Keynote Address by Alexander Schaub, Director General, European Commission, DG Internal Market

It is an honour and a particular personal satisfaction for me to deliver the opening speech at this conference launching the Transatlantic Corporate Governance Dialogue. Let me first of all congratulate the European Corporate Governance Institute and the American Law Institute for their initiative to set up such a Dialogue. Dialogue is an essential precondition to mutual understanding. It should be as upstream as possible of regulators initiatives. And mutual understanding is the basis to any effective cooperation, be it of a regulatory nature or not.

A Transatlantic Dialogue on corporate governance is essential given the strong economic interdependence between the EU and the US. And this interdependence can only intensify as technology expands the possibilities for overseas trading and as the remaining barriers to the remote provision of services are removed.
This should therefore make it easier for US companies to raise money on European markets and for US investors to profit from investment opportunities in the EU and vice versa. But at the very heart of this process is confidence: confidence that the company in which transatlantic investors invest operate within a sound corporate governance framework, and have sound corporate governance practices.

1. THE ECONOMIC IMPORTANCE OF CORPORATE GOVERNANCE

The growing importance of corporate governance on the political agenda is not just a response to the recent wave of scandals in the US and in Europe. First and foremost it is a key component of a strategy to boost business' competitiveness and to foster efficiency in a modern economy.

Good corporate governance is an essential prerequisite for the integrity and credibility of financial institutions, stock exchanges, individual corporations, and indeed the whole market economy. By ensuring greater transparency, fairness and accountability with respect to shareholders and other stakeholders, good corporate governance builds economic confidence and trust. It facilitates access to external financing and plays a critical role in channelling savings to productive investment.

Corporate governance is thus not an end in itself. Rather, its aim is to promote the long-run success of a company and to ensure economic growth in a market economy. Undertaking risky ventures and engaging in projects with more distant payoffs, all that require the certainty and trust that good corporate governance can provide.

We have to ask ourselves today – whether it is not the well run, diligent, transparent, productive companies – sensitive to their shareholders – acting ethically and responsibly, who will survive and in the long term. Surely yes. The short-termism, cowboy, overrisky activities of some companies – those won't survive.

Making this link between corporate governance, investment and economic growth illuminates the importance of corporate governance for the domestic and global economies. In today's integrated markets, failure to deal with the regulatory issues associated with corporate governance can have strong repercussions on global financial markets and jeopardize financial stability.

2. THE EU CORPORATE GOVERNANCE FRAMEWORK

All these concerns, together with those raised by recent corporate scandals, have triggered and nurtured the discussions across the Atlantic, as well as in other parts of the world. Given the strong transnational dimension of corporate governance, the European Commission also endeavoured to promote the development of a sound corporate governance framework at the level of the European Union. Such a framework relies on four pillars:

(i) Enhancing transparency on EU capital and securities markets;
(ii) Encouraging loyal and competent financial intermediaries and proper supervision of financial institutions;
(iii) Developing sound mechanisms for internal controls, including real shareholders' control;
(iv) Ensuring effective external controls by auditors.

Such a four-strand approach to corporate governance is also followed by our main trading partners. We share a common objective of restoring investor confidence, preventing corporate failures and strengthening the checks and balances in companies by increasing transparency and accountability.

3. THREE COMMON CHALLENGES

Recent cases of major corporate governance framework failures on both side of the Atlantic have meant that we both face a number of key challenges that need to be addressed urgently. Let me very briefly highlight some of them and outline the Commission's approach to meet them.

3.1 First Challenge: improve the integrity and accountability of board members

The first challenge is to improve the integrity and accountability of companies' Boards. Board reform, and the pros and cons of the one-tier and two-tier board system, have been and still are the subject of extensive academic discussion. But what is more important is the role, competence and responsibilities of board members.

Non-executive and supervisory directors have a duty to fill the gap between uninformed shareholders and fully informed executive managers, by monitoring the latter closely. In order to make the board of directors a more effective tool to check on the power of the management, special attention needs to be paid to the role, quality and integrity of their non executive directors.

Board members should also be truly accountable to the owners of the company. Shareholders need to be able to ensure that management pursues their interest. They must therefore be given the means to act as watchdog, to protect their interests as well as those of the other stakeholders.

The European Commission has proposed several initiatives aiming at modernising the board of directors and enhancing shareholders' rights.. It will soon adopt a legally non-binding recommendation to the Member States to design a framework to promote the role of (independent) non-executive or supervisory directors. This should define the minimum standards applicable to the creation, composition and role of the nomination, remuneration and audit committees and to assess the degree of independence of board members. The Commission will also propose to enhance directors' responsibilities. The collective responsibility of all board members for financial and key non financial statements should be confirmed as a matter of EU law in the short term. The Commission is also developing a framework to ensure a high level of transparency of directors' remuneration and to allow shareholders to make their voice heard on the remuneration policy of the company and on remuneration items linked to the share price. Finally the Commission is working on the elaboration of a proposal for a directive to facilitate the exercise of fundamental shareholders' rights and tackle the problems associated with cross-border voting. This proposal should be adopted next year.

3.2. Second challenge: restore the auditors' credibility

A second challenge that I believe needs to be addressed is to restore credibility in an effective external control mechanism. The most prominent external control mechanism is control by the auditors. The independent audit of a company and the required disclosure to the supervisory bodies constitute the backbone of effective financial market regulation. Concerns have been expressed about whether the incentives for external auditors are properly aligned with the interests of the shareholders. Independent auditors have, on commercial grounds, been tending to enter into activities that risked compromising the objectivity that the shareholders and the investing public expect. In many countries, dramatic failures and financial scandals have appeared without previous notice by the auditors. In some instances, only months before, auditors had still given their certification of the financial statements of the company without any limitation.

Recent events have demonstrated that urgent action was required to restore the credibility of external audits. This led the European Commission to adopt the proposal for a Directive to modernise Statutory Audit within the European Union. This proposal seeks notably to promote the use of international auditing standards and to ensure that independent quality assurance systems will be in place in all Member States. It also addresses other important issues, namely:

(i) Should European law make audit committees mandatory? In the light of the general confidence crisis, the Commission considers that such a requirement would strengthen the independent monitoring of the financial reporting process and help to prevent any undue influence by the executive management.
(ii) Should mandatory rotation of the audit partner or the audit firm be imposed? The Commission believes that mandatory rotation will contribute to avoiding conflict of interest. Member States would have the option of requiring either a change of key audit partners dealing with an audited company every five years, if the same audit company keeps the work, or a change of the audit firm every seven years.
(iii) How to strengthen public oversight over the audit profession? The traditional concept of relying solely on self regulation of the audit profession is sometimes perceived as not being sufficiently conducive to investor confidence. The Commission proposal therefore requires Member States to organise an effective system of public oversight for all statutory auditors and audit firms.

Recent corporate scandals have emphasised the strong need for internationally consistent oversight over audit firms. This led the European Commission to propose a framework for cooperation with relevant authorities of third countries. This approach has been developed in intense and close co-operation with the US Public Company Accounting Oversight Board (PCAOB). The PCAOB has issued a rule on oversight of non US audit firms which is the counterpart to our proposal. I believe that this innovative co-operative work-sharing approach is the only sound way to deal with the regulatory challenges of globally operating audit firms.

3.3 Third challenge: fair presentation of the company through sound and reliable accounting
The third challenge is to make sure that an independent audit nevertheless is accompanied by a high level of "truth and fairness" of the financial statements: they must fairly present the company position in a way that is clear and transparent to all stakeholders. Publicly traded companies therefore should be required to apply a set of high quality international accounting standards for the preparation of their consolidated financial statements. In this context the decision to adopt International Accounting Standards is important. Since they are based on principles, IAS standards should be more easily adaptable to financial innovation than other more rule based standards such as the US GAAP. The remaining difficulties with IAS 39, which is based on a US standard, demonstrate the limits of a deeply-rooted rule based approach.

But I believe we need to go further and work towards a global consensus on the key prerequisites for a fair presentation of the company in order to limit inconsistencies and confusion. It is therefore extremely important to promote the convergence of accounting standards with determination. We are all encouraged by the cooperation between the FASB and IASB. Nevertheless we believe that ultimately the EU and US will have to cooperate on recognising the equivalence of each set of rules. This is an issue on which more progress is needed over the coming months, but we are cautiously encouraged by some of the recent moves of the SEC. We hope that the SEC will draw up a road map towards recognition of IAS very shortly to show the intent of the United States authorities to make this process work.

4. THE EUROPEAN APPROACH

The European approach to these challenges is to some extent substantially different to the one followed in the United States: it is a matter of "comply or explain" versus law enforcement; principle versus rule based; bottom up versus top down. Concepts such as flexibility, subsidiarity, proportionality, mutual recognition and home country control are common language in an EU regulatory environment but somewhat alien in a US environment. Any idea to design a "one size fits all" approach to corporate governance problems is rejected by market participants. As highlighted by the Commission in its Action Plan, what matters is to be firm on the principles but flexible on their application: no overly prescriptive regulatory infrastructure and legislation only where this is necessary, for instance when legal obstacles need to be tackled to facilitate cross-border restructuring and cross-border voting.

5. TOWARDS A TRULY EU-US CO-OPERATIVE APPROACH

As you have noticed, the approach chosen at EU level is quite different from the approach followed in the Sarbanes Oxley Act which introduced detailed corporate governance requirements. This was especially the case for financial reporting and internal control.

Despite these differences in approaches, I am convinced that the EU and the US can find a new way forward for a transatlantic cooperative approach to corporate governance. As was demonstrated by our cooperation with the PCAOB on the issue of audit firm registration and oversight, the EU and the US can work together to solve problems after they have arisen. Such cooperation for ex post conflict resolution must be completed with greater ex ante upstream cooperation to prevent new conflicts from emerging. Surely this makes complete sense when we are dealing with a transatlantic capital market that, for bonds, equities and bank assets alone is worth 50 trillion USD – or 6 times our respective GDP's.

The European Union has a unique experience to offer in bringing together different legal, cultural and regulatory traditions in a common denominator of internal market legislation. The cooperative approach has proven to work well in the competition policy area. Should this successful concept not be further explored in the context of the EU-US regulatory dialogue on financial markets? This could be the platform for developing a co-operative approach in the globalising world.

6. CONCLUSION

Ladies and Gentlemen, please let me conclude:

The EU and the US count for more than 50% of the world economy and about 90% of the world capital markets. We do have a specific responsibility to work together constructively: to organise dialogue and cooperation with a view to ensuring efficient and credible solutions which guarantee effective levels of investor protection and a high level of efficiency for business.

Not only must we avoid unnecessary duplication of controls and costs for regulators, companies and auditors and ensure that regulatory authorities intervene effectively and in a timely manner. I am convinced we have a lot to learn from each other. This is why a constructive and regular dialogue such as the one launched today is important to appreciate where one system has developed a more sophisticated approach and to promote regulatory best practice. This may foster a greater convergence in our respective approaches. And convergence is important for investors who want to be sure that they will get the same level of protection in another jurisdiction and for issuers who want to be clear that they are on a level playing field with their US counterparts. This is crucial to restore confidence in our market economies. This is the challenge ahead of us which we need to embrace.

Thank you for your attention and I wish all of us a fruitful conference.