit (DB) plans to defined contribution (DC) plans.

U.S. firms are particularly interested in offering investment services to DC plans because of the extensive American experience with 401(k) plans and individual retirement accounts. The assets of DC plans now constitute a majority of pension assets in the U.S., although DB plans still hold over 40% of pension assets. U.S. firms offer DC plans not only a broad choice of pooled products, but also an extensive array of record-keeping and educational services.

However, the general principles underlying the E.U.'s policy of free trade in financial services have not been well implemented by certain E.U. countries. Indeed, many U.S. executives believe that certain E.U. countries have used the occasion of pension reform to reassert nationalistic approaches to financial services. For instance, German pension plans must be managed by a specialized institution incorporated and located in Germany. It bears emphasis that U.S. executives are focused on the investment of E.U. pension assets, rather than on the contribution, distribution or taxation of pension assets – which have more impact on local budget issues.

While these issues are addressed in the proposed E.U.'s Pension Directive, the Directive has a long and somewhat tortured history – through the E.U. Commission, the E.U. Parliament and the E.U. Council. The original Commission proposal included the prudent person principle but gave member states the ability, within prescribed limits, to impose some quantitative restrictions, including a cap on investments in non-matching currencies. In its first reading, Parliament went further than the Commission in the direction of codifying the prudent person rule and would have required that exceptions be phased out over a period of years.

The Council of Ministers reached a compromise in June of 2002, which takes a few steps backwards by allowing more quantitative restrictions. Member states can impose more detailed rules than the prudent person rule for plans in their countries, including quantitative restrictions, if they are prudentially justified. In addition, to the extent member states impose these rules on plans within their own country, they can require institutions conducting cross-border activities in their country to comply with the following restrictions on their activities in the host state: a 30% cap on investments in unregulated markets, a 5% cap on investment in a single issuer and 10% cap on investment in issuers in the same group, and a 30% cap on investment in assets denominated in currencies other than those in which liabilities are expressed.

Moreover, the Pension Directive now involves the issue of biometric risks (risks of longevity, disability and premature death). The original Commission proposal did not cover biometric risks. In its first reading, Parliament added a provision requiring that plans offer the option of coverage for biometric risks through a lifelong pension, disability coverage, and provision for survivors. However, the recent version of the Pension Directive promulgated by the Council of Ministers drops all of Parliament's provisions on biometric risks.

The Council's text for the Pension Directive now goes for a second reading to Parliament, which is expected to have a difficult debate on both these issues. Some hope that Parliament will accept the Council's text as the political compromise that it is, but it is unclear whether the conservative forces in Parliament will agree to drop biometric risks. If they try to bring back biometric risk coverage, the more liberal proponents of pension reform have indicated they likely will counter by trying to bring back the Parliament's rules phasing out all quantitative investment restrictions. Moreover, if Parliament ends up passing a version that is different from the Council's text, the Directive goes to the Conciliation process. If the differences are significant, the result may be a failure to pass any Pension Directive.

Thus, this would be a propitious time for the Group to support the implementation of a truly European approach to the investment of E.U. pension assets. Under such a Pension Directive, legislation in every E.U. country should incorporate the following key requirements:

a) Prudent person rule – No E.U. country should quantitatively restrict how pension assets can be invested, but rather should rely on principles of diversification and prudence. Research has demonstrated that pension plans experience higher returns under these principles than categorical asset allocations imposed by a national government.

b) Level playing field for providers – All types of authorized financial services firm, including E.U. subsidiaries of U.S. securities firms and asset managers, should be allowed to offer services and products to E.U. pension plans. The competition among providers and products will help maximize returns to plan participants and beneficiaries.

c) Cross-border flexibility – Financial institutions that qualify to manage pension funds should be free to provide service or products from any location within the E.U. Allowing managers such locational freedom will achieve efficiencies that reduce the cost of plan management to the benefit of plans.

d) Biometric risks – These should be left to each E.U. country to address, since such risks are more related to pension benefit structures than investment of pension assets.

4. Anti-Takeover Defenses

In the U.S., most publicly traded companies are owned by a widely dispersed group of shareholders, even though a few institutions may hold blocks of shares as large as 10% of the outstanding. One of the key checks on inferior company performance in the U.S. is the potential for non-negotiated changes in control. While the SEC rules on corporate takeovers are neutral, some state statutes and state cases tend to be more protective of targets rather than bidders. Nevertheless, many hostile takeovers have been completed in the U.S.

In the E.U., by contrast, the typical situation (outside of the U.K.) is characterized by heavily concentrated ownership of publicly traded companies – with the dominant block of shares held by the national government, local families or commercial banks. These dominant shareholders control the board of directors, which often have duties to labor and community interests as well as shareholders. The board (or supervisory board in the case of German two-tier board) appoints a CEO who is usually more responsive to the interests of the dominant shareholder than minority shareholders. In turn, the dominant shareholder or primary bank serves as an effective check on the CEO, as hostile takeovers are relatively rare in the E.U. (outside of the U.K.).

The attitudes and rules toward hostile takeovers in the E.U. have been slowly converging toward those in the U.S., although substantial differences remain. In June of 2002, the E.U.'s highest court – the European Court of Justice – rejected the use of "golden shares" by E.U. governments to veto a proposed acquisition of a partially state-owned company. When E.U. governments had privatized local companies, they often had retained "golden shares" to protect against cross-border acquisitions of local companies. However, the European Court left open an exception for national security defense – which allowed the Court to uphold Belgium's golden share in two energy companies and may apply to other industries.

At the same time, the European Commission – led by Commissioner Bolkestein – has been in the process of rewriting the E.U.'s Takeover Code. In 2001, a highly-negotiated version of that Code failed to pass on a tie vote (273 to 273) in the European Parliament. The opposition was led by Germany, which has a special law limiting any single shareholder to 20% of Volkswagon's total voting rights. More generally, Germany appeared to object to the Code's provisions that would have required advance approval of shareholders for certain takeover defenses, including the poison pill.

In 2002, however, Germany put into effect its own Takeover Code with a general requirement that the Management Board refrain from taking any action to frustrate a takeover offer, subject to five exceptions:

1. The Management Board may take any action that it prudently could take if there were no takeover bid.

2. In any event, the Management Board may search for a competing bid from a "White Knight."

3. The Management Board may take any action to frustrate a takeover bid if such action is approved by the Supervisory Board within its legal authority. (Note shareholders must approve the authorization of the shares and the elimination of preemptive rights – both prerequisites to the issuance of a poison pill.)

4. The Management Board may take any action to frustrate a takeover bid if such action is approved at a shareholder's meeting after the takeover bid is announced.

5. The Management Board may take any action to frustrate a takeover bid if such action has been approved in advance of a shareholders' meeting. (Note that this exception allows a "blind" prior consent by shareholders to a broad set of anti-takeover measures.)

Given the adoption of the new German Takeover Code and the current consideration of a revised version of the E.U. Takeover Code, the Group may decide to recommend a set of anti-takeover measures that would be similar to those available to U.S. companies chartered in Delaware (the most important state for corporate charters). In addition, the Group may wish to consider suggestions that distinguish between E.U. companies with dominant shareholders and those where the dominant shareholder is a declining force.

The gradual decline in the role of the dominant shareholder in the E.U., if not accompanied by the rise of a viable takeover threat, puts more pressure on the corporate board as an effective constraint on corporate management. However, outside of the U.K., the E.U. does not have a well-developed tradition of independent directors. Moreover, the situation is complicated by the two-tier board structure where the supervisory board, headed by a non-executive chairman, includes an equal number of labor and shareholder representatives. Thus, the Group could publicly support the development of a cadre of truly independent directors in the E.U. and other procedural measures designed to improve board process.

If a company has a dominant shareholder, then there is no need to worry about the separation of equity ownership from management control. In this context, the main concern is whether the dominant shareholder and its handpicked CEO collude to the detriment of minority shareholders. To protect minority shareholders, the Group may wish to recommend various measures. These might include, for example, restrictions on dual-vote shares giving the holder a majority of votes with a minority of share ownership; and the U.K. rule forcing an acquirer of more than 30% of a company's shares to make a bid for all the remaining shares.