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LLM THESIS

The EU Regulation on the Cross-border Provision of Investment Services

**From Mutual Recognition and Competition among
Rules to 'Regulation through
Committee'**

Laurits Schmidt Christensen
European University Institute, Florence
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The EU Regulation on the Cross-border Provision of Investment Services From Mutual Recognition and Competition among Rules to 'Regulation through Committee'

"The speed of change in European and global financial markets today is breathtaking and accelerating. The velocity and complexity of the changes underway are among the most profound in the history of financial markets. There are many forces at work: Globalisation, which has created a highly competitive environment; rapid progress in communication and information technologies, which are reducing the costs of trading, spurring financial product innovation, with the introduction of new products almost a daily occurrence; and the Euro, which, by removing exchange rate risk in the Euro area, is helping push European financial markets towards more integration. This process is reshaping European securities markets, including stock exchanges and market participants"

**Opening Paragraph of the Lamfalussy Report on the Regulation of European
Securities Markets**

7 November 2000

Chapter 1 Introduction

This thesis is about the EU regulation of the cross-border provision of investment services.

The objective of the thesis is to identify the regulatory strategies underlying the current and future regulation in the field of investment services.

The thesis departs from the assumption that the field of investment services is undergoing a change of regulatory strategy. The regulation in the field has for long been based on a regulatory strategy of mutual recognition and competition among rules. Concurrently, a regulatory strategy based on the adoption of detailed regulation and the creation of a common policy by and within a network of committees has emerged. This regulatory strategy is referred to as 'regulation through committee' in the thesis. The strategy of 'regulation through committee' has gained more and more

weight in the field of investment services. Recent developments show that the importance of 'regulation through committee' will continue to increase in the future. To describe in detail and test the assumption of a change from the regulatory strategy of mutual recognition and competition among rules to the strategy of 'regulation through committee' in the field of investment services, the thesis will seek to answer the following three questions:

1. What is the underlying regulatory strategy of the current EU regulation on the provision of investment services?
2. What is the underlying regulatory strategy of the future EU regulation on the provision of investment services?
3. In the future regulation of the provision of investment services, will the choice of regulatory strategy differ depending on whether a given piece of regulation has the objective of protecting retail or professional investors?

1.1 The Background of the Thesis

The above quotation from the Lamfalussy Report captures eloquently the fundamental changes of the European financial markets that are currently taking place. The fundamental changes of the financial markets also affect the environment for the provision of investment services in Europe.

The three key drivers of the fundamental changes in the field of investment services are globalisation, the Internet and the Euro.

The very wide concept of globalisation is used in this thesis to denote the fact that services, capital and information can and do flow freely across national borders. In relation to investment services in the EU, globalisation or, rather Europeanisation, has opened investors' eyes to the investment opportunities available in other Member States.

The emergence of the Internet as a commonly available and advanced means of communication enhances the cross-border provisions of investment services. The communication and the provision of investment services on the Internet are significantly cheaper and faster than in the off-line environment.

The introduction of the Euro has eliminated some of the risks and uncertainties related to investment services from other Member States.

Globalisation, the Internet and the Euro have changed the settings for the cross-border provision of investment services. This has sparked a debate on the regulation of financial markets and of investment services within the EU. As recently as the 18-19 September 2001 the Commission hosted an open hearing in Brussels on the upgrading of the regulation in the field of investment services¹. The debate has identified a range of problems arising from the current regulatory framework and has resulted in proposals for its reform.

¹ "Commission to Host Open Hearing on Investment Service Directive ", 14 September 2001. This press release is available at www.europe.eu.int/comm/internal_market/en/finances/

1.2 The Scope of the Thesis and Definitions

The scope of the thesis is limited to the cross-border provision of investment services within the EU.

‘Cross-border provision of investment services’ is defined as the provision of investment services by an investment firm established in one Member State (the ‘home Member State’) to an investor in another Member State without the establishment of a commercial presence, such as a branch or a subsidiary, in that Member State (the ‘host Member State’)

The definition of ‘investment services’ in this thesis reproduces the definition in the primary piece of regulation in the field, namely the Investment Service Directive². The definition of investment services in the Investment Service Directive and accordingly in this thesis, covers the *reception and transmission*, on behalf of investors, of orders relating to the instruments listed below; the *execution* of such orders other than for own account; the *dealing* in any of the instruments listed below for own account; the *managing of portfolios* of investments in accordance with mandates given by investors on a discriminatory, client-by-client basis where such portfolios include one or more of the instruments listed below³.

The ‘instruments’ covered by the Investment Service Directive and accordingly by this thesis include transferable securities, units in collective investment undertakings⁴, money-market instruments, financial-futures contracts, including equivalent cash-settled instruments, forward interest-rate agreements (FRAs), interest-rate, currency and equity swaps and options to acquire or dispose of any instruments listed above, including equivalent cash-settled instruments.

The definition of ‘investment firm’ also copies the definition in the Investment Service Directive. An investment firm is defined as “any legal person the regular occupation or business of which is the provision of investment services for third parties on a professional basis”⁵.

‘The on-line provision of investment services’ is defined as the provision of investment services by the Internet.

In the best of legal traditions, this section on the scope of the thesis would not be complete without mentioning the aspects of the regulation of investment services that are not included in the thesis.

² Council Directive 93/22/EEC on Investment Services in the Securities Field, OJ 1993, L 141, p. 27.

³ The Investment Service Directive also covers the underwriting in respect of issues of any of the instruments listed above and/or the placing of such issues. This investment service is not described in the thesis.

⁴ Council Directive 85/611/EEC of 20 December 1985 on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJ 1985, L 375 p. 3, includes special rules for units in collective investment undertakings. As the thesis deals broadly with the provision of investment services, this very specific directive is not included.

⁵ Investment Service Directive article 1(2)

The thesis focuses on the cross-border provisions of investment services by home state investment firms to host state investors. It does therefore not deal with the situations where the services are provided through a host state branch or subsidiary. Nor does it deal with freedom for stock exchanges or regulated markets to offer access to their trading platforms in other Member States.

The thesis does not deal with the tax or data protection law aspects of the cross-border provision of investment services. Also excluded from the scope of the thesis, is the case law on the freedom of establishment of companies, including investment firms.

Lastly, the general and enticing discussion of the constitutional legitimacy of 'regulation through committee' is not covered in the thesis.

1.3 The Materials Used in the Thesis

The description and analysis of the field of investment services in this thesis are based on a range of materials.

First and foremost the several directives with an impact on the cross-border provision of investment services have been used. To achieve the best possible understanding of the directives' substantive provisions, the related preparatory works have been consulted. The case law as well as the provisions of the EU Treaty's and the Rome Convention on the Law Applicable to Contractual Obligations of particular relevance for the provision of investment services have also been examined.

Next, different legal literature has been used. This includes literature on the regulatory strategy of mutual recognition and competition among rules, and on the regulatory strategy of 'regulation through committee'. Legal literature describing the substantive regulation on investment services has also been examined.

Lastly, the thesis draws extensively on a large body of expert reports, policy papers, communications, and working documents produced by the Commission, committees and expert groups working for the Commission, and other bodies with a special interest in the field of investment services.

1.4 The Structure of the Thesis

The first part of the thesis (chapters 2 and 3) describes the two regulatory strategies on which the analysis of the current and future regulation of investment services in the following chapters will be conducted. Chapter 2 describes the regulatory strategy of mutual recognition and competition among rules. Chapter 3 examines the strategy of 'regulation through committee'.

The second part (chapters 4-6) of the thesis deals with the current EU regulatory framework for the provision of investment services. Chapter 4 describes the current regulatory framework for the provision of cross-border investment services. It examines the content of five directives, the case law and the provisions in the Treaty and in the Rome Convention on the Law Applicable to Contractual Obligations of relevance for the provision of cross-border investment services. In chapter 5, the problems and the impediments to the free movement of investment services arising from the current regulatory framework are identified. Chapter 6 analyses of the

current regulatory framework from the perspective of the regulatory strategy of mutual recognition and competition among rules.

Part three (chapters 7-8) deals with the use of committees in the current and future regulatory framework for the provision of investment services. Chapter 7 describes how committees currently are and how they will be involved in the regulation of the provision of investment services. In chapter 8, an analysis of the current and future regulation in the field from the perspective of the strategy of 'regulation through committee' is conducted.

Chapter 9 concludes the thesis and discusses its findings.

Chapter 2 The Regulatory Strategy of Mutual Recognition and Competition among Rules

The following chapter describes the strategy of mutual recognition and competition among rules in the EU. The purpose of the chapter is to create a basis for the analysis of the current regulatory framework for the provision of cross-border investment services in chapter 6.

2.1 Competition among Rules

2.1.1 A Definition of Competition among Rules

Competition among rules can be defined as a process leading to the alteration of national regulation in response to the actual or potential impact of the mobility of economic factors such as goods, services, and other factors of production on national economic activity⁶. The primary condition for competition among rules is that the goods, services, and factors of production can move freely from one country to another. This unrestricted mobility is dependent on its acceptance by the countries between which competition among rules takes place.

Competition among rules can be viewed from a market perspective. From this perspective national governments, national regulatory and supervisory authorities⁷ stand on the supply side of the market for regulation with businesses and consumers of goods and services constituting the demand side. The 'product' that regulators provide to the demand side of the market is regulation. By adjusting national rules to provide the most favourable regulatory environment in the eyes of the demand side, regulators compete with other countries' regulators to attract the mobile factors of production or to induce buyers of services or goods to make their purchases in their country. The continuous adjustment of national rules to provide a regulatory advantage leads to competition among rules.

To distinguish between the different elements of the process of competition among rules the following terminology will be used⁸. Competition among rules is a general term covering regulatory competition, regulatory arbitrage, and regulatory emulation. Regulatory competition is competition between countries to attract investment or business activity or to promote the competitiveness of incumbent industries by providing a favourable regulatory environment. Regulatory arbitrage is the corresponding actual or potential action by businesses or consumers in selecting the best country in terms of regulatory environment for investment or purchase.

2.1.2 The Basic Conditions for Competition among Rules

The primary basic condition for competition among rules is, as mentioned above, the unconditional and unrestricted mobility of goods, services and production factors within the area where competition among rules takes place. Unrestricted mobility between countries ensures businesses and consumers the right to move or to purchase their services from the country with the most favourable regulatory environment. At

⁶ SUN, J.-M. and PELKMANS, J., "Regulatory Competition in the Single Market", *Journal of Common Market Studies*, March 1995, p. 68-89.

⁷ In the following both governments, regulatory and supervisory bodies will be covered by the term regulators.

⁸ WOOLCOCK, S., "Competition among Rules in the Single European Market" in MCCAHERY et al (Eds.), *International Regulatory Competition and Coordination*, Clarendon Press 1996, p. 297.

the same time it exposes national businesses to competition from these countries. The threat or impact of national companies going abroad or being exposed to foreign competition or of consumers purchasing their services abroad acts as the impetus for regulators to make their national regulation more competitive.

The unrestricted regulatory de jure mobility must be accompanied by unrestricted de facto mobility. If the cost of communication and shipment of goods and services or the price of a business re-establishing in another country is too high, the cost differences that make regulatory arbitrage attractive are eliminated and regulatory competition will not be triggered.

The second basic condition for competition among rules is mutual recognition on the basis of prior minimum harmonisation. Mutual recognition means that country A accepts the legislation of country B in a given field as equivalent to its own. Businesses complying with the legislation in their home country B do not in addition have to comply with the legislation of country A where it is performing economic activity, for example when providing a service to a consumer in country A.

The fulfilment of the condition of mutual recognition based on minimum harmonisation is a prerequisite for the fulfilment of the first condition of unrestricted mobility. Speaking solely in theoretical terms, mutual recognition is not required for competition among rules to take place. It can be argued that an absolute prohibition on all mobility restrictions would suffice to facilitate competition among rules. Real-world experiences however show that regulators do not readily accept the unrestricted mobility of goods, services, or factors of production. They require some guarantee that the policy objectives in the field are secured in other ways and market participants in their countries are protected against market failure. Commonly agreed minimum harmonisation standards are therefore a necessary prerequisite for mutual recognition and unrestricted mobility of foreign products, services and businesses⁹.

On this basis, the acceptance of mutual recognition as a regulatory strategy can be seen as an agreement to the horizontal transfer of regulatory and supervisory powers from the country (the host country) in which a regulated activity takes place to the country (home country) where the entity performing this activity is located¹⁰. The agreement is reciprocal, as any state will at times act in its capacity as a home state and at times in its capacity as a host state. The minimum harmonisation constitutes the terms of the agreement that must be observed for it to take effect.

While mutual recognition and minimum harmonisation thus facilitates regulatory competition, it should be noted that it at the same time limits its scope. Due to the minimum harmonisation countries are only able to compete above the level laid down through harmonisation or in adjacent areas¹¹.

⁹ WOOLCOCK p. 304.

¹⁰ NICOLAÏDIS, K., "Mutual Recognition of Regulatory Regimes: Some Lessons and Prospects", *Harvard Jean Monnet Working Paper 7/97*, Harvard Law School, 1997, p. 2.

¹¹ WOOLCOCK p. 305 points out that in addition an efficient competition policy is required to ensure that businesses do not agree to refrain from exposing foreign counterpart to the competition that could spark regulatory competition. It has further been proposed that the EU competition rules should apply to regulators operating in the 'market for regulations' cf. WOOLCOCK p. 305 referring generally to MAJONE, G.

The third basic condition for competition among rules is that businesses and consumers have a reliable informational basis for conducting their regulatory arbitrage. This requires the fulfilment of the three sub-conditions of perfect information, discreteness and enforcement.

The first sub-condition requires that perfect information about the regulatory differences is available to enable businesses to compare different countries' legislation before engaging in regulatory arbitrage. The information requirement also applies to consumers deciding in what country to purchase their goods and services. Lastly, regulators need full and transparent information. They would otherwise be unable to compare and adapt the national regulations in response to other countries' regulatory advantages.

The second sub-condition of discreteness is defined as transparency and information to the *effect* of national regulatory differences¹². Businesses and consumers should be able to assess the relative effects of the entire range of national regulatory differences before conducting their regulatory arbitrage. They should be in a position to compare the full content of the regulatory 'packages' they subscribe to when choosing one country for another, rather than simply comparing specific regulatory differences. Competition among rules should hence be understood as competition between different national 'packages', which include differences on the regulatory level as well as non-legal differences. This can also be phrased as competition among different regulatory styles¹³ i.e. between the aggregates of national regulations within a given field and the underlying legal cultures. Viewing the process as a competition between regulatory styles explains why the adjustment of a single provision in order to make the national regulatory regime more competitive can be either impossible or without the desired effect when the provision in question is profoundly intertwined with a set of national rules and legal culture. The discreteness requirement is also relevant for regulators assessing the relative effect of a specific change of the regulatory 'package' they provide.

The third sub-condition for guaranteeing a reliable informational basis is effective enforcement. The underlying rationale of the sub-condition is that there must be consistency between the rules formally in force and the way they are actually enforced. If enforcement is not efficient, certainty as to the nature and effect of regulatory differences is lost. Businesses and consumers will not be able to conduct their regulatory arbitrage in such a climate of uncertainty. The requirement of effective enforcement is also of importance for mutual recognition. Besides contributing to creating a reliable informational basis, visible effective enforcement by the authorities of country B makes it easier for country A's regulators to accept country B regulation as equivalent and entitled to mutual recognition.

In sum, Competition among rules is dependent on the fulfilment of the basic conditions of unrestricted mobility, mutual recognition based on minimum harmonisation and a reliable informational basis. The degree to which the three conditions are fulfilled decides the likelihood and the scope for competition among rules.

¹² The term discreteness is introduced by WOOLCOCK p. 302.

¹³ WOOLCOCK p. 303.

2.2 Mutual recognition and Competition among rules in the EU

2.2.1 Mutual recognition in the EU

Competition among rules is closely linked to mutual recognition. This is the case in the EU. Mutual recognition in the EU however predates competition among rules and it was originally introduced to break the political deadlocks of the time, rather than to promote competition among rules.

Woolcock identifies the origin of the principle of mutual recognition to a conflict in the seventies on the trade barriers arising from the differences in the regulation of technical standards, primarily between Germany and France¹⁴. Up till that point the EC had been pursuing a strategy of perfect harmonisation which had proven extremely slow and inflexible. Instead of attempting to harmonise the divergent technical standards, the conflict was solved by allowing products complying with the legislation of its country of origin to be exported to other member states without having to comply with these countries' technical standards. This was termed the mutual recognition approach.

A second contribution to the mutual recognition approach came with the 1979 Cassis de Dijon judgement. The ECJ held that products lawfully produced in one Member State at the outset can be marketed in all other member states. The ECJ thereby introduced a principle of judicial mutual recognition. The effect of the mutual recognition principle was limited by the exemption that proportional national legislation justified by a public good objective could be upheld against foreign goods. By including this exemption the ECJ established itself as an arbiter on the equivalence and mutual recognition of Member States' rules.

The 1985 White Paper on completing the internal market institutionalised the principle of regulatory mutual recognition and paired it with the principle of minimum harmonisation. The objective was to provide a legislative alternative to the cumbersome process of full harmonisation of technical standards. Harmonisation should instead be based on mutual recognition accompanied by minimum harmonisation of essential technical requirements. A product complying with the directive-based technical standards of one Member State can be freely marketed in all the other member states.

In its pure form regulatory mutual recognition differs from the principle of judicial mutual recognition by not allowing for exemptions on public good grounds of the Cassis de Dijon kind. Once the minimum requirements are met, the equivalence and mutual recognition of home state legislation cannot be questioned. This makes it easier and faster to establish whether a given national rule is compatible with free movement law than by establishing this through judicial review before the ECJ.

However, there is no such thing as a pure principle of regulatory mutual recognition. A number of the mutual recognition directives allow for exceptions on general good grounds similar to case law created exceptions.

Member states are further free to adopt technical standards above the minimum requirements set by the harmonisation directives and apply these to national products.

¹⁴ WOOLCOCK p. 293.

A reason for adopting a higher and probably costlier level of technical standards could be to give national consumers the choice between domestic products with higher technical standards and imports complying only with the minimum requirements. Moreover, it would allow national businesses to export products with a certified higher technical standard.

The principle of regulatory mutual recognition was readily transposed beyond the field of technical standards. The 1989 Second Banking Directive shows the use of the regulatory mutual recognition approach in the field of services. In broad terms, it allows banks to supply services in all member states subject to compliance with the regulation of their home member state.

An additional development facilitating competition among rules in the EU was the introduction of the principle of subsidiarity. Subsidiarity limits the field of common European action and presupposes the continued existence of some regulatory divergence between the member states. The principle of subsidiarity can be interpreted as introducing a rule on the optimal assignment of regulatory competence in a multi-layered government structure¹⁵. Where the optimal regulation in a given field can be expected to result from regulatory competition and the risk of market failure remains low, it follows from the principle of subsidiarity that regulation should be left to the member states. Conversely, where harmonisation is needed to obtain the optimal regulatory outcome, the principle of subsidiarity points in the direction of EU harmonisation.

While the preference for an integration strategy based on mutual recognition is clear from the above, it is more difficult to find reference to the competition among rules this strategy is likely to trigger.

The 1985 White paper makes a short allusion to competition among rules. Its opening chapter lists as one of its objectives to ensure that the integrated European market "is flexible so that resources, both of people and materials, and of capital and investment, flow into the areas of greatest economic advantage"¹⁶. This can be read as a careful reference to competition among rules. However, the undisputed focus of the White Paper is breaking the political deadlock and the creation of one single market with the use of the mutual recognition and minimum harmonisation strategy. The promotion of competition among rules in comparison remains a secondary and unarticulated objective.

Reference to the link between mutual recognition and competition among rules in the EU can be found in the academic literature¹⁷. Advocates of competition among rules identify the principle of mutual recognition with competition among rules and stress its superiority as a regulatory strategy to perfect harmonisation. It should be noted that in their eyes regulatory competition was primarily an alternative to the older perfect

¹⁵ WOOLCOCK, p. 290.

¹⁶ Completing the Internal Market, White Paper from the Commission to the European Council, p. 5.

¹⁷ REICH, N., "Competition between Legal Orders: A new Paradigm of EC Law?", *Common Market Law Review* 1992, p. 861, and JOERGES, C., "The Market Without the State? The 'Economic Constitution' of the European Communities and the Rebirth of Regulatory Politics", *European Integration On-line Papers (ELoP)*, vol. 1 1997, no. 19, p. 14. Available at <https://eiop.or.at/eiop/text/1997-019a.htm>.

harmonisation strategy. Their critique does therefore not fully apply to mutual recognition and minimum harmonisation approach.

In sum, although competition among rules is not an articulated objective of the mutual recognition approach the following factors facilitating competition among rules can be identified.

2.2.2 The Factors Facilitating Competition among Rules in EU

The post-1992 regulatory environment established by the White Paper and subsequent developments encompasses the following factors which in combination facilitate competition among rules: Free movement, Minimum harmonisation, mutual recognition and subsidiarity.

The principle of free movement in the Treaty facilitates by its very nature unrestricted mobility, one of the basic conditions for competition among rules to take place.

Minimum harmonisation and mutual recognition enhance unrestricted mobility. They guarantee national regulators that their markets will not be flooded with products or services produced under lenient foreign regulatory regimes. National law based on common harmonised minimum standards is by definition equivalent to other member states' regulation in the same field. The equivalence of Member States laws implementing minimum harmonisation directives results in a limitation of the scope for exemptions from the principle of free movement on public good grounds inherent in both the principles of judicial and regulatory mutual recognition.

The subsidiarity principle facilitates regulatory competition. Inherent in the principle of subsidiarity is the acceptance of a certain level of regulatory divergence and autonomy for member states structuring their regulation as they see fit even if this entails doing so to attract businesses and purchasers of services and goods.

Whereas these factors facilitate competition among rules in the EU, one fact of life limits it, namely the number of EU member states. In the ideal theoretical world of competition among rules there should be as many jurisdictions as there are different preferences to the content of the regulatory 'packages'. Given the limited number of member states not all businesses' or consumers' preferences can be fully accommodated.

In sum, these factors facilitate competition among rules in the EU. They provide for unrestricted mobility and include an acceptance of national regulatory divergence, two elements that facilitate competition among rules to take place. However, they do little to provide a reliable informational basis on which businesses and purchasers of goods and services can conduct regulatory arbitrage. The mutual recognition approach does therefore not appear to include a strategy to fulfil this basic condition for competition among rules.

2.2.3 A Model of Competition among Rules in the EU

The factors facilitating competition among rules listed above do not create competition among rules by themselves. Regulatory competition is triggered by the actual or potential move of goods, services or factors of production to more favourable regulatory environments i.e. the regulatory arbitrage of the market

participants. Regulatory competition is the response of regulators who find themselves providing an inferior regulatory 'product'. Regulatory competition is often a result of pressure on national regulators by businesses disfavoured by a certain rule.

Sun and Pelkmans¹⁸ have designed a model for describing the process of competition among rules in the EU. They identify the points along the regulatory path where regulators and businesses and/or consumers meet and interact, thereby fuelling the regulatory competition process. Whether this interaction and subsequent regulatory competition takes place, depends on whether the following factors makes it attractive for businesses to approach their national regulators: Cost differentials between national regulatory environments, the competitiveness of the relevant national industry relative to its EU competitors, the industry's ability and willingness to lobby, and the national regulatory authority's incentive to change national regulation.

Two settings can be identified in which regulatory competition can be initiated. In the first, free movement and mutual recognition is in place due to harmonisation. In the second, harmonisation has not taken place, mutual recognition is not guaranteed and market access obstacles exist in the form of divergent national regulation.

The latter setting is by far the most restraining to regulatory competition. A service provider meeting obstacles when providing his services to another Member States must attempt to bring about mutual recognition either via the regulatory track (European harmonisation) or via the court track (proceedings for the ECJ). He can pursue three strategies when entering the new market.

Firstly, he can decide to enter without challenging the rules of the Member States into which he provides his services.

Secondly, he can lobby the Commission or his national regulator to initiate infringement proceedings for the ECJ or initiate proceedings himself on the national level thereby entering the court track. If the ECJ or a national court following a preliminary reference finds the disputed national rule to be incompatible with the principle of free movement, it will be amended by the infringing Member State and the obstacle thereby eliminated. Alternatively, the opening of an infringement case may start a process on the regulatory track resulting in harmonisation and mutual recognition.

As a third strategy, the service provider can lobby his national regulator to promote harmonisation on the European level, which ideally would also lead to mutual recognition.

If mutual recognition is in place, the scene is set for competition among rules between the member states. The competition among rules competition takes place in different stages.

The first stage of the regulatory competition process is triggered by businesses' and consumers' regulatory arbitrage in response to the regulatory differences between the member states. This arbitrage can take two forms. In the first, businesses migrate to

¹⁸ "Regulatory Competition in the Single Market", *Journal of Common Market Studies* 1995, p. 67-89.

the jurisdictions where the conditions for their particular economic activity are the most favourable. In its second form, the businesses are in de facto immobile, but the services they produce can – thanks to free movement – freely be sold throughout the Community. In this form regulatory competition is a result of consumers of services purchasing their services in the Member States with the legislation shaping the services that best matches their preferences.

In the second stage of the regulatory competition process, businesses in Member States with unattractive regulatory regimes find themselves exposed to competition from Member States with more attractive regulations. Businesses can choose to respond by moving to these member states. This option might not be available due to high sunk costs and other ties to their residence state. The businesses might therefore choose to lobby their national regulator to eliminate the regulatory disadvantage. The national regulator may choose to limit the foreign competition by relying on a public good exemption if one is included in the harmonisation directive in the field. Alternatively, he may choose to change the national regulation in order to eliminate the competitive disadvantage.

This regulatory change might kick off a regulatory race between the member states, if the Member State, which so far has provided the most attractive regulatory environment, now is the one exposed to competition. If the regulatory differences retain a degree that will make businesses and consumers profit from conducting regulatory arbitrage, the regulatory competition process will start over again.

There are two foreseeable outcomes of this regulatory race. If no prior harmonisation has taken place, a strongly convergent legal landscape is likely to emerge as the end result of the regulatory race to accommodate business interests. If prior harmonisation has taken place, the scope for regulatory arbitrage is narrower and the incentives for continued regulatory competition are therefore likely to be weaker. The foreseeable outcome is a legal landscape with slightly divergent regulations.

The described outcomes are not final. With new business developments, new regulatory problems will arise. This will re-start the regulatory competition in the field. An important caveat applies to this model of competition among rules in the EU. National businesses interests can seldom be uniformly identified as one. Within a member state, some companies prefer a more lenient, some a more rigid regulatory regime.

2.2.4 The Example of Banking

As mentioned above, the EU Second Banking Directive provides an example of the principle of mutual recognition in the field of services. Sun and Pelkmans give two examples of how competition among rules can take place in the field of services¹⁹. The Second Banking Directive introduced mutual recognition and free movement and thereby set the scene for regulatory arbitrage and regulatory competition to take place. However, the following examples show that competition among rules did not take place in the way predicted by the model.

¹⁹ SUN and PELKMANS, p. 80.

The first example shows how regulatory competition will not take place without some reaction from the national businesses exposed to foreign competition. A French bank offered high interest deposit accounts to Belgian clients – a financial product not allowed under Belgian law. The expected pressure by Belgian banks exposed to this foreign competition on the Belgian regulator to change the law was not observed. One can only speculate, but following the logic of the model of the competition among rules the number of Belgian consumers choosing the favourable French bank account might have been too low for Belgian banks to really worry. Belgian consumers might have refrained from ‘purchasing’ from French banks due to lack of information and confidence in their products.

The second example shows how regulatory competition is dependent on foreign businesses finding it worthwhile to enforce the principles of free movement and mutual recognition and challenge national rules limiting their activity in another member state. A UK bank provided a number of advantageous financial products in France through its branches. Subsequent French law outlawed these financial products, possibly due to lobbying from French banks. The UK bank chose to comply with this new legislation rather than to challenge it. In this case, compliance was probably preferable to the time- and money-consuming process of challenging the French legislation. This brought the regulatory competition process to a stop.

Although the two examples partly followed the model of regulatory competition, it is clear that the process of regulatory competition is complex and includes a variety of factors, which can only be accounted for with difficulty by a simple model. The conclusion to be drawn from the above model is according to Sun and Pelkmans that a number of ‘real-world’ factors are likely to divert the ideal path of competition among rules.

This leads to two observations. Firstly, the benefits of regulatory arbitrage and regulatory competition may well be outweighed by practical costs. Secondly, the potential regulatory gains from regulatory competition vis-à-vis harmonisation might be smaller than asserted by its proponents. The reason being that harmonisation based on minimum standards and mutual recognition is more flexible and therefore less costly than the perfect harmonisation strategy that competition among rules originally was proposed as an alternative to.

2.3 The Advantages and Disadvantages of Competition among Rules

2.3.1 The Advantages of Competition among Rules

Firstly, competition among rules allows consumers and businesses to choose the national legislation that best matches their preferences. This results in increased allocative efficiency. It further allows national regulation to be tailored to local conditions. Moreover, it allows weaker economies to compete with more efficient economies by maintaining lower and less costly standards to attract economic activity.

Secondly, competition among rules has a disciplining regulatory and fiscal effect on national regulators – polemically referred to as the taming of Leviathan. Regulators are compelled to provide the desired public goods at the lowest possible regulatory price. Comparing national regulation with that of the neighbours provides a useful yardstick for measuring its efficiency and leads to de-regulation in areas of economic activity where unnecessary regulatory intervention has taken place.

Thirdly, given a real-world environment of imperfect information among market participants and regulators, competition among rules facilitates a market-driven discovery process allowing consumers and businesses to signal their regulatory preferences through their arbitrage between different countries' regulation. As mentioned above, the scope for experimentation and discovery depends on the degree to which the harmonisation has set the boundaries for regulatory competition.

Fourthly, competition among rules simplifies the regulatory process by avoiding the cumbersome process of reaching political consensus. Instead 'buyers' of regulation vote with their feet through their regulatory arbitrage.

Fifthly, it reduces the risk of regulatory failure in the form of incoherent regulation resulting from political compromise.

Sixthly, competition among rules may diminish the risk of capture of the regulator by national interest groupings. With competition among rules in play these groupings' influence on regulators to create protectionist regulation will diminish. Instead, the groupings will use their reduced influence in favour of the creation of a more competitive regulatory regime thereby additionally contributing to the regulatory race.

2.3.2 The Disadvantages of Competition among Rules

Firstly, as shown by the example of banking there is a risk of the competition among rules process being halted by 'real-world' obstacles halting the development towards new regulatory optimums or discoveries. The regulatory arbitrage that drives competition among rules might not take place because of imperfect information, businesses' choice not to exploit the regulatory differences, or legal or de facto restrictions on mobility such as infrastructure costs. Consumers might have been 'educated' to prefer host country standards by long-standing national regulation in which case an incoming service provider will find it more attractive to comply with host state regulation than to make use of his mutual recognition right and introduce home country services. Even if regulatory arbitrage does take place, it must have an appreciable effect before a response from the national regulator can be expected.

Secondly, regulatory competition may result in sub-optimal regulation i.e. either too much or too little regulation. Most likely is too little regulation because regulatory competition illuminates unnecessary national regulatory cost and thereby paves the way for deregulation in order to create a less costly regulatory regime. There is a risk that too much deregulation will render the remaining legislation incapable of securing the policy objectives and addressing the market failures. Advocates of regulatory competition, however, argue that there is a natural limit to the deregulatory race to the bottom. They argue that while businesses prefer a low level of regulation, they also require a certain regulatory infrastructure. Countries that deregulate too much will not be able to provide this regulatory infrastructure and will therefore disqualify themselves from further participation in the regulatory race.

A less likely outcome of regulatory competition is too much legislation – a race to the top. This is the result of one dominant country adopting high standards for its domestic market and smaller countries following suit to be able to export products of the same high standard. The problem of too much regulation arises when the

dominant country's regulation is too intense and costly, and the countries following suit adopt the same unnecessary legislation.

A third possible disadvantage of regulatory competition is that it may result in never-ending regulatory change. This is the downside to an on-going regulatory discovery process. The perpetual change of national rules can produce uncertainty for businesses and may thus ultimately damage the interests that regulatory competition was meant to benefit. Adapting business methods to new regulation means increased transaction costs for businesses.

Fourthly, regulatory competition has no eye for externalities such as market failures with an impact on more than one country. One example is the regulation of systemic risk of banks that must encompass the risks arising from the cross-border interdependence in the financial world.

Lastly, regulatory competition increases the risk of barriers to trade remaining in place due to its implicit acceptance of national regulatory divergence. This is the case in fields where the principle of mutual recognition is formally in place but not fully adhered to in practice.

2.4 Interim Conclusion: Mutual recognition and Competition among Rules

Competition among rules is both theoretically and particularly in the EU context closely linked to mutual recognition. Mutual recognition based on minimum harmonisation constitutes together with the unrestricted de jure and de facto mobility and a reliable informational basis the basic conditions which must be fulfilled for competition among rules to take place.

The analysis of the current regulatory framework for the provision of investment services in the following chapters will start by identifying the existing degree of mutual recognition. Once the degree of mutual recognition is established, it will be considered whether the conditions for competition among rules are satisfied and to what extent competition among rules is facilitated by the current regulatory framework for the provision of investment services. Lastly, it will be considered whether competition among rules has in fact already taken place.

The result of competition among rules is the alteration of Member States' laws. A race to the top or to the bottom with convergent or divergent national regulations as the outcome, has been envisaged. The sum of advantages listed above indicates competition among rules as a superior method for policy creation. The most efficient and balanced policy is to be found through the continued interaction between regulators regulatory competition and market participant's regulatory arbitrage. Competition among rules allows market participants to enjoy the most well suited regulatory 'products' and enhances a continuous and dynamic regulatory learning process. In addition, this is achieved at the lowest regulatory cost and with the lowest risk of distortion and capture by self-interested politicians.

It should be recalled that all these advantages of competition among rules can only be fully enjoyed if the basic conditions for competition among rules are satisfied. Given the real-world obstacles to competition among rules, it is unlikely that the basic

conditions will be satisfied in full and the competition among rules will be able to provide the promised regulation reflecting market needs.

Chapter 3 'Regulation through Committee'

In the previous chapter the regulatory strategy of mutual recognition and competition among rules has been described. The core of this regulatory strategy is that the Member States' mutual recognition removes barriers to the free movement of services and creates an integrated market. Subsequently, the competition among rules that ideally arises in an environment of mutual recognition produces the regulation that best fits the needs of the market through a regulatory race.

In this chapter an alternative regulatory strategy is presented, namely 'regulation through committee'²⁰. 'Regulation through committee' is defined as the co-operative development in EU committees of detailed regulatory solutions to dismantle the barriers to free movement of services, create integrated markets and establish common policies. The unique characteristic of 'regulation through committee' is that as a result of the co-operation on common regulation and policies distinct 'communities' of committee members emerge for each regulatory field where committees are used. These 'communities' develop their own problem definition and solution philosophies, which determine how they address new regulatory challenges.

The 'regulation through committee' regulatory strategy emerged in the shadow of the regulatory strategy of mutual recognition and competition among rules and for the time being the two regulatory strategies co-exist. It cannot be ruled out that the importance and use of 'regulation through committee' will increase and the mutual recognition and competition among rules strategy will have less importance as an EU regulatory strategy.

One clear distinction between the two regulatory strategies must be made. The mutual recognition and competition among rules strategy lays down principles for how substantive rules should be structured. In comparison, 'regulation through committee' lays down the principles for the procedural framework within and according to which substantive regulatory solutions should be developed.

The purpose of this chapter is to establish a basis for the analysis of the use of committees in the field of investment services in the following chapters. This analysis will include with both legal and non-legal aspects of the use of committees in the field.

In this chapter the concept of 'regulation through committee' in the EU is described. Special focus is on the history and rules on the committees assisting the Commission in the performance of its task. Committees assisting the Council and the European Parliament are not described.

The first part of this chapter describes the role of committees on the different stages of EU policy-making. The second part focuses on the history of and the legal rules regulating committees, in particular the so-called comitology committees. The third part summarises the results of five non-legal studies on the use of committees in the EU. The studies provide an additional perspective on the use of committees in the EU

²⁰ This term is used by JOERGES, C. and NEYER, J., "From Intergovernmental Bargaining to Deliberative Political Process: The Constitutionalisation of Comitology", *European Law Journal*, September 1997, p. 277.

complementing the formal legal perspective. They also explain why 'regulation through committee' should be seen as a distinct regulatory strategy and not just an institutional arrangement. At the end of the chapter the conditions for, and advantages and disadvantages of 'regulation through committee' are described.

3.1 Brief Overview of the Use of Committees in the Rule Making of the EU

Committees participate in all three stages of EU rule making: Policy development, policy decision and policy implementation²¹.

On the development stage committees take the form of either ad hoc advisory interest committees established by the Commission or standing scientific committees established either by the Commission or the Council. These committees are used to gather expert knowledge necessary for drafting proposals for new legislation. The function of the development stage committees is to assist the Commission in drafting legislative proposals that will be accepted by Council and EP.

The committees are composed of independent experts as well as experts from Member States' administrations. The Commission chairs the committees it has established. Council committees are chaired by Member State representatives. In some legal areas the Commission has imposed an obligation on itself to consult the standing scientific committees.

At the policy decision stage the committees take the form of council workings groups. The working groups' function is to examine and adapt the Commission's legislative proposals so that they will be approved by the COREPER or the Council will approve. The working groups are composed of national officials and chaired by the representative of the Member State holding the presidency. The Commission participates in order to defend its proposals. These committees are not included in the following description.

On the policy implementation stage the so-called comitology committees have a strong position in the form of comitology committees composed of Member States representatives and chaired by the Commission. Formally the Commission adopts implementing measures where it has been delegated the power to do so in a directive or regulation. In fact, the Member States have a very strong influence on the content of these implementing measures. The comitology committees exist in three variants: advisory, management and regulatory, indicating increasing degrees of committee and hence Member States control on the Commission's implementing powers. Comitology committees have three functions: Policy implementation rule making, policy application, and policy evaluation and up dating. The carrying out of these functions involves to varying degrees elements of rule interpreting, fund approving and rule setting. Although this feature is more explicit in the rule setting function, the functions all involve normative powers. Most committees perform one function rather than a combination.

²¹SCHÄFER, G. F., "Linking Member State and European Administrations – The Role of Committees and Comitology" (chap.1) in ANDENAS, M. and TÜRK, A. (eds.), *Delegated Legislation and the Role of Committees in the EU*, Kluwer 2000, p. 3-24, and "Committees in the EC Policy Process: A First Step towards Developing a Conceptual Framework" in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA 1996, p. 3-24. A more detailed summary of the cyclic model of policy stages is given below.

3.2 Committees Assisting the Commission: Comitology and Non-comitology Committees

In the following particular attention focus is on the so-called comitology committees that assist the Commission on the policy implementation stage of EU rule making. The term comitology will be used in a narrow sense to encompass the committees established and following the procedures of the Council's comitology decision²². Committees assisting the Commission falling outside the scope of the comitology decision will be referred to as non-comitology committees.

3.3 The History of Comitology Committees

The origin of Comitology can be traced back to the beginning of the 1960s where extensive and detailed regulation was required in the field of common agricultural policy. In response to the workload the Council in 1962 established the first management committee whereby it could delegate the day-to-day management and implementation to the Commission while at the same time retain a certain level of control on this regulatory activity through the committee. The development continued in 1966 with the establishment of the first regulatory committee. This type of committee was used in the fields of customs, veterinary and feeding- and foodstuffs legislation.

The Single European Act institutionalised the use of committees. The optional basis for the delegation of power to the Commission in article 211 4th indent was supplemented by the new article 202 3rd indent obliging the Council to delegate implementation powers to the Commission and to lay down rules for the exercise of these. In connection with Single European Act the Council issued its first comitology decision²³. The decision laid down the rules and principles for the use of comitology procedure and limited the types of comitology committees to three: Advisory, management and regulatory²⁴. The latter two types were found in two variants, the file procedure and the contre-file, implying varying degrees of Council control on the implementation.

The Maastricht Treaty put the European Parliament on equal footing with the Council as regards the adoption of legislative measures under the co-decision procedure²⁵. In the light of this the European Parliament demanded equal control on the powers delegated to comitology committees in legislative measures adopted under this procedure. This led to the Modus Vivendi agreement of 20 December 1994²⁶ between the European Parliament, the Council and the Commission. The agreement

²² Council Decision 1999/468, OJ 1999, L 184/23, corrigendum in OJ 1999, L 269/45, laying down the procedures for the exercise of implementing powers conferred on the Commission.

²³ Council Decision 87/373/EEC of 13 Jul 1987 laying down the procedures for the exercise of implementing powers conferred on the Commission, OJ 1987, L 197/33.

²⁴ The Decision also provided for a fourth procedure – the safeguard procedure. This procedure will not be included in the following description because it only applies to trade policy measures cf. DEMMKE, C. et al., "The History of Comitology", in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA, 1996, p. 67.

²⁵ Art 251.

²⁶ Modus Vivendi between the European Parliament, the Council and the Commission concerning the implementing measures for acts adopted in accordance with the procedure laid down in Article 189b of the EC Treaty, OJ 1996, C 102/1. The agreement was of limited validity and was to expire automatically with the 1996 Intergovernmental Conference cf. DEMMKE, C. et al., "The History of Comitology", in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA, 1996, p. 77.

defined a right for the European Parliament to receive Commission drafts for comitology implementation measures²⁷ together with the timetable for their adoption. The European Parliament should also be informed and have the right to state its opinion if a draft for an implementation measure was rejected by the comitology committee. Lastly, it obliged the Commission to take into account as far as possible any of the European Parliament's comments on a draft. The European Parliament's influence on the implementation was further strengthened by the Samland-Williamsen agreement²⁸ which obliged the Commission to provide the European Parliament with annotated agendas for and the voting results of each meeting of the management and regulatory committees. The agreement also gave the European Parliament the right to attend comitology meetings.

During the 1997 Amsterdam European Council it was decided not to amend the Treaty provision on comitology. Instead an annexed declaration²⁹ calling for a reform of the comitology decision was adopted. After much debate on inter alia the involvement of the European Parliament, a new comitology decision was adopted. The new comitology decision simplified the comitology procedures, established criteria for the choice between the them, and provided for increased transparency and greater involvement of the European Parliament. The decision constitutes the main piece of the legal basis for comitology and is described below.

3.4 The Legal Basis of Comitology

3.4.1 The Treaty Provisions and Case-Law on Delegation of Power

The Treaty includes two provisions on the delegation of implementing powers from the Council to the Commission: Article 211 provides:

"To ensure that the objectives set out in this Treaty are attained the Council shall, in accordance with the provisions of this Treaty:

- ensure coordination of the general economic policies of the Member States;
- have power to take decisions;
- confer on the Commission, in the acts which the Council adopts, powers for the implementation of the rules which the Council lays down. The Council may impose certain requirements in respect of the exercise of these powers. The Council may also reserve the right, in specific cases, to exercise directly implementing powers itself. The procedures referred to above must be consonant with principles and rules to be laid down in advance by the Council, acting unanimously on a proposal from the Commission and after obtaining the Opinion of the European Parliament."

Article 211 4th indent provides:

"In order to ensure the proper functioning and development of the common market, the Commission shall:

- exercise the powers conferred on it by the Council for the implementation of the rules laid down by the latter."

²⁷ The European Parliament had obtained this right with the Plumb-Delors agreement, which however only covers draft implementing acts of a legislative nature. SG(88) D/03036, EP-Dok. 123.217, in: European Parliament. Conference on Committee Chairmen: The Application of Modus Vivendi on Comitology: Practical Guidelines for Parliament's Committees, 7 July 1995, p. 21-22. The Plumb-Delors agreement continued to govern EP influence on comitology committees in non-co-decision areas cf. DEMMKE, C. et al., "The History of Comitology", in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA, p. 78.

²⁸ Agreement of 25 September 1996, OJ 1996, C 347/125.

²⁹ Declaration relating to the Council Decision of 13 July 1987, OJ 1997, C 340/137.

As described above article 211 4th indent predates 202 3rd indent. It gives the Council the option to confer implementing power on the Commission without accompanying requirements. 202 3rd indent on the other hand obliges the Council to delegate implementing powers to the Commission. The delegation can be made conditional on the fulfilment of certain requirements. These requirements must be in accordance with rules and principles laid down in the Council decisions on comitology of 1987 and 1999. Lastly, it allows the Council to reserve the implementing powers to itself in specific cases. The Council is however obliged to state in detail why it prefers to retain the implementing powers³⁰

The Council's basic practice has been to use these provisions to empower the Commission to implement the acts the Council has adopted on the basis of the Treaty, or more seldom the Council has retained the implementing powers for itself.

The wording of the Treaty thus allows for delegation of power to the Commission. Delegation is defined widely and "comprises both the drawing up of implementing rules and the application of rules to specific case by means of acts of individual application"³¹. The scope of this power depends firstly on the extent of the powers delegated (the commission's mandate) and secondly on the comitology procedure that Council has chosen to retain control. The rules governing this – the case law of the ECJ and the comitology decision will be described in the following

The Commission exercises its implementation powers by issuing directives and regulations.

3.4.2 The Substantive Limits to Delegation – The Distinction between Essential Requirements and Implementing Measures.

Delegation is limited by the distinction between essential requirement and implementing measures. Only the competence to adopt implementing measures can be delegated to the Commission. The basic acts laying down the essential requirements must be adopted according to the legislative procedures in the Treaty.

The Court in the Köster case³² reasoned that "both the legislative scheme of the Treaty, reflected in particular by the last indent of article 155 (now 211), and the consistent practice of the Community institutions establish a distinction, according to the legal concepts recognized in all Member States, between measures directly based on the Treaty itself and derived law intended to ensure their implementation".

The case Germany vs. Commission³³ shows that the distinction between essential elements and implementing measures is to be drawn on the basis of whether the provision is a part of the overall objective of the basic delegating act. The case was about a provision in a Commission agricultural regulation imposing sanctions on individuals. The ECJ held that although the provision imposed personal sanctions it

³⁰ Case 16/88, Commission vs. Council, ECR 1989 p. 3457, para 10.

³¹ Case 16/88, Commission vs. Council, ECR 1989 p. 3457.

³² Case 25/70, Einfuhrstelle vs. Köster, ECR 1970 p. 1161.

³³ Case 240/90 Germany vs. Commission, ECR-I 1992 p. 5383.

should not be considered an essential element because it was not aimed at conveying the basic guidelines for Community policy in the area³⁴.

The ECJ appears to leave the distinction between essential elements and implementing measures very much to the political assessment of the Council³⁵. This follows from the 1993 *European Parliament vs. Commission* case³⁶. The case dealt with the empowerment of the Commission to elaborate an exhaustive list of substances that could be included in organic products. The ECJ held in an obiter dictum that although the Commission had not included genetically modified organisms in the list, it could have done so since such an amendment of the list would not have constituted an essential element.

3.4.3 The Procedural Requirements to Delegation Provisions – How Specific Must Enabling Provisions Be?

The case law above leaves the Council with wide discretion to decide what tasks can be categorised as implementing measures. However, even wide implementing powers must originate from a provision in a basic enabling act. The enabling provisions must fulfil certain requirements and specify the extent of the delegated power.

This *Rey Soda* case³⁷ shows that the requirements to the specificity of a delegation provision are low. In this case the Commission issued a regulation on the basis of a very broadly termed mandate with the end result that an Italian company was subjected to an additional tax. The Italian company challenged the regulation before the ECJ without success. In reaching its result the ECJ applied a result-oriented interpretation emphasising that the Commission was the only body able to observe and react quickly to the changing conditions of the market, in this case the market for agricultural products, and that its implementing powers therefore should be construed widely.

The ECJ arrived at a similar result in the case *Germany vs. Commission*³⁸ where it accepted a provision laying down rules for sanctions against individuals as an implementing measure. The court held that “since the Council has laid down in its basic regulation the essential rules governing the matter in question, it may delegate to the Commission general implementing power without having to specify the essential components of the delegated power; for that purpose, a provision drafted in general terms provides a sufficient basis for the authority to act”³⁹. The case shows the low requirements to the specificity of the delegating provision.

³⁴ Case 240/90 *Germany vs. Commission*, ECR-I 1992, para 37: “In the present case the rules challenged by the German Government cannot be classified as essential to the common organisation of the market established by the first basic regulation and the scheme of aid established by the second basic regulation. Such classification must be reserved for provisions which are intended to give concrete shape to the fundamental guidelines of Community policy. That is not true of penalties, such as surcharges or exclusions, which are intended to underpin the options chosen by ensuring the proper financial management of the Community funds designated for their attainment”.

³⁵ TÜRK, A., “Case Law in the Area of the Implementation of EC Law”, in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA, p. 173.

³⁶ Case 156/93, ECR-I 1995 p. 2019.

³⁷ Case 23/75, *Rey Soda vs. Cassa Conguaglio Zuccheri*, ECR 1975, p. 1279.

³⁸ Case 240/90, *Germany vs. Commission*, ECR-I 1992 p. 5383.

³⁹ Case 240/90, *Germany vs. Commission*, ECR-I 1992 p. 5383, para.41.

In the case *Central-Import Münster*⁴⁰ the ECJ came to a slightly different conclusion when it held that an enabling provision must clearly specify the boundaries of the competence delegated to the Commission. The case dealt with the implementation of a Council regulation on intervention in trade with non-Member States in case of market disruption. The ECJ held that the enabling provision in question was sufficiently clear as to the situations where protective measures could be taken, the criteria for establishing such a situation and the kind of measures to be taken.

This difference in the ECJ's case law can be explained by the fact that the first two cases dealt with the common agricultural policy whereas the latter fell outside this field. In sum, in the field of agricultural policy the requirements to the enabling provision are low. Conversely, delegating provisions outside the field of agricultural policy must have a certain degree of specificity⁴¹.

3.4.4 The Limits on the Commission's Exercise of Delegated Powers

The ECJ has laid down different requirements to the enabling provisions within and outside the area of agricultural policy. The limits on what the Commission can do when using its implementing powers follow the same line. Outside the area of agricultural policy the Commission can only make use of the measures specified in the enabling basic acts. Inside the area of agricultural policy the Commission has wider implementing powers⁴².

Even in the area of agricultural policy there are limits to the Commission's implementation powers. In the case *United Kingdom vs. Commission*⁴³ the ECJ held that the delegated power could not be used in a way that limited the free movement of agricultural goods without a clear basis in the basic enabling act.

The Commission is also limited by the essential elements of the basic act. It cannot derogate from the basic act without a clear legal basis⁴⁴ in the basic act and derogation is only allowed to the extent that it does not jeopardise the attainment of the essential elements of the basic act⁴⁵.

3.4.5 The Limits on the Commission's Implementing Power by the Council and the Member States

In the *Köster* case⁴⁶ the ECJ accepted that the Council, in the form of member states representatives in a management committee, could retain some control on the Commission's implementing powers. This did not constitute an infringement of the Commission's right of decision and independence, nor did it violate the institutional balance. Although the legal basis of the time article 211 did not clearly provide for delegation to be conditional on requirements such as comitology control the ECJ accepted this. The legality of making delegation dependent on comitology control was clarified with the introduction of article 202 what explicitly allows this.

⁴⁰ Case 291/86, *Central-Import Münster*, ECR 1988, p. 3679.

⁴¹ TÜRK, A., "Case Law in the Area of the Implementation of EC Law", in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA, p. 179.

⁴² Cf. Case 22/88, *Vreugdenhil*, ECR 1989 p. 2049, para 17.

⁴³ Case 61/86, *United Kingdom vs. Commission*, ECR 1988, p. 431.

⁴⁴ Case 100/74, *C.A.M. vs. Commission*, ECR 1975, p. 1393.

⁴⁵ Case 230/78, *Eridania*, ECR 1979, p. 2749, para 8.

⁴⁶ Case 25/70, *Einfuhrstelle vs. Köster*, ECR 1970 p. 1161.

3.4.6 The Council and the Member States' Control on the Commission's Implementing Powers – the Comitology Procedures

As required by article 202 the Council has laid down the rules for its control of the Commission's implementing powers in the comitology decision. The decision envisages three types of committees: Advisory, management and regulatory. The Decision further includes provisions on the criteria for choosing between the different types, the involvement of the European Parliament and transparency.

Article 1 of the decision reiterates that implementing powers shall be delegated to the Commission in accordance with the relevant provisions in the basic instrument. The procedural requirements for the exercise of the delegated power must be in conformity with the Comitology Decision i.e. follow one of the comitology procedures.

Article 2 lays down the non-binding criteria for choosing between the procedures. The management procedure is recommended for the implementation of common agricultural and fisheries policies or of programmes with substantial budgetary implications. The regulatory procedure is recommended for adopting measures of general scope designed to apply essential provisions of basic instruments. It should also be followed where a basic instrument allows for non-essential elements to be adapted or up-dated. The advisory procedure constitutes a residual category to be followed whenever this is deemed appropriate.

Articles 3-5 describe the three kinds of comitology committees. The committees are constituted of Member States representatives and chaired by the Commission, which however does not have voting rights. The committees adopt their own rules of procedure on the basis of a standard published in the Official Journal⁴⁷. The function of the committees is to form and communicate an opinion on the Commission drafts for implementing measures. The committees differ as to the procedures for adopting an opinion and as to the implications of a negative opinion.

A mandatory committee adopts opinions on Commission drafts for implementing measures, if necessary by a vote⁴⁸. The opinion of the committee is recorded in the minutes, if requested stating the opinions of any dissenting Member State. Even in the case of a negative committee opinion the Commission can adopt its original draft. It is however obliged to take 'the utmost account' of the committee's opinion and inform it of the manner in which this has been done.

A management committee is also presented with Commission drafts. It adopts its opinions by qualified majority. The relative weight of the Member States' votes follows the same formula as in the Council⁴⁹. In case of a negative opinion the Commission has the option to proceed with its draft. This option shall however only be used in matters of urgency. The Commission shall forthwith inform the Council of the negative opinion. The Council can replace the Commission's implementing

⁴⁷ Cf. article 7(1) of the decision.

⁴⁸ VAN DER KNAAP, P., "Government by Committee: Legal Typology, Quantitative Assessment and Institutional Repercussions in the European Union", in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA, p. 91.

⁴⁹ Cf. art 4 (2) of the decision referring to art 205 (2) of the Treaty.

measures with its own within a time limit of up to three months. If the Council does not adopt a decision within the time limit, the Commission can adopt its draft.

The regulatory committee procedure is identical to the management procedure as regards voting. In case of a positive opinion the Commission can adopt its draft. If the opinion is negative or no opinion is delivered, the Commission submits its draft to both the European Parliament and the Council. This applies where the basic enabling act was originally adopted following the legislative co-decision procedure⁵⁰. If the European Parliament considers that the proposal exceeds the powers delegated to the Commission, it informs the Council. The Council acts on the proposal within a time-limit of up to three months with due regard to the European Parliament's position. If the Council opposes the proposal, the Commission must re-examine it and may subsequently present an amended proposal, re-present the original proposal or forward a legislative proposal on the basis of the Treaty. If the Council does not express a negative opinion within the time limit, the Commission adopts the draft.

Besides the right to comment on the Commission's possible excess of its implementing power in connection with the regulatory committee procedure, the European Parliament has a general right to be informed of comitology proceedings. This includes the right to receive committee agendas, the drafts for implementing measures of basic acts adopted under the co-decision procedure, the results of the committee votes, summary records of the committee meetings and lists of the bodies to which the Member States representatives belong. If the European Parliament finds that a Commission draft exceeds the enabling provisions of a basic act adopted under the co-decision procedure, it can issue a resolution. The Commission then is obliged to re-examine its proposal. Taking account of the resolution the Commission can submit a new draft to the comitology committee, continue the comitology process or submit a legislative proposal to the European Parliament and the Council. The Commission must in all cases inform the European Parliament of how it has reacted to the resolution.

Lastly, the comitology decision includes provisions intended to increase the transparency of comitology. Firstly, the general public has the same access to comitology documents that it has to Commission documents. A register with references of all the documents sent to the European Parliament must be established in 2001. The Commission must also publish a list of all committees assisting it in its implementation tasks specifying the basic act under which they are established. Moreover, the Commission must annually publish a report on the committees.

3.5 The Types of and the Rules Regulating Non-Comitology Committees

Besides the comitology committees a variety of other committees assist the Commission in the performance of its tasks. Mainly because their functions and influences on the regulatory process are difficult to identify and because they are not formally involved in the decision-making process, they have not received the same attention as comitology committees in terms of legal rules or case law nor in terms of legal writing.

⁵⁰ Cf. art 251.

A larger number of committees with different functions assist the various EU institutions⁵¹. Of special relevance here are the non-comitology committees that assist the Commission in the performance of its tasks of proposing new legislation and implementing measures. Two examples are the interest committees (consultative committees) and the scientific committees (expert committees)⁵². The two types of committees primarily assist the Commission in drafting the proposals for new legislation to the Council or for implementing measures to the comitology committees.

Interest committees are composed of representatives of European interest organisations selected by the Commission. They exist for each sector or common market organisation having a management committee.

Commission scientific committees consist of national civil servants but may include private specialists appointed by the Member States. The scientific committees provide an inexpensive way of gathering of information and technical expertise. The Commission is very dependent on the scientific committees due to its limited resources. As the scientific committees are intensively involved in the preparation of new legislation, they have a substantial influence on the legislative process. The scientific committees are also involved in providing expert advice in relation to the drafting and implementation of secondary Commission legislation⁵³.

3.6 Summary of the Legal Basis for Comitology and Non-comitology Committees

The comitology and non-comitology committees have a variety of shapes and are regulated by a variety of rules. Their common feature is the function of assisting the Commission in its legislative and implementing tasks.

The Commission' activity on the implementation level is controlled by the Council through the comitology committees. The Comitology Decision and a large body of case law developed over time regulate this activity in detail.

The nature of the involvement of non-comitology committees in the Commission's activities is less clear. There are no specific rules governing this aspect of the use of committees.

A formal legal categorisation of committees, both comitology and non-comitology, can be made along the following lines⁵⁴. The main distinction is whether the consultation of the Commission is compulsory. This distinction generally repeats the distinction between comitology and non-comitology committees. Secondly, committees can be distinguished according to the legal basis they are established on: by a specific Council act, in a general council act or set up by a specific Commission

⁵¹ VAN DER KNAAP, P., "Government by Committee: Legal Typology, Quantitative Assessment and Institutional Repercussions in the European Union", in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA, p. 84-90.

⁵² VAN DER KNAAP, P., "Government by Committee: Legal Typology, Quantitative Assessment and Institutional Repercussions in the European Union", in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA, p. 85-86.

⁵³ SAUTER, W. and VOS, E., "Harmonisation under Community Law: The Comitology Issue" in CRAIG, P. and HARLOW, C.(Eds.), *Lawmaking in the European Union*, Kluwer 1998, p. 175.

⁵⁴ SAUTER, W. and VOS, E., "Harmonisation under Community Law: The Comitology Issue" in CRAIG, P. and HARLOW, C. (Eds.), *Lawmaking in the European Union*, Kluwer 1998, p. 174.

act. Thirdly, a functional distinction can be made on the basis of what stage of the regulatory activity the committee is involved. Distinction is made between committees directly involved in the implementing process (comitology committees), committees that provide political-normative feedback on proposals for implementation measures and new legislation (interest committees) and committees that provide technical advice in the drafting and implementation phases (scientific committees).

3.7 A Non-legal Perspective on the Use of Committees in the EU

This chapter summarises five studies on the use of committees in the EU. The studies cover both comitology and non-comitology committees unless otherwise mentioned.

3.7.1 Schäfer's Cyclic Model of Policy Stages

Paul Schäfer describes the role of committees in the EU regulatory process⁵⁵ on the stages of policy development, policy decision and policy implementation by using a cyclic model. The three stages are inter-linked and constitute a cycle. The cyclic model illustrates how every implementation stage is followed by a new policy development stage.

On the development stage interest committees or standing scientific committees assist the Commission in drafting legislative proposals for the Council and European Parliament. Schäfer observes that an important side effects of the committee co-operation on this stage is the horizontal exchange of information and dialogue between Member States administrations and the internalisation of a European perspectives within these.

On the policy decision stage Council working groups assist the Commission in giving legislative proposals a content that the COREPER or the Council will approve. Schäfer observes that the same national officials are often members of both the development stage advisory committees and the decision stage working groups in the same field. From a formal perspective the national officials act as technical experts on the development stage whereas they represent their respective national political positions on the decision stage. It is difficult for both committee insiders and outside observers to separate the two functions. The positive side of the personal overlap is increased efficiency – the same officials that have reached consensus as technical experts on the development stage are unlikely to re-open the discussion when they meet as political representatives. The negative side is that the debate on the decision stage will be foreclosed by the consensus reached on the development stage. A national official participating on the development stage is likely to have a strong say on the shaping of the political position of his Member States for the decision stage negotiations. He is likely to defend the proposal reached on the development stage and shape the national position accordingly thereby excluding alternative views, which have not already been included in the development stage proposal.

⁵⁵SCHÄFER, G. F., "Linking Member State and European Administrations – The Role of Committees and Comitology" (chap.1) in ANDENAS, M. and TÜRK, A. (eds.), *Delegated Legislation and the Role of Committees in the EU*, Kluwer 2000, p. 3-24, and "Committees in the EC Policy Process: A First Step towards Developing a Conceptual Framework" in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA 1996, p. 3-24.

On the implementation stage comitology committees composed of Member States officials and chaired by the Commission operate. It is not unusual that these officials are also members of committees operating on the other stages of the regulatory process.

The cyclic model illustrates how the process of rule making is an on-going process and that due to the personal overlap the distinction between the committees on the different stages is blurred.

3.7.2 EIPA study 2000 on the Loyalties of Committee Members

A recent empirical study among Member States committee members examined some factual aspects of the use committees and the loyalties of committee members⁵⁶ to their national institutions and the supranational committees they participate in.

The study shows that 60-70 percent of national officials participating in EU committees allocate more than a day a week to EU matters. The study supports the finding above that the same officials are often members of more than one committee within a given field. This applies particularly for the officials of the smaller Member States.

As for the loyalties of national officials participating in EU committees, the study shows that they retain their allegiance to their national governments. The officials perceive their committee colleagues mainly as representatives of their respective governments. However, the study also shows that committee members while remaining loyal to their national governments develop a sense responsibility and loyalty towards the committees they are members of. A strong identification with the technical community around the committees they participate in can also be observed. The committee members are particularly open to arguments from colleagues who have demonstrated considerable knowledge in the past.

The study shows considerable trust in the Commission as a neutral actor independent of national interests. The authors conclude that although national officials first seek to further the interest of their Member States there are strong indications of the existence of decision-making culture where the quality and their technical soundness of the argumentation is decisive for the regulatory solutions adopted.

3.7.3 Van der Knaap: Committee Decision-Making

Van der Knaap's study reveals different aspects of how committees work⁵⁷.

He too identifies an extensive personal overlap between the committees. It is common that expert group and advisory comitology committees are composed of the same individuals. For cost-saving reasons expert group and advisory comitology committees working on the same matter and with the same composition hold their

⁵⁶ SCHÄFER, G. et al., "The Experience of Member States Officials in the EU Committees: A Report on Initial Findings of an Empirical Study", *Eipascope* 2000, no. 3, p. 29-35. The authors underline that their results should only be seen as an indication of how EU committee operate since their material is not representative neither as to nationality nor to the kind of committees the Member States official participated in, p. 29.

⁵⁷ VAN DER KNAAP, P., "Government by Committee: Legal Typology, Quantitative Assessment and Institutional Repercussions in the European Union", in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA, p. 101-106.

meetings on the same day in the morning and afternoon respectively. Moreover, the same committee can have multiple functions subject to different comitology procedures. It is unclear to what extent this leads to uncertainty among the committee members as to whether a non-comitology or a comitology procedure and in the latter case as to which of the three comitology procedures is being followed. The Commission's legal service has emphasised that clarity to the procedure must be ensured at the beginning of each committee meeting.

It is not known to what extent the Commission is influenced by the Member States' control on the implementation varying with the applicable comitology procedure. It can be observed that the Commission is hardly ever met with a negative opinion⁵⁸.

One reason for the small number of negative opinions expressed by comitology committees may be the preparatory work done in comitology working groups. In the comitology working groups the national representatives that are members of the comitology committees act as technical experts⁵⁹ and reach consensus before the questions are discussed in the comitology committee.

Formally only comitology committees have influence on the legislative procedure. Van der Knaap refers to pilot studies showing that both the comitology and non-comitology committees influence the Commission. In both types of committees the Commission supports dialogue and facilitates exchange of views and information. According to the pilot studies neither the Commission nor the committees members distinguish between the various procedures when reaching decision within the committees. The influence of the committees on the Commission depends on their expertise in the field, internal consensus and clear task definition and less on the influence they formally have⁶⁰.

Lastly, Van der Knaap notes that representatives from private organisations from time to time participate in comitology committee meetings either as representatives of their organisations or as temporary national experts.

In sum, the significance of whether a comitology procedure is followed or not and the importance of the formal degree of Member States influence is difficult to detect. Van der Knaap indicates that other factors such as the committees' expertise in the field, internal consensus and a clear task definition matter more than formal rules.

3.7.4 Joerges and Neyer: Deliberative Supranationalism

A study into the attitudes and perceptions of members of the committees in the field of foodstuffs has been conducted by Joerges and Neyer⁶¹.

⁵⁸ VAN DER KNAAP, P., "Government by Committee: Legal Typology, Quantitative Assessment and Institutional Repercussions in the European Union", in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA, p. 104.

⁵⁹ FALKE, J., "Comitology and Other Committees: A Preliminary Empirical Assessment", in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA, p. 128.

⁶⁰ VAN DER KNAAP, P., "Government by Committee: Legal Typology, Quantitative Assessment and Institutional Repercussions in the European Union", in PEDLER, R.H. and SCHAEFER, G.F., *Shaping European Law and Policy*, EIPA, p. 105.

⁶¹ The results and an analysis of the study is provided in JOERGES, C. and NEYER, J., "From Intergovernmental Bargaining to Deliberative Political Process: The Constitutionalisation of Comitology", *European Law Journal*, September 1997, p. 273-299.

The field of foodstuffs is characterised by a need for adapting regulation to new developments with due regard to the principle of free movement, differing normative-political interests, the latest scientific knowledge, and the different impacts that new regulation will have on the economies of the individual Member States. 'Regulation through committee' provides a forum for balancing these objectives and conciliating the inherent tension between them.

The study shows *inter alia* that the Commission dominates the work of the committees and that it is not severely constrained by the threat of referral to the Council in case of a negative committee opinion. The committees constitute forums in which the Commission in consensus with the Member State representatives determine long-term strategies and discuss emerging regulatory issues.

The most important finding is that the prevailing form of decision making is by consensus even when the formal rules prescribe qualified majority. Consensus is reached on the basis of the technical argumentation and less on the basis of which Member States carry the stronger voting power. Over time national representatives develop a common problem definition and solution philosophy, which incorporates both the normative-political interests and the free movement objective.

The study shows that Member States representatives on the committees do not merely seek to further their pre-formulated national political agendas. They are open to new arguments and are prepared to change their positions in the course of the deliberations on new regulation that take place in the committees. This denotes the work of committees as "a long-term oriented process of working and learning" in order to adopt and maintain common state-of-the-article regulation. In the course of this process a common policy directed towards the attainment of an agreed 'common weal' is likely to emerge.

This form of problem solution and policy adoption is termed deliberative supranationalism by Joerges and Neyer. Deliberative supranationalism is both an analytical and a normative standard.

Joerges and Neyer propose that the objective of rules on 'regulation through committee' should be to ensure the quality of the deliberation and consequently its outcomes. The conditions for achieving the highest quality of deliberation vary from field to field. The appropriate plurality of interests in the deliberative process must be found on a case by case basis.

In sum, the study shows how committee decision-making is driven by the Commission and based on consensus, technical arguments and the development of a problem solving philosophy and culture specific to the individual committees. The objective of rules on committee should be to facilitate deliberation in order to reach the most balanced and well-suited regulatory solutions. 'Regulation through committee's constitutes a novel form of interest group formation and decision-making, which should be distinguished from regulatory strategies based on centralised regulation, or on mutual recognition and competition among rules⁶².

⁶² JOERGES, C. and NEYER, J., "From Intergovernmental Bargaining to Deliberative Political Process: The Constitutionalisation of Comitology", *European Law Journal*, September 1997, p. 277.

3.7.5 Vos and Sauter: The Committees and Networks in the Field of Telecommunications

A case study by Vos and Sauter⁶³ in the field of telecommunications takes a broad perspective on committees. The study looks at the entire network of committees and national authorities in the field of telecommunications of which the comitology committees are the European hubs.

Comitology committees have only recently been introduced in the field of telecommunications but have already reached a high level of activity as regards the number of committees, the frequency of meetings, and the number of participants including experts from private organisations. The representatives on the committees are appointed by independent national telecommunication authorities.

The study shows that besides their membership in EU committees the same officials participate in committees outside the EU. This creates a link between the EU committees and other international fora in the telecommunications area. Moreover, the involvement of experts secures that the scientific debate on the basis of which the regulation is shaped has an advanced technical level.

In sum, the study shows that the EU committees should be seen as a part of a sectoral network consisting of independent national regulatory authorities and international organisations. The full picture of 'regulation through committee' hence encompasses the individual committees, the individual representatives on the committees, the national bodies they represent, and the network that links them together.

3.8 Summary of the Studies on Committees

Drawing from the studies above the following observations on the role of committees in the EU can be made.

The committees on the different stages of rule making in the EU are not separated by strict formal lines. The identified high degree of personal overlap leads to the conclusion that the committees within an area of technical regulation constitute one coherent technical community of mainly national officials and representatives of private organisations.

It is not known to what extent the formal rules governing a specific committee impact on the way decisions are made. Van der Knaap's study indicates that factors such as committees' expertise in the field, internal consensus and a clear task definition determines their influence. Joerges and Neyer take a step further and conclude that deliberative supranationalism based on consensus decision-making, technical argumentation and the development of common problem solving philosophies and cultures best describes the way committee decisions are made.

This is supported by the finding that although national officials remain loyal to the interest of their Member State, they also feel a strong allegiance to 'their' committees and the surrounding technical communities.

⁶³ SAUTER, W. and VOS, E., "Harmonisation under Community Law: The Comitology Issue" in CRAIG, P. and HARLOW, C. (Eds.), *Lawmaking in the European Union*, Kluwer 1998, p. 180-182.

Lastly, the EU committees should not be seen as structures isolated within the EU structures. They constitute an important part of a broader networks of independent national regulatory authorities and an international organisations and fora.

3.9 The Advantages and Disadvantages of 'Regulation through Committee'

3.9.1 The Advantages of 'Regulation through Committee'

The first and most important quality of is its ability on the basis of a deliberative problem-solving culture to provide the detailed regulation, which is required for the establishment of the internal market. 'Regulation through committee' as opposed to competition among rules involves active regulatory intervention to secure the obstacles arising from national regulatory disparities are removed and that free movement is facilitated. 'Regulation through committee' also allows for due consideration to be given to other policy objectives such as addressing market failures besides facilitating free movement. As a result of a European debate and polity is being developed although admittedly within the small circle of individuals associated to the committees.

Secondly, the involvement in the policy creation of the national experts who are responsible for its day-to-day administration and therefore have the best understanding of the issues is likely to increase the quality of the regulation. Their participation is the best guarantee for avoiding regulatory lapses and adopting regulation to meet new developments.

Thirdly, 'regulation through committee' provides a flexible and fast tool for adjustment of the regulation. If an adequate legal basis in the form of an enabling basic act is in place, comitology committees are able to respond speedily and adjust the regulation in response to developments in the regulated area of economic activity. This contrast with the slow and cumbersome legislative procedures provided for in the Treaty.

Fourthly, 'regulation through committee' facilitates a continuous learning process. The committees constitute fora where national regulators meet, exchange and refine their individual regulatory answers into common state-of-the-art regulation.

Fifthly, the use of committees secures the adequate involvement of the latest scientific evidence in the field.

Sixthly, the decision making on the basis of rational, technical, scientific arguments exposes possible protectionist agendas of the individual Member States. In this environment of technical debate national measures are evaluated in detail to establish the coherence with the objectives they are said to pursue and their proportionality. A side effect of this is the internalisation of EU objectives and of the interests of individuals and companies from other Member States in national policies and administrations. It also provides a bulwark against intergovernmental bargaining and conciliation of national interests by replacing these with trans-national regulatory regimes based on technical argumentation.

Seventhly, the participation of national officials in the EU committee has the side effect of internalisation of EU objectives in to the national administrations. Due to the internalisation of EU objectives national authorities are more likely to take due regard

of the EU objectives when applying and creating the national rules. They are also more likely to consider the interests of nationals of other Member States which, due to the use of the principle of home country control, depend on them for their protection. One example in the field of investment services is home state authorities applying their rules in such a way that ensures the protection of host state investors.

Lastly, implementation is facilitated because the implementing national authorities have been involved in the creation of the regulation. The adopted legislation is more likely to include special provision for any national idiosyncrasies. For the same reason national authorities will have an easier task implementing because they already have a full understanding of the new regulation. Moreover, having been involved in its adoption national authorities are less likely to oppose the new regulation and more likely to implement it loyally.

3.9.2 The Disadvantages of 'Regulation through Committee'

Firstly, there is no guarantee that the technical knowledge available in the committees is used in the decision-making. Even when the inclusion of technical knowledge is obligatory, there is no guarantee that it is in fact followed, especially where political interests are at stake.

Secondly, there is no guarantee that a sufficient plurality of normative-political positions is included in the debate of the committees. Although access to the committee networks is not completely barred, it is limited and the ways of entry in form of participation rights are far from clear.

Thirdly, although protectionist arguments are not accepted and the relative weight of individual Member States votes matters less in the scientific and consensus-based decision-making culture of the committees, the advantages of the large Member States should not be underestimated. The scientific debate in the committees is likely to be dominated by the larger Member States, which can allocate resources necessary to underpin their positions with strong technical arguments. The resource imbalance has an even stronger impact on the limited participation rights granted to non-government actors.

Fourthly, the common place critique of 'regulation through committee' is its lack of transparency. Although the new comitology decisions provides for the same access to comitology documents as to general Commission documents, it is not transparent how decisions are made and by whom in the individual cases and committees.

Fifthly, the 'regulation through committee' is seen to lack legitimacy⁶⁴. This critique stems from the observation that even very important decisions are made by committees at the European level that only have very tenuous links to the European and national parliaments.

⁶⁴ This critique is part of the larger discussion on the constitutional legitimacy of comitology, which is not covered in the thesis. See LINDSETH, P.L., "'Weak' Constitutionalism? Reflections on Comitology and Transnational Governance in the European Union", *Oxford Journal of Legal Studies*, 2001, p. 145-163, and WEILER, J., "Epilogue: 'Comitology' as Revolution – Infranationalism, Constitutionalism and Democracy" in JOERGES, C. and VOS, E., *EU Committees: Social Regulation, Law and Politics*, Oxford 1999.

Sixthly, as mentioned above the use of 'regulation through committee' is seen to distort the balance between the EU institutions. Particularly the influence of the European Parliament in areas covered by the co-decision procedure is curtailed by use of 'regulation through committee', which strengthens the power of the Commission and particularly the Council/Member States vis-à-vis the European Parliament.

3.10 Interim Conclusion: 'Regulation through Committee'

In this chapter the legal rules regulating the committees assisting the Commission in particular the comitology committees have been described. Moreover, five non-legal studies describing how committees in the EU work have been summarised.

The description of the legal rules regulating committee is based on the case law and the Comitology Decision. It shows that broad powers can be delegated to the Commission who formally adopts the implementing measures. In fact, Member States maintain a strong grip on the implementation through the comitology committees.

The broad access to delegate power to the formally the Commission and factually to the Commission and the comitology committees and the few restrictions on their exercise of this power provides the basis for the regulatory strategy of 'regulation through committee'. This space for regulation has led to the emergence of the 'regulation through committee'. 'Regulation through committee' has developed because there was and is a need for the flexible and adoption and adjustment of common regulation and for day-to-day policy co-ordination at the European level. The full picture of the use and importance of committees and of 'regulation through committee' would not be complete without mentioning the non-comitology committees on the other levels of EU policy-making. Despite their lack of formal powers, they also have a significant influence of the shaping of common European policies.

The reason why the use of committee constitutes a distinct regulatory strategy and not just an institutional arrangement is shown by the summarised non-legal studies. They describe a distinct way of regulating in the EU.

The studies draw a picture of adopting regulations within and by 'communities' of officials and other experts within the regulatory fields where committee structures have been established. Common problem-solving philosophies and policies are created within these communities. The communities cut across the formal borders of different committees because of the large personal overlap. An important point is that the members of the committee communities co-operate on a continuous basis over a long period of time. As representatives of their respective national authorities they are faced with the similar developments of the economic activity they regulate, and within the committee communities they co-operate to develop regulatory responses to these developments. The 'community' feeling is reflected in the preferred way of decision-making, namely by consensus on the basis of technical deliberation.

It should be remembered that although the strategy of 'regulation through committee' has gained a strong position in some areas of EU law, it should not be overlooked that the committee members remain loyal to their respective Member States. The described ideal of 'regulation through committee' strategy will therefore not always reflect how decision-making is done within the committees. This applies in particular

where Member States have a strong political interest in an issue which a committee is deciding.

An important point of critique of 'regulation through committee' and its ability to adopt the most balanced regulation is the risk of not all positions being included in the deliberative process. An important condition for 'regulation through committee' fulfilling its regulatory promises of detailed and state-of-the-art regulation is therefore that the representation of a plurality of both normative-political and technical positions is ensured.

The description in this chapter of the legal rules on the use of committees and the regulatory strategy of 'regulation through committee' will be used for the analysis of the current and future use of committee in the field of investment services in the chapters below.

Chapter 4 The Current EU Regulatory Framework for the Provision of Cross-border Investment Services

This chapter describes the EU regulation of the direct cross-border provision of investment services. Special attention will be given to the regulation on the on-line cross-border provision of investment services. The chapter does not deal with the regulation of other financial services such as banking and insurance services. The regulation and case law in these fields will however be described when of relevance for the regulation of investment services. The same applies for the regulation on investment firms' branches in host Member States.

The first part of the chapter describes the most important European regulatory rules with an impact on the provision of investment services. This includes first and foremost the Investment Service Directive⁶⁵, but also the Capital Adequacy Directive⁶⁶, the Directive on Investor Compensation Schemes⁶⁷, the proposed Directive on Distance Marketing of Consumer Financial Services⁶⁸, the case law on free movement of services and the EC Convention on the Law Applicable to Contractual Obligations⁶⁹ are examined. Also the recent E-commerce directive⁷⁰ is examined because it deals specifically with the on-line provisions of services and hence supplements the sector specific directives.

In the second part of the chapter the problems and shortcomings of the current regulatory framework are identified.

Besides the examined rules a number of other directives apply to the provision of cross-border financial services. Some deal with specific financial products such as the UCITS Directive⁷¹ and proposed Directive on the Activities of Institutions for occupational retirement provision⁷². Others have a broader horizontal scope and regulate particular aspects of advertising and consumer protection for example the Directive on Misleading and Comparative Advertising⁷³, the Directive on injunctions

⁶⁵ Council Directive 93/22/EEC on Investment Services in the Securities Field, OJ 1993, L 141, p. 27.

⁶⁶ Council Directive 93/6/EEC on the Capital Adequacy of Investment Firms and Credit Institutions. OJ 1993, L 141, p. 1.

⁶⁷ Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on Investor-compensation Schemes, OJ 1997, L 84, p. 22-31.

⁶⁸ COM (1999) 385 final, Amended Proposal for a European Parliament and Council Directive concerning the Distance Marketing of Consumer Financial Services and Amending Directives 97/7/EC and 98/27/EC.

⁶⁹ OJ 1980, L 266. A consolidated version is published in OJ 1998, C 27, p. 34.

⁷⁰ Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market (Directive on electronic commerce), OJ 2000, L 178, p. 1-6.

⁷¹ Council Directive 85/611/EEC of 20 December 1985 on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJ 1985, L 375, p. 3-18.

⁷² COM (2000) 507 Final, Proposal for a Directive of the European Parliament and of the Council on the Activities of Institutions for Occupational Retirement Provision.

⁷³ Council Directive 84/450/EEC relating to the approximation of the laws, regulations and administrative provisions of the Member States concerning misleading advertising, OJ 1984, L 250, p. 17, as amended by Directive 97/55 of the European Parliament and of the Council amending Directive 94/450/EEC concerning Misleading Advertising so as to include comparative advertising, OJ 1997, L 290, p. 18.

for the protection of consumers' interests⁷⁴, and the Directive on unfair terms in consumer contracts⁷⁵. As these directives include specific provisions for enhancing consumer protection in general, they will not be individually described in this thesis⁷⁶.

4. 1 The History of Regulation of Investment Services

The first step towards EU harmonisation of the provision of investment services was the Commission Recommendation concerning a European Code of Conduct Relating to Transactions in Transferable Securities⁷⁷. The objective of the Recommendation was to establish common standards of ethical behaviour, ensure well-functioning securities markets and safeguard the public interest. To this end, it included provisions requiring financial intermediaries to act fairly and loyally in the dealings with clients.

The 1985 White Paper endorsed a regulatory approach based on the principles of minimum harmonisation, home country control and mutual recognition.

This regulatory approach was first employed in the securities field with the adoption of the Directive on Undertakings for Collective Investment in Transferable Securities⁷⁸, and some years later with the Second Banking Directive⁷⁹. The Second Banking Directive established the so-called European passport for banks i.e. a right to provide services freely throughout the EU only subject to home country authorisation and supervision. The European passport for banks gave investment firms a regulatory competitive disadvantage⁸⁰ as they did not enjoy the same right and therefore incurred additional compliance costs when providing services abroad. This disadvantage was eliminated with the adoption of the Investment Service Directive⁸¹. The two directives have similar structures and many of their provisions are identically worded. The playing field between the two types of financial service providers has further been levelled with the Capital Adequacy Directive⁸². This directive on the capital reserves

⁷⁴ Directive 98/27/EC of the European Parliament and of the Council on the Injunctions for the Protection of Consumer's Interests, OJ 1998, L 166, p. 51.

⁷⁵ Council Directive 93/13/EEC on Unfair Terms in Consumer Contracts, OJ 1993, L 95, p. 29.

⁷⁶ It should however be noted that the Annex 2 (a-c) of the Directive on Unfair Terms in Consumer Contracts includes special provisions for financial services whereby the standards for what is deemed unfair are relaxed due to the characteristics of the financial services provided.

⁷⁷ Commission Recommendation 77/534/EEC concerning a European code of conduct relating to transactions in transferable securities, OJ 1997, L. 212, p. 37.

⁷⁸ Council Directive 85/611/EEC of 20 December 1985 on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJ 1985, L 375 p. 3-18.

⁷⁹ Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC, OJ 1989, L 386, p. 1-13.

⁸⁰ Traditionally banking and investment service provision activity in the UK is exercised by separate entities – savings and investment/merchant banks respectively – and regulated and supervised accordingly. Conversely, in Continental Europe particularly in Germany these services are provided by the same entities, the universal banks. The granting of the European passport solely to banks disadvantaged investment firms i.e. the investment/merchant banks, primarily located in the UK cf. LAU HANSEN, J., *Fondsbørsen – Aspekter af en fondsbørsretlig forudsætning*, Green§Jura 1999, p. 188.

⁸¹ The Council directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ 1993, L 141, p. 27-46.

⁸² Council Directive 93/6/EEC on the Capital Adequacy of Investment Firms and Credit Institutions. OJ 1993, L 141, p. 1.

which investment service providers are required to maintain applies to both investment firms and banks providing investment services.

The provision of on-line services attained strong attention with the emergence of Internet and e-commerce. A very ambitious harmonisation programme has since been developed. This has inter alia resulted in the E-commerce Directive, which marks the current state of EU regulation of on-line services including investment services. The E-commerce directive stands out from the other directives examined as it applies horizontally to on-line services. The integration strategy underlying this directive therefore varies slightly from the sector specific directives.

Since the Investment Service Directive no significant harmonisation measures on investment services have been introduced. Recently, the field of capital markets and financial services has been the object of much attention and debate. The fact that EU capital markets are less developed than their US counterparts and that this works against the competitiveness of the EU has been highlighted. The enthusiasm for the US model has cooled since the burst of the dot.com bubble, but the development of strong capital markets and accompanying regulatory reform is still seen as a *sine qua non* for future European economic development and prosperity⁸³. To this end the Financial Services Action Plan was adopted in 1999⁸⁴. It comprises a catalogue of regulatory measures to be implemented by 2005. The importance of its timely implementation for the development and growth of the European economy has been compared to the 1985 White Paper on the completion of the Internal Market⁸⁵. The Financial Services Action Plan includes specific measures for new regulatory measures in the field of investment services. Alongside the Action Plan's proposals for new substantive measures, an expert group headed by Alexandre Lamfalussy working under the auspices of the Commission has issued a proposal for the future regulatory techniques to be employed in the field of investment services. These developments indicate a new regulatory paradigm in the field. They will be examined in the following chapters.

4.2 Categories of Investment Service Regulation

When analysing financial regulation in general it is useful to distinguish between regulation of the service provider and of the service itself⁸⁶.

The regulation of the service providers can be broken down into regulation on authorisation and on prudential supervision. Regulation on authorisation encompasses conditions on the reputation, capital, adequate infrastructure and business plan of the service provider. Authorisation upon fulfilment of these conditions is mandatory for initiating activity as an investment service provider. Regulation on prudential supervision regulation mirrors the regulation on authorisation. It requires the basic

⁸³ Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets. Brussels 9 November 2000, p. 2. The report is available at www.europa.eu.int/Comm/finances.

⁸⁴ COM (1999) 232, Commission Communication, Financial Services: Implementing the Framework for Financial Markets: Action Plan.

⁸⁵ Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets. Brussels 9 November 2000, p. 2. The report is available at www.europa.eu.int/Comm/finances.

⁸⁶ DALHUISEN, J.H., "Liberalisation and Re-Regulation of Cross-border Financial Services", *European Business Law Review*, May/June 1999, p.158-192 (part I.), July/August, p. 284-305 (part II.), September/October 1999, p. 354-370 (part III.), p. 158.

conditions for authorisation as well as additional conditions ensuring the integrity of the firm to be fulfilled on an on-going basis.

The regulation and supervision of the services themselves can be broken down into regulation on conduct of business supervision and on product control of investment products. The regulation of conduct of business supervision can be divided into conduct of business rules, which regulate the relationship between the service provider and purchaser, and rules on advertising. The product control regulation of investment products is often found in national contract law requiring financial services to include certain characteristics and prohibiting other, thereby shaping the investment product.

Regulation of investment services can hence be categorised as regulation on 1) authorisation, 2) Prudential supervision, 3) Conduct of business supervision, and 4) Product control⁸⁷. This categorisation will be employed in the following. The analysis of the degree of mutual recognition and the scope for competition among rules of the current regulatory framework will be based on these categories.

4.3 The Investment Service Directive

The Investment Service Directive⁸⁸ is the most important piece of legislation on the provision of investment services. It was passed by the Council of 10 May 1993 with the implementation deadline of 31 December 1995. Its legal basis is art 47(2) of the Treaty. The following describes its rules on the provision of cross-border investment services. It does not deal with the provisions on branches and regulated markets.

The scope of the directive covers a range of services relating to specific instruments provided by an investment firm to third parties i.e. professional as well as retail investors. The services and instruments covered are defined in the annex to the directive.

The annex' section A on the services covered lists the reception and transmission of orders on behalf of investors, execution of orders for others, dealing for own account, managing portfolios in accordance with investors' mandates and underwriting or placing of new issues.

The instruments covered according to section B of the annex are transferable securities, units in collective investment undertakings, money-market instruments,

⁸⁷ DALHUISEN, J.H., "Liberalisation and Re-Regulation of Cross-border Financial Services", *European Business Law Review*, May/June 1999, p.158-192 (part I.), July/August, p. 284-305 (part II.), September/October 1999, p. 354-370 (part III.), p. 158. Similar categories are employed by Tisson in "What is the General Good in EU Financial Law?", *Legal Issues of European Integration* 1997 no. 2, Kluwer 1998, p. 1-46, p. 5 and 26. Tisson distinguishes between 1) Rules relating to market access for offerors of services, 2) Rules on market behaviour of service offerors, 3) Private law rules purporting to contents of the services offered on the market. Tisson's first category corresponds to the regulation on authorisation and prudential supervision, his second category to conduct of business supervision, and the third to product control.

⁸⁷ The Council directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ 1993, L 141, p. 27-46.

⁸⁸ The Council directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ 1993, L 141, p. 27-46.

financial futures contracts, forward interest-rate agreements, interest-rate, currency and equity swaps, and options.

The annex' section C lists the non-core services an investment firm can provide as a supplement to its section A core services. These include safekeeping and administration of section B instruments, safe custody services, loan-giving related to transactions of section B instruments where the loan-giving investment firm is involved in the transaction, advice to undertakings relating to structure and strategy, services relating to underwriting, investment advice related to section B instruments and foreign exchange service connected to the provision of investment service.

An investment firm is defined as a legal person that provides investment services to third parties on a professional basis. The directive allows Member States to extend the definition of investment firms to non-legal persons if these comply with conditions securing the protection of third parties. Credit institutions i.e. banks providing investment services are partially subject to the directive cf. article 2(1). A range of investment services providers listed in article 2(2) is excluded from the scope of the directive.

The core principle of the directive – the right to provide cross-border investment services only subject to home state authorisation and supervision – stems from article 14. This so-called European passport allows investment firms to provide the services throughout the EU for which they have obtained authorisation in their home state. The home state is the Member States where the firm's registered office is situated, of if under its national law it has no registered office, the Member States in which its head office is situated cf. article 1(6b). The investment firm must have its head office in the Member States where it has its registered office.

The Member State in which the investment service is provided is defined as the host state. A host State is prohibited from imposing additional authorisation requirements, capital requirements, or measures having an equivalent effect on the home state investment firms. The directive makes a few exceptions from the principles of mutual recognition and home country control and designates power to host Member States on these matters. The exercise of these host Member State powers is subject to the general good test. The general good test is identical to the test employed by the ECJ when considering whether a national measure constituting a barrier to the free movement of services can be upheld with reference to an imperative requirement of public interest. The general good test like the imperative requirement of public interest test includes a proportionality requirement.

The directive's arts 3-6 lay down the conditions for taking up activity as an investment firm. Commencement of investment firm activity is conditional on home state authorisation. The authorisation must specify both the section A core and the section C non-core services the firm is permitted to provide. Firms can only be authorised to provide non-core services in addition to core services. The conditions for authorisation are that the firm's management is of sufficiently good reputation and experience, and with some exceptions that the firm's decision-making body is composed of at least two persons. The firm must submit a programme of operations describing the firms envisaged activities and organisation. Moreover, the identity of

the firm's controlling owners must be disclosed. Lastly, the firm must satisfy the capital requirements of the capital adequacy directive⁸⁹ described below.

Arts 8-13 lay down the investment firms' operating conditions. Operating conditions are under home state control. The home state supervises and ensures that domestic investment firms satisfy the authorisation conditions including the capital requirements as well as other rules within the exception of the areas where the directive designates the power to the host Member State. To ensure that the management and controlling owners of the investment firm are continuously composed of individuals of a sufficiently good reputation and experience any significant change in the circle of owners or managers must be disclosed to the competent authorities who have the option to oppose such changes.

Member States must draw up prudential rules for its domestic investment firms in accordance with the basic principles set out in the directive. These basic principles require prudential rules to include provisions on sound administrative and accounting procedures, electronic data processing control, and adequate internal control mechanisms including rules on employees' personal transactions. Moreover, the prudential rules must ensure that investor's ownership rights to specific funds and instruments are safeguarded. Records of all transactions must be kept to facilitate the authorities' supervision. Lastly, the prudential rules must require investment firms to be structured in a way to avoid conflicts of interests between investors or between the investors and the firm.

Art 11 on conduct of business rules is an exemption to the principle of home country control. The implementation and the supervision of compliance with the conduct of business rules is the responsibility of the Member States "in which a service is provided" cf. art 11(2). This provision is in general interpreted as referring to the host state in which the investor is resident. The overall purpose of the conduct of business rules is to protect the interests of the clients and the integrity of the market. In the application of the conduct of business rules host Member States must take due account of the professional nature of the investor. This can be done by adopting different sets of conduct of business rules applicable to retail and professional investor respectively. Each Member State must adopt conduct of business rules, which ensure that investment firms act honestly and fairly, with due skill, care and diligence, and that they employ the necessary resources and procedures for the proper performance of their activities. Investment firms must obtain from their investor clients information about their financial situation, investment experience and the objectives of their investment ('know your customer'). An investment firm executing an order must make this assessment with respect to the investor from which the order originates even when the order was placed by another investment firm on the investor's behalf. Investment firms must also disclose any relevant material information to the investor clients. The conduct of business rules must also require that conflict of interest rules are avoided. Where a conflict is unavoidable clients must be treated fairly. This provision in host states' conduct of business rules exists alongside the obligation in the home state prudential rules to avoid conflicts of interests.

⁸⁹ Council Directive 93/6/EEC on the Capital Adequacy of Investment Firms and Credit Institutions. OJ 1993, L 141, p. 1.

Alongside the conduct of business rules information requirements the investment firms were formerly obliged to inform their clients of the scope of the investor compensation scheme applicable before concluding a transaction. This provision was repealed with the entry into force of the Investor Compensation Scheme Directive on 26 September 1997⁹⁰. The obligation to inform investors on the applicable protection scheme now follows from the Investor Compensation Scheme Directive article 10.

As for advertising, article 13 allows investment firms to advertise their services in host Member States through all available means of communication subject to host state rules on form and content of advertising adopted in the interest of the general good.

Prior to providing investment services in host Member States home state investment firms must comply with the following procedure. The procedure is initiated by the investment firm's notification to its home authority of its intention to provide services to a specific host state and its intended programme of operations. This information is forwarded to the host state authority within a month from the notification. The investment firms may then start to provide the investment services in question in the host Member State. Where appropriate the host state authorities must indicate to the incoming investment firm the host state general good rules *inter alia* the conduct of business rules the firm must comply with.

Articles 19(3)-(5) state that in case of infringements by a home state investment firm of the rules on which the directive confers power to the host Member States, the host state authority must proceed by the following steps. Firstly, the host state authority must require the service provider to comply with the rules. If this is without effect, it should contact the home state authority of the infringing investment firm, which is obliged to intervene immediately. Should home state sanctions prove inadequate, the host state authority may prevent or penalise the continued infringement of its national rules. This procedure does not affect the powers of the host Member States to prevent or penalise violations within its territory of its conduct of business rules or other general good rules cf. article 19(6). In emergency cases the host state authority can take precautionary measures to protect investors and other service purchasers.

The host Member States can subject an incoming service provider to furnish it with the information necessary for the monitoring of its compliance with the host state rules. The requirements must not be more stringent than those applying to indigenous investment firms. Investment firms are also required to keep records on transactions conducted in the past five years and report their transactions in the more important securities within short time limits.

The final part of the Investment Service Directive regulates the competent national authorities and their operations. Member States must designate as competent authorities for the Investment Service Directive one or more public authorities, bodies recognised by national law or by bodies recognised by public authorities that are expressly empowered for that purpose. Moreover, the Directive includes detailed provisions on national and trans-national co-operation, information exchange, confidentiality and disclosure of information related to the supervised investment

⁹⁰ Article 16 of Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on Investor-compensation Schemes, OJ 1997, L 84, p. 22-31.

firms. Article 29 provides that the Council by itself and without the use of committees can adopt necessary adjusting or updating measures to the directive in accordance with the comitology decision⁹¹. Article 29 also contemplates the establishment of a comitology committee. A proposal for the establishment of a comitology committee for both the Investment Service Directive and the Capital Adequacy Directive was made by the Commission in 1995⁹². Despite a long debate consensus on the proposal was not reached. The legislative procedure was terminated in the spring 1998 due to disagreement on the choice of comitology procedure⁹³.

4.4 The Capital Adequacy Directive

The Capital Adequacy Directive⁹⁴ regulates the capital requirements for investment firms and banks in relation to their investment service activity. The directive was adopted on 15 March 1993 with an implementation deadline of 31 December 1995⁹⁵. Its legal basis is article 47(2). The directive and its annexes draw up the detailed technical rules on required capital of investment firms. In the following these will be briefly examined.

The Capital Adequacy Directive supplements the Investment Service Directive in establishing the minimum harmonisation basis for the mutual recognition and home country control in the field of investment services. The fulfilment of its requirements on initial capital for investment firms is a condition for authorisation and hence for benefiting from the European Passport. The Investment Service Directive states the need for the harmonisation of rules on investment firms' own funds, initial capital and the monitoring of compliance with these rules. The Capital Adequacy Directive contains provisions in response to those needs. Moreover, it seeks to ensure the continuity of financial institutions, protect consumers and create a level playing field between credit institutions and investment firms.

The directive applies to both investment firms and credit institutions. Excluded from its scope are inter alia investment firms, which only transmit orders from investor without holding their money or at any time placing themselves in debit with the clients. The directive is a minimum directive as it does not prohibit Member States from imposing stricter rules on national investment firms.

The minimum initial capital requirements vary from 50000 to 730000 Euros depending on the degree to which the firm holds client funds, deals for its own account or underwrites issues on a firm commitment basis.

The core of the directive is the requirement to maintain own funds equalling at least the investment firm's position, settlement, counterparty, delivery, foreign exchange

⁹¹ Referral is made to the former Comitology Decision 87/373/EEC of 13 Jul 1987 laying down the procedures for the exercise of implementing powers conferred on the Commission, OJ 1987, L 197, p. 33.

⁹² COM (1995) 360 Final, Proposal for European Parliament and Council Directive amending Council Directive 93/6/EEC on Capital Adequacy of Investment Firms and Credit Institutions and Council Directive 93/22/EEC on Investment Services in the Securities Field.

⁹³ Cf. Commission PRE-LEX homepage and European Parliaments OEIL homepage. Both homepages are accessible via www.europa.eu.int/eur-lex.

⁹⁴ Council Directive 93/6/EEC on the Capital Adequacy of Investment Firms and Credit Institutions. OJ 1993, L 141, p. 1.

⁹⁵ Article 12(1) fixing the implementation deadline to that of the Investment Service Directive.

risks, and the residual category of other risks. The precise extent of this obligation is calculated in accordance with the detailed provisions in the annexes to the directive.

Alongside the own fund requirements the directive requires investment firms and credit institutions to monitor and control their large exposures. Moreover, it includes provisions on supervision on a consolidated basis of financial holding structures.

As regards supervision on the compliance with the capital requirements the directive assigns this power to the home Member States of the investment firm. The directive requires the Member States to appoint a specific competent authority and inform the Commission thereof. The national authorities are to exchange information and co-operate closely. The directive contemplates the later adjustment of the directives detailed provisions by the Council and later by a comitology committee cf. article 10 and preamble article 27. As described above this comitology committee was never established. Adjustments to the directive are accordingly made by the Council itself.

4.5 The Directive on Investor Compensation Schemes

Article 12 of the Investment Service Directive required investment firms to inform investors of the investor compensation scheme, which would apply to an envisaged transaction. The article also included a commitment by the Commission and the Council to adopt harmonised rules on this matter that would come into effect on the same day as the Investment Service Directive.

Although this deadline was not observed a directive on investor compensation schemes⁹⁶ was adopted on 3 march 1997. The legal basis of the directive is article 47 (2). The directive was to be implemented by 26 September 1997.

The objectives of the directive are to ensure that investors are compensated in the event that the investment firm handling their investments is unable to meet its obligations and more generally to maintain the confidence in the financial systems. It applies both to national and to cross-border investment activity. It promotes cross-border provision of investment services by guaranteeing a minimum level of compensation. Moreover, it eases the access of investment firms to host Member State markets. In the absence of such minimum harmonisation, host Member States might have considered it justified to require membership of its national compensation schemes from incoming investment firms adhering to home state compensation schemes which were not regarded as offering equivalent protection cf. recital 6. On this background it is remarkable that the directive does not include a clearly phrased provision on mutual recognition and the provision of cross-border service. The directive is a minimum directive as it does not preclude national provisions which afford a greater or more comprehensive cover to investors.

The directive covers investment firms as defined in the Investment Service Directive and credit institutions providing investment services. It applies to the investment business i.e. primarily the annex A core services regarding the instruments listed in annex B to the Investment Service Directive. The directive is not formally limited to retail investors but the minimum required compensation level of 20000 Euro. This means that larger investors are only covered to a very limited extent. Moreover, the

⁹⁶ Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on Investor-compensation Schemes, OJ 1997, L 84, p. 22-31.

directive allows Member States to exclude or grant a lower level of compensation to certain types of investors including professional and institutional investors, supranational and national institutions, high-level investment firms managers or stakeholders and large companies from the compensation scheme.

The directive obliges each Member State to ensure that at least one investor-compensation scheme is introduced within its territory. The carrying out of investment activity by investment firms authorised within one Member State is conditional on adherence to a compensation scheme. This principle is subject to a limited number of exceptions. Where an investment firm is excluded from a compensation scheme and fails to arrange for an equivalent level of protection of its investor clients, its authorisation is withdrawn forthwith. The directive hence adds an additional condition for the carrying out of investment activity to the conditions of the Investment Service Directive.

Article 10 of the investor compensation-scheme directive obliges investment firms to give actual and potential investors the necessary information to identify the compensation scheme to which the firm adheres. The information must be given in a readily comprehensible manner on the provisions of the scheme, specifically on its scope and the covered amount. The article continues the information obligation in the now repealed article 12 of the Investment Service Directive.

Compensation is paid to investor in two cases. Either where an administrative authority finds that an investment firm for the time being is unable to fulfil its obligations towards the investor or where a court has made a ruling regarding the firm that suspends the investor's ability to make claims against the firm. The investor can claim compensation for losses arising from the firm's inability to repay money or to return instruments belonging to the investor.

As mentioned above, the directive provides for a minimum compensation level of at least 20000 Euro. The compensation can be limited to a certain percentage of the claim. For claims below 20.000 Euro at least 90 % must be covered. The investor's aggregate claim must be duly compensated irrespective of the number of accounts, the currency and location within the Community. This provision ensures that investors from other Member States are not treated arbitrarily. Where an administrative or judicial decision on the investment firm's inability to meet its obligation towards the investors has been made, the compensation scheme must inform and when relevant compensate the investors as soon as possible.

Article 10 (3) requires Member States to limit the investment firms' use of the information on the applicable compensation scheme in their advertising in order to prevent such use from affecting the stability of the financial system and investor confidence. Member States can limit advertising investment firms' use of this information to a factual reference to the applicable scheme. This very specific provision supplements the general provision on marketing of investment services in Investment Service Directive article 13. It limits the use of the compensation scheme as a marketing tool as home state investment firms are prohibited from drawing attention to the advantages offered by their national compensation scheme. The directive does not make it clear whether the home or host state law implementing article 10(3) should apply to cross-border service provision. In the absence of a clear

rule, it can be assumed that the general principle in Investment Service Directive article 13 applies, namely that host state rules on advertising can only be applied to incoming investment firms in so far as this can be justified with reference to the general good.

4.6 The Proposal for the Directive on Distance Marketing of Consumer Financial Services of July 1999

The Directive on Distance Marketing of Consumer Financial Services has been on its way since November 1998. The latest amended proposal is of July 1999⁹⁷. The imperative importance of this directive was underlined at the recent Stockholm European Council Meeting where a deadline for its adoption was set to the end of 2001⁹⁸.

The proposed directive has a broad scope of application covering all financial services⁹⁹. In the following the provision relevant for the provision of investment services will be described on the basis of the July 1999 proposal. The directive is based on articles 47(2), 55 and 95.

The preamble states the dual objective of the directive is to contribute to the consolidation of the internal market for financial services and ensure a high level of consumer protection. This will benefit both service providers and consumers, which will gain access to "the widest possible range of financial services available in the Community so that they can choose those that are best suited to their needs" cf. recital 3. A prerequisite for consumers exercising this choice is that consumer protection measures are in place enhancing the confidence in distance services.

Recital 5 observes that financial services because of their intangible nature are well suited for being provided from a distance, for example via the Internet. The directive is structured in a way that ensures that it will not soon be outdated and allows it to be adapted to the future development of the technical means through which services are provided. Recitals 9-10 state that divergent rules on the distance marketing of financial services to consumers impede the functioning of the internal market and competition. It is therefore necessary to introduce common rules without deflating the level of consumer protection. The high level of consumer protection set in the directive hence excludes the adoption of higher national standards in the field cf. recital 9. Very importantly, the directive does hence not include a minimum clause allowing Member States to set stricter rules for their national service providers. On this background it is noteworthy that the directive does not include a clearly phrased mutual recognition clause. The directive does not preclude the application of directives on specific financial services such as the Investment Service Directive but supplements these as regards the marketing of these services.

⁹⁷ COM (1999) 385 Final, Amended Proposal for a European Parliament and Council Directive concerning the Distance Marketing of Consumer Financial Services and Amending Directives 97/7/EC and 98/27/EC.

⁹⁸ COM (2001) 286 Final, Financial Services Political Challenges, Fourth Report, p. 4.

⁹⁹ The proposed directive is similar to Directive 97/7/EC of the European Parliament and of the Council on the Protection of Consumers in Respect of Distance Contracts, OJ 1997, L 144, p. 6, which explicitly excludes financial services from its scope.

The directive covers rules regulating the distance marketing of financial services to consumers. Distance marketing is defined as a situation where the supplier and consumer communicate without being simultaneously present at the same geographical place. The directive applies only to services provided by suppliers operating under an organised distance services provision scheme when the supplier in question exclusively makes use of distance communication from the time of the first contact between the two parties to the time of the conclusion of the contract. The directive does therefore not apply to distance marketing and provision of services on an occasional basis. The directive only applies to the first operation between the parties where successive operations take place irrespective of whether these are governed by one single or more separate contracts.

It follows from the title of the directive that it is concerned with the protection of consumers. The protection granted to consumers by the directive cannot be dispensed with by agreement. In case of dispute on whether sufficient information has been provided, whether the consumer has consented to the conclusion of the contract and on the performance of the contract, the supplier has the burden of proof. A contractual clause shifting the burden of proof is deemed an unfair contractual term within the meaning of the directive on unfair terms in consumer contracts¹⁰⁰.

Before concluding a contract for investment services consumers must be informed of the period of validity of the offer, the likelihood of price fluctuations and the factors for determining the price at the time of conclusion of the contract, the cost of using the means of distance communication, and if applicable the right of withdrawal and the price for exercising it. If the consumer is not informed of the price for withdrawal, the supplier cannot require any compensation if the later consumer exercises this right. Moreover, the consumers must be given information of the law applicable to the contract and the court having jurisdiction in the cases where it is possible to contract out of the law and the jurisdiction of the consumer's place of residence. Lastly, the consumer must be given information on the authority supervising the investment firms and on applicable out-of-court complaint procedures. The information must be provided in a clear and comprehensible manner. The commercial purpose of any communication from the service provider must be clear and comply with the principle of fairness in commercial transactions. Investment firms are specifically exempted from providing information on their identity and address, the main characteristic on the service they provide, the arrangement for payment and the total price of the service. They are also exempt from providing information on the minimum duration and the provisions or cancelling the contract. These exemption are without prejudice to the information requirements investment firms are subject to under the Investment Service Directive conduct of business rules. The reason for exempting investment firms from these information obligations was to align the proposed directive with the existing sectoral directives, among them the Investment Service Directive¹⁰¹.

Following the conclusion of the contract all contractual terms including the information provided before the conclusion must be communicated to the consumers. This communication must be given in a paper version or on a durable medium such as

¹⁰⁰ Council Directive 93/13/EEC on Unfair Terms in Consumer Contracts, OJ 1993, L 95, p. 29.

¹⁰¹ COM (1999) 385 Final, Explanatory Memorandum, Amended Proposal for a European Parliament and Council Directive concerning the Distance Marketing of Consumer Financial Services and Amending Directives 97/7/EC and 98/27/EC, p. 5.

a disk, a CD-ROM, or an e-mail allowing the consumer to store the information on the hard disk of his computer.

The consumers have a right of withdrawal. This right can be exercised without indication of any grounds and without penalty. A consumer can withdraw within 14 to 30 days from the date on which he received the information required above. The Member States determine the exact number of days for withdrawal within the span of 14 to 30 days. Without the consumer's express consent the supplier can not commence to perform the contract before the expiry of this withdrawal period. Article 4 (1) in fine provides that the investment firms must comply with withdrawal periods provided for in their home Member States and that they are not bound by the different periods laid down in the law of the consumer's state of residence.

The right of withdrawal does not apply to a number of specified financial services. These include contracts which have been fully completed, and the reception, transmission, execution of orders and services in respect of and related to transferable securities, money market instruments, UCITS, financial futures and options, and exchange and interest instruments whose price depends on market fluctuations outside the service provider's control. The reason for excluding these services is that investors would otherwise be able to speculate in withdrawing from the investments on which they incurred losses. The investment services listed in the annex A to Investment Service Directive are hence not subject to the right of withdrawal with the exception of contracts for portfolio management. The provision does however not prejudice the annulment of contract where the consumer has been unfairly induced by the supplier to conclude the contract.

In the case of a consumer exercising his withdrawal right, he is obliged to compensate the provider for the part of the contract already performed in the form of a lump sum corresponding to the price of the service or calculated on a pro rata basis. The compensation price may not be such that it can be constructed as a penalty.

If the service contracted for is unavailable the supplier must inform the consumer without undue delay. Where the service is partially available, the supplier can only perform partially with the express consent of the consumer.

The Member States must also ensure that unsolicited services to a consumer accompanied by a request for payment are prohibited and that the consumer cannot be tacitly bound by an unsolicited service except where this is accepted under national law on the tacit renewal of contracts.

Unsolicited communications by automated calling systems and fax machines require the consumer's prior consent. As regards other unsolicited communications such as emails their lawfulness depends on the law of the home Member State. Member States allowing this marketing method must ensure that consumers must either give their prior consent or that these unsolicited communications may only be employed where the consumer does not express his manifest objection. In the case of unsolicited communications by telephone, the service provider is obliged to reveal his identity and the commercial purpose at the beginning of the conversation. The Member States must provide for appropriate sanctions for infringement of these rules. Although such measures cannot formally be qualified as penalties, the directive proposed that such

sanctions included an extended withdrawal right for consumers of resulting from unsolicited communications.

Member States are obliged to ensure effective complaint and dispute settlement procedures. Member States must grant public bodies or consumer and professional organisations the right to take action before national courts or administrative bodies to ensure the correct application of the directive. Member States must also encourage the co-operation between national out-of-court dispute schemes on cross-border disputes.

4.7 The E-commerce Directive

The E-commerce Directive¹⁰² has a broad scope of application, which also covers the provision of investment services. The general provisions of the e-commerce directive does not prejudice the application of the provisions of sector specific directives such as the Investment Service Directive, but supplements and adds additional requirements to the provision of these particular services. In the following the provision of relevance for the provision of cross-border investment services will be described.

The E-commerce Directive was adopted by the Council on 8 June 2000 on the basis of articles 47(2), 55 and 95. The deadline for implementation is 17 January 2002.

Its preamble is very extensive and includes a catalogue of both explanatory elements and policy objectives. The primary objective of the directive is to contribute to the proper functioning of the internal market by ensuring the free movement of information society services between the Member States. This objective is repeated in article 1 of the directive. Information society services are defined as any service normally provided for remuneration, at a distance, by means of electronic equipment for the processing (including digital compression) and storage of data, and at the individual request of a recipient of a service. Examples of information society services include a wide range of on-line economic activities such as selling of goods and services. It is not a requirement that the on-line activity gives rise to contracting. The free provision of on-line information, commercial communications, video-on-demand, access and transmission of information on an electronic infrastructure or the access to search engines, in so far as this constitutes economic activity, are information society services. The off-line delivery of the goods or services is not covered by the directive. The directive does not apply to the use of information technology between private parties or in the relationship between employer and employee.

The directive seeks to develop the European information society and to allow both service providers and recipients to benefit fully from the opportunities offered by technological development and electronic commerce. The means to bring about this objective is the elimination of the barriers constituted by legal divergence within the EU and uncertainty as to which national measures impeding the provision of services can be justified with reference to the ECJ case law. By the same token the directive is without prejudice to the level of inter alia consumer and investor protection as long as measures securing these objectives are compatible with the Treaty principles of free

¹⁰² Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market (Directive on electronic commerce), OJ 2000, L 178, p. 1-6.

movement cf. article 1(3). Further, the Directive does not establish additional international private law rules on the choice of law or jurisdiction.

Recital 27 of the preamble deals specifically with the relevance of the directive in the field of financial services. The directive and the proposed directive for marketing of consumer financial services contribute to the legal framework for the on-line provision of financial services. The directive does prejudice the future harmonisation of specific aspects of investment service regulation, for example the harmonisation of rules of conduct.

The preamble recital 57 reiterates the ECJ case law allowing Member States to take measures against the evasion of national law by service providers that re-establish in other Member States while directing all or most of its activity to the Member States where it was originally established.

Article 3 includes a very clear provision on mutual recognition and home country control - the so-called internal market clause. The Member States in which a service provider is established must ensure that the service provider complies with national legislation in the field co-ordinated¹⁰³ by the directive. The co-ordinated field covers the requirements laid down in Member States' laws applicable to information society service providers or information society services, regardless of whether they are of a general nature or specific for the field of information society services cf. article 2 (h). Correspondingly, host Member States are from the starting point prohibited from restricting the provision of information society services from other Member States. The preamble recital 22 elaborates on the provision of the division of competence between home and host Member States. The supervision at the source of activity i.e. in the home country is considered to be the most efficient at the attainment of the public interest objectives. Moreover, the recital states that information society services in principle should be subject to the law of the home Member States. Lastly, it underlines the need for national authorities to pay due regard to the interests of national as well as service recipients of other Member States in order to improve the mutual trust.

The directive's internal market clause of free movement, home country control and mutual recognition is subject to a number of general derogations listed in an annex to the directive¹⁰⁴. These include rules on the contractual autonomy of the parties,

¹⁰³ Article 2 (i) defines the "co-ordinated" field as encompassing requirements with which the service provider has to comply in respect of the taking up of the activity of an information society service, such as requirements concerning qualifications, authorisation or notification, and the pursuit of the activity of an information society service, such as requirements concerning the behaviour of the service provider, requirements regarding the quality or content of the service including those applicable to advertising and contracts, or requirements concerning the liability of the service provider. The co-ordinated field does not cover requirements applicable to goods as such, applicable to the delivery of goods, and applicable to services not provided by electronic means.

¹⁰⁴ The annex lists:

- copyright, neighbouring rights, rights referred to in Directive 87/54/EEC(1) and Directive 96/9/EC(2) as well as industrial property rights,
- the emission of electronic money by institutions in respect of which Member States have applied one of the derogations provided for in Article 8(1) of Directive 2000/46/EC(3),
- Article 44(2) of Directive 85/611/EEC(4) on UCITS, [application of host state law on advertising]
- Article 30 and Title IV of Directive 92/49/EEC(5), Title IV of Directive 92/96/EEC(6), Articles 7 and 8 of Directive 88/357/EEC(7) and Article 4 of Directive 90/619/EEC(8) (Insurance Directives),

specific obligations concerning consumer contracts, the advertising of UCITS and the permissibility of unsolicited commercial communications¹⁰⁵. Additional general derogations for financial services in general and investment services in particular were proposed, but these were not accepted by the Council and the European Parliament¹⁰⁶

Article 1(3) states that the directive complements the level of consumer protection established by other directives in so far as this does not restrict the provision of information society services.

Besides the general derogations, the directive also provides for specific derogations from the internal market clause by allowing Member States to uphold measures, which restrict services from other Member States under conditions similar to the ones laid down in the case law. Such restricting measures must be necessary for the protection of one of the objectives listed in article 4 (a(i)) which include the protection of investors. The measures must be directed against a given information society service which prejudices the objective and they must be proportional. Procedurally a Member State considering to apply a restricting measure must firstly request and await that the home Member States of the service provider takes action. Only if the home state does not take any steps or these are inadequate, can the host state take action against the home state service provider. It must also notify the Commission in advance of its intention to take restricting measures. This cumbersome procedure does however not apply in cases of urgency, where notification must be done as soon as possible.

A service provider is considered to be established in the Member States where the centre of the economic activity he pursues through a fixed establishment for an indefinite period is located or provided from. A service provider is not considered to be established where the technical structure facilitating the provisions of services such as its website is located, nor is he considered to be established where its services in the form of the website can be accessed.

Although the principle of home country control as well as the recital 22 indicate a strong bias towards home country law, article 1 (4) specifically states that the directive does not establish additional rules on private international law nor does it deal with the jurisdiction of Courts. The directive does not deprive a consumer of the protection afforded to him by mandatory protection rules in the Member States in which he is resident cf. recital 55. However, this is supplemented by recital 23, which states that the applicable substantive law designated by rules of private international

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- the freedom of the parties to choose the law applicable to their contract,
 - contractual obligations concerning consumer contracts,
 - formal validity of contracts creating or transferring rights in real estate where such contracts are subject to mandatory formal requirements of the law of the Member State where the real estate is situated,
 - the permissibility of unsolicited commercial communications by electronic mail..

¹⁰⁵ Moreover, the Directive does not apply to tax law, competition law, the public activity of notaries, lawyers relations to their clients before courts, gambling activities nor questions relating to information society services covered by Directives 95/46/EC and 97/66/EC on data protection.

¹⁰⁶ COM (2001) yyy Final, Communication from the Commission to the Council and the European Parliament, E-commerce and Financial Services, p. 8. The communication is available at www.europa.eu.int/Comm/finances.

law must not restrict the freedom to provide information society services as established in this Directive.

The following chapters of the directive include the detailed provisions as opposed to the general principles.

Member States are prohibited from subjecting the taking up and pursuit of the activity as information society service provider to prior authorisation. This does not preclude sector specific authorisation requirements for taking up a given activity as such, for example the authorisation requirements for investment services activity.

In its dealing with service recipients and authorities a service provider must give easy, direct and permanent access to information including its name, its geographic address, and its contact details. Information regarding pricing must be clear and unambiguous. Where applicable it must disclose its number of registration in a trade register, its VAT identification number and the particulars of any authorisation scheme and authority in is subject to.

Before a service recipient places an on-line order, the service provider must provide him with information on the following in a clear and unambiguous way: The technical steps to conclude the contract; whether or not the concluded contract will be filed by the service provider and whether it will be accessible; the technical means for identifying and correcting input errors prior to the placing of the order; and the languages offered for the conclusion of the contract.

The recipient must be able to store and reproduce the general terms and conditions of the contract. Where applicable, the service provider must indicate the codes of conduct it adheres to and how these can be consulted electronically. Before placing the order the recipient must be given the opportunity via appropriate, effective and accessible to identify and correct input errors. Where an order has been placed electronically, the service provider must electronically and without undue delay acknowledge the receipt of the recipient's order. The order and the acknowledgement of receipt are deemed to be received when the parties to whom they are addressed are able to access them. Non-consumer parties may opt out of these mandatory information requirements. The requirements only apply partially to contracts concluded by email or other individual communication.

The directive has specific rules for commercial communications. Commercial communications are defined as any form of communication designed to promote, directly or indirectly, the goods, services or image of a company, organisation or person pursuing an economic activity. The mere provision of information allowing direct access to the activity of the company, organisation or person, in particular a domain name or an electronic-mail address, does not constitute a commercial communication. All commercial communications must be clearly identifiable as such and identify the person or company on whose behalf it was made. These requirements apply with particular strength to unsolicited commercial communications. Home Member States that allow unsolicited communications must ensure that service providers making use of this method consult regularly and respect the opt-out registers in which natural persons not wishing to receive such commercial communications can register themselves. Promotional offers and games must be

clearly identifiable as such and the conditions for participation must be clear and unambiguous. The use of promotional offers and competitions in the marketing is conditional on these methods being allowed by the law of the home Member States.

All Member States are obliged to ensure that contracts can be concluded by electronic means. With the exception of some particular types of contracts, contracts concluded electronically should be considered equivalent as regards validity and effectiveness to traditional contracts.

The chapter III of the directive includes a number of specific provisions on its implementation.

The Member States and the Commission shall encourage the drawing up of codes of conduct by professional and consumer organisations that contribute to implementation of the information requirements and on-line contracting. The Member States and the Commission must particularly work to ensure the participation of consumer organisations in the drafting of codes of conduct that affect their interests. All codes of conducts as well as any assessment of their influence on the provision of information service shall voluntarily be communicated to the Commission.

Member States must ensure that their legislation does not hinder the use of out-of-court dispute settlement mechanism including on-line ones available under national law. Member States must encourage the establishment of adequate procedural guarantees for the procedure of such dispute mechanisms, particularly in the field of consumer disputes. Alongside the focus of out-of-court dispute settlement, the Member States laws must provide for rapid measures against alleged infringements. In line with the requirement regarding codes of conduct out-of-court dispute settlement bodies are encouraged to inform the Commission of their practices and decisions relating to electronic commerce. This requirement also applies to the Member States administrations and courts.

The directive also deals with the co-operation between Member States. Member States must allocate sufficient resources to the implementation, supervision and gathering of information from service providers required by the directive. The co-operation is achieved by Member States identifying one or more national contact points to which references regarding the directive can be made. Following reference to a contact point, a Member State must provide as quickly as possible the assistance and information to the requesting Member States or the Commission within the limits of its national law. Member States must also establish contact points for service providers and recipients from which they can obtain general information on contractual rights and complaint mechanism.

4.8 The Case Law on Free Movement of Services

The case law on free movement of services retains considerable importance for the provision of investment services alongside the extensive harmonisation measures. Firstly, the case law regulates the investment services that fall outside the scopes of the directives. Secondly, as regards the services covered by the directives the case law applies to the matters not covered by the directives and to the application of the national measures implementing the sometimes broad and unclear provisions of the

directives¹⁰⁷. Thirdly, some provisions of the directives must be constructed in accordance with the case law.

The concept of general good in the Investment Service Directive provides an illustrating example of the latter¹⁰⁸. The Directive provides that certain host country rules can only be applied to service providers from other Member States where this can be justified with reference to the general good. The origin of the concept of general good is found in the ECJ's case law on imperative requirements of public interest¹⁰⁹. With reference to an imperative requirement of public interest a Member States can defend and uphold a piece of national legislation that would otherwise be prohibited as a non-discriminatory restriction. The concept was introduced in the case law as an exemption to the principle of judicial mutual recognition and the extension of the concept of restrictions to free movement beyond discriminatory measures. The purpose of exempting public interest measures was to counterbalance this development's far-reaching effects. When the Commission 'copied' the ECJ mutual recognition approach from the case law to the 1985 White Paper harmonisation programme, it also 'copied' the concept of imperative requirements of public interest or general good. The directive's concept of general good should therefore be interpreted in accordance with the case law on imperative requirements of public interest.

In the following a summary of the leading case law on free movement of services will be made with special focus on the judgements on financial services and the concept of imperative requirements of public interest.

4.8.1 The Freedom to Provide Services

Article 49 of the Treaty prohibits all restrictions on the freedom to provide services of EU service providers who are established in a Member States other than that of the person for which the services are intended. The freedom to provide services is a residual category to the Treaty provisions on the free movement of goods, workers and capital.

Three standard scenarios of service provision can be envisaged¹¹⁰. First, the service provider travels to the service recipient's state of residence, the host state, where he provides the service. Second, the service recipient travels to the service provider's state of residence, the home state, to receive the service¹¹¹. Third, neither the provider

¹⁰⁷ Case 220/83 Commission vs. France: "...when the wording of secondary community law is open to more than one interpretation, preference should be given to the interpretation which renders the provision consistent with the Treaty rather than the interpretation which leads to it being incompatible with the Treaty. Consequently, the directive should not be construed in isolation and it is necessary to consider whether or not the requirements in questions are contrary to the above mentioned provisions of the Treaty and to interpret the directive in the light of the conclusion reached in that respect".

¹⁰⁸ The Commission has taken the same view in the field of banking services cf. SEC (1997) 1193 Final, Commission Interpretative Communication, Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive, p. 17.

¹⁰⁹ Cf. USHER, J., *The Law of Money and Financial Services in the EC*, 2nd Edition, Oxford University Press 2000, p. 106.

¹¹⁰ OECD Report, Cross-border Trade in Financial Services: Economics and Regulation, 2000, p. 26. The Report is available at www.oecd.org.

¹¹¹ Cases 286/82 Luisi and Carbone, ECR 1984, p. 195, paras 10 and 16.

nor the recipient leave their state of residence¹¹². The service is instead provided by means of communication such as mail or Internet.

To the three basic scenarios other more unusual ones can be added. One is where both the recipient and the service provider, possibly from the same Member States, travel to another Member State where the service is provided and received¹¹³. The Treaty is applicable to all situations where a service provider provides services in a Member State other than the one in which he is established, no matter from which Member State the recipients originate¹¹⁴. A second uncommon scenario is where the service recipient moves to another Member State and a contract concluded with a service provider of the first Member States at the time while the recipient was still resident there continues to run¹¹⁵. All these scenarios are covered by the scope of the freedom to provide services.

The prohibitions on restrictions of the free movement of services covers directly and indirectly discriminatory measures as well as non-discriminatory restrictions on the cross-border provision of services. This construction is based on a functional approach to the concept of restriction encompassing all national measures that negatively affect the cross-border movement of services. This follows from the wording of the ECJ judgements on the free movement of services¹¹⁶. In particular, host Member States are not allowed to “make the provision of services in its territory subject to compliance with all the conditions required for establishment and thereby deprive of all practical effectiveness the provisions of the Treaty whose object is, precisely, to guarantee the freedom to provide services”¹¹⁷. This applies with even stronger force where the service is provided without the service provider physically moving into the host state territory. Such a restriction not only influences the service providers’ opportunities to market his services in other Member States. It also denies service recipients the choice of services from other Member States.

Public as well as private law rules with restrictive effects are prohibited¹¹⁸. This follows from the Hubbard case where the ECJ stated: “The effectiveness of Community Law cannot vary according to the various branches of national law which it may affect”¹¹⁹. The Commission has taken a similar position in its Interpretative

¹¹² An example is case 76/90 Säger vs. Denemeyer and Co. Ltd., ECR-I 1991, p. 4239.

¹¹³ Case C-154/89, Commission vs. France, ECR-I 1991, p. 659.

¹¹⁴ Case C-154/89, Commission vs. France, ECR-I 1991, 659, para 10.

¹¹⁵ Case 15/78, Société Générale Alsacienne de Banque SA mod Walter Koestler, ECR 1978, p. 1971.

¹¹⁶ Cf. Inter alia case 222/95, Société Civile Immobilière Parodi vs. Banque H. Albert de Bary et Cie, ECR 1997-I, p. 3899, p. 18: “...that article 59 and 60 of the Treaty require not only the elimination of all discrimination on the grounds of nationality of providers of services who are established in another Member State but also the abolition of any restriction, even if it applies without distinction to national providers of and to those of other Member States, which is liable to prohibit, impede or render less advantageous the activities of the provider of services established in another Member States where he lawfully provides similar services.” and similarly case 76/90 Säger vs. Denemeyer and Co. Ltd., ECR-I 1991, p. 4239, p. 12.

¹¹⁷ Case 76/90, Säger vs. Denemeyer and Co. Ltd., ECR-I 1991, p. 4239, para 13.

¹¹⁸ TISSON, M., “What is the General Good in EU Financial Law?”, *Legal Issues of European Integration* 1997 no. 2, Kluwer 1998, p. 4., and WOUTERS, J., “Conflict of Laws and the Single Market for Financial Services”, *Maastricht Journal of European and Comparative Law* 1997, p. 190.

¹¹⁹ Case 20/92, Anthony Hubbard vs. Peter Hamburger, ECR 1993-I, p. 3777, p. 19. The case dealt with a discriminatory provision of national procedural law.

Communication on the Concept of General Good in the Second Banking Directive¹²⁰. It should be noted however that the ECJ has never been given the opportunity to apply the concept of restriction beyond discriminatory measures in the private law area¹²¹. In fact, in the Koestler case¹²² regarding a rule of private law the ECJ based its decision solely on a discrimination test and did not consider the possibility of a non-discriminatory restriction. The dispute related to German rule providing that debts arising from wagering contracts were not actionable. Contracts for time-bargains on transferable securities were lawful under French law but prohibited and consequently not actionable under German law. The Koestler case however predates the Cassis de Dijon case¹²³ that introduced the principle of mutual recognition and extended the concept of restriction. It is therefore not conclusive for the current state of law¹²⁴.

Where it is established that a national measure is either discriminatory or non-discriminatory, it can be upheld with reference to the article 46(1) grounds of public policy, security and health, provided that it does not constitute arbitrary discrimination and satisfy a test of proportionality. These grounds relate to the persons performing the service rather than the service itself¹²⁵.

Where it is established that a service provider whose activity is entirely or principally directed towards the host Member States has established himself in another Member State in order to evade the legislation of the host Member States, the latter may take steps to prevent his exercise of the freedom to provide services¹²⁶. The scope for Member State action against evasion has been clarified by the Centros case on the freedom of establishment. Following this judgement the question of whether benefiting from a more lenient regulatory regime in another Member States constitutes unlawful evasion must be determined with due reference to the purpose of the Treaty freedom in question¹²⁷.

4.8.2 The Imperative Requirements of Public Interest

As mentioned above the concept of imperative requirements of public interest was developed concurrently with the principle of mutual recognition and the extension of the concept of restrictions on the free movement of services to non-discriminatory restrictions. With reference to an imperative requirement of public interest, a Member State can justify and uphold its challenged non-discriminatory legislation. The conditions for relying on such a justification have been elaborated in the case law.

¹²⁰ SEC (1997) 1193 Final, Commission Interpretative Communication, Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive, p. 26.

¹²¹ TISSON, M., "What is the General Good in EU Financial Law?", *Legal Issues of European Integration* 1997 no. 2, Kluwer 1998, p. 5.

¹²² Case 15/78, Société Générale Alsacienne de Banque SA mod Walter Koestler, ECR 1978, p. 1971.

¹²³ Case 120/78, Rewe-Zentral AG vs. Bundesmonopolverwaltung für Branntwein, ECR 1979, p. 649.

¹²⁴ TISSON, M., "What is the General Good in EU Financial Law?", *Legal Issues of European Integration* 1997 no. 2, Kluwer 1998, p. 5. and AG Jacobs in his Opinion to Case C-76/199 Säger vs Denkmeyer & co. Ltd, ECR-I 1991, p. 4221, p. 22 (page 4234) refers to the Koestler case as an isolated case based on discrimination whereas article 49 should encompass non-discriminatory restrictions. AG Jacobs does however not comment on whether the fact that the Koestler case dealt with a private law measure explains why the decision was based on a discrimination test.

¹²⁵ USHER, J., *The Law of Money and Financial Services in the EC*, 2nd Edition, Oxford University Press 2000, p. 100.

¹²⁶ Case 33/74 Van Binsbergen vs. Bestuur van de Bedrijfsvereniging voor de Metallnijverheid, ECR 1974, p. 1299.

¹²⁷ Case C-212/97, Centros Ltd. Vs. Erhvervs- og Selskabsstyrelsen, ECR-I 1999, p. 1459, p. 25.

A national measure, which constitutes a non-discriminatory restriction can be upheld:

- Where the disputed national measure regards a point of law, which has not been harmonised. The ECJ considers carefully whether existing harmonisation measures covers the disputed question by establishing minimum regulatory standards and whether home state implementing legislation should therefore be recognised as equivalent i.e. perfect mutual recognition. If perfect mutual recognition can be established, the host Member States reliance on an imperative requirement of public interest to justify the challenged national measure is precluded.
- If the disputed measure does not require the duplication of similar requirements that the service provider already satisfies in his home state. The ratio behind this condition is to avoid a situation where the service provider becomes subject to a double regulatory burden and incurs additional costs by fulfilling similar requirements twice.
- If the disputed measure is applied in a non-discriminatory manner, both directly and indirectly.
- If the disputed measure can be justified by an imperative requirement of public interest
- If it is suitable for securing the attainment of the objective which it pursues.
- If less restrictive measures that would secure the attainment of the objective are not available.
- If the disputed measure does not go beyond what is proportional to attain the general good objective. In other words that the objective pursued is so significant that it justifies a restriction on the free movement of services.

The concept of imperative requirements of public interest cannot be defined conclusively. It encompasses a range of socio-economic values compatible with the Treaty. The open-ended list of accepted imperative requirements of public interest is expanded on a case to case basis.

4.8.3 The Imperative Requirements of Public Interest in the Field of Investment Services

In the field of financial services the following imperative requirements of public interest can be invoked. The list is however not conclusive due to the openness to new objectives inherent in the concept of imperative requirements of public interest.

In the field of financial services consumer protection is the most important imperative requirement of public interest recognised by the ECJ. Its importance is underlined by its prominent position in many of the directives examined above. The German insurance case¹²⁸ illustrates how the ECJ distinguishes between different financial services and categories of consumers and how it on this basis carefully scrutinises the need for protection and the corresponding proportionality of the challenged national measure¹²⁹. The ECJ's tolerance of a national measure depends on the type, risk-level and complexity of the financial service and the degree of sophistication and the

¹²⁸ Case 205/84, *Commission vs. Germany*, ECR 1986, p. 3755.

¹²⁹ VAN GERVEN, W. and WOUTERS, J., "Free Movement of Financial Services and the European Contracts Convention" (chap. 3) in ANDENAS, M. and KENYON-SLADE, S., *EC Financial Market Regulation and Company Law*, London 1993, p. 59.

situation of the receiving consumer¹³⁰. For Investment services the need for protection will depend on the sophistication of the investor receiving the service and its complexity and risk degree. In the Alpine Investment case¹³¹ emphasis was put on the complexity and risk of the commodity future product¹³², the surprise element of the used cold calling marketing technique and the non-expert nature of the potential investors. The case also shows that the consumer in the ECJ's opinion as a point of departure should be protected by the authorities in the consumer's residence Member State¹³³.

Secondly, financial market integrity can be invoked as an imperative requirement of public interest objective. This objective has both a micro- and a macro-economic aspect.

From the micro-economic perspective it refers to the vulnerability of financial markets to the lack of investor confidence in the services provided on the market and its service providers. Financial market integrity or in other words the good reputation of a Member States' financial services¹³⁴ is closely related to the consumer protection objective. This is shown by the Alpine Investment case. The micro-economic financial market integrity objective is however broader than the consumer protection objective as it encompasses the indirect protection of consumers outside the home country and can be invoked to protect other market participants than consumers¹³⁵.

From the macro-economic perspective the integrity of financial markets objective regards the overall function of financial intermediaries in the economic process. This objective can be invoked to defend national legislation, which prevents excessive risk-taking and ensures the financial strength of financial intermediaries. In the Pafitis Panagis case¹³⁶ the ECJ inter alia accepted that the disputed national measure should be assessed with due consideration for "the equilibrium of the savings system" and "to ensure the continuing stability of the banking system"¹³⁷. Due to the extensive harmonisation of prudential requirements and supervision of investment service providers, the macro-economic side of the financial market integrity objective has not maintained great importance. These questions are in general subject to perfect mutual recognition with the consequence that host Member States reliance on this imperative requirement of public interest defence is precluded.

Lastly, both the coherence of the fiscal system and the effectiveness of fiscal supervision has been invoked and accepted to the list of imperative requirements of

¹³⁰ TISSON, M., "What is the General Good in EU Financial Law?", *Legal Issues of European Integration* 1997 no. 2, Kluwer 1998, p. 17.

¹³¹ Case 384/93, Alpine Investments BV vs. Minister van Financiën, ECR-I 1995, p. 1167, paras 4, 42 and 46.

¹³² A commodity future is defined as a "contractual agreement to sell or purchase a standardised amount of a specific physical commodity (eg cereals, metal, oil) at a predetermined price and at a set date in the future" cf. *Dictionary of Banking*, UBS, 1998. The contract for the commodity underlining the future is very seldom performed. Instead the difference between the market price and the price by the future is calculated and the exceeding amount or loss is paid to or paid by the investor.

¹³³ Alpine Investments, para 43.

¹³⁴ Alpine Investments, paras 43-44.

¹³⁵ TISSON, M., "What is the General Good in EU Financial Law?", *Legal Issues of European Integration* 1997 no. 2, Kluwer 1998, p. 18.

¹³⁶ Case 441/93, Panagis Pafitis vs. Trapeza Kentrikis Ellados AE et al., ECR 1997-I, p. 1347

¹³⁷ Case 441/93, Panagis Pafitis vs. Trapeza Kentrikis Ellados AE et al., ECR 1997-I, p. 1347, para 49.

public interest objectives. As tax law aspects of the provision of investment services is not included in this thesis, these objectives will not be described.

4.9 The EC Convention on the Law Applicable to Contractual Obligations ('the Rome Convention')

The Rome Convention on the Law Applicable to Contractual Obligations is strictly speaking not an EU act. The parties to the Convention are primarily the Member States of the Union and it was published in the Official Journal¹³⁸. The Convention applies to cases with an international element and accordingly the choice between the application of two or more countries' law. Given the intrinsic cross-border element of the notion of services, the application of Convention and Treaty provisions on the free movement of services to the same conflicts is apparent¹³⁹. The Convention is examined in this chapter because of its importance for the cross-border provision of investment services.

The Convention covers any situation where a choice between different national contracts laws has to be made with the exception of inter alia company law and conflicts arising out of the negotiable character of negotiable documents. Conflicts regarding transactions of transferable securities and financial intermediaries' actions in this connection which do not have to do with the negotiable character of the instruments are hence covered by the Convention. Contracts for investment services are therefore usually within the scope of the Convention.

The fundamental principle of the Convention is the parties' autonomy to choose the applicable law.

In the absence of the parties' choice the Convention points to the law of the country to which the situation is most closely connected. As a guiding principle this is established by examining what the characteristic performance of the contract is. The country of residence, central administration or principal place of business of the party who is to effect the characteristic performance is deemed to be the country to which the contract is most closely connected. The choice of law is made accordingly. In the case of retail investment services the Convention is most likely to point to law of the country where the central administration of the investment firms is situated¹⁴⁰. In contracts between professional parties it is more difficult to determine who is effecting the characteristic performance as these relationships may involve the exchange of different assets each of which can be deemed the characteristic for the contract¹⁴¹. Where the characteristic performance of the contract cannot be determined or the circumstances point to a third country the guiding principles can be disregarded.

The Convention grants special protection to consumers i.e. persons acting outside their profession or trade. Given certain conditions, a consumer cannot be deprived of

¹³⁸ OJ 1980, L 266. A consolidated version can be found in OJ 1998, C 27, p. 34.

¹³⁹ WOUTERS, J., "Conflict of Laws and the Single Market for Financial Services", *Maastricht Journal of European and Comparative Law* 1997, p. 174.

¹⁴⁰ WOUTERS, J., "Conflict of Laws and the Single Market for Financial Services", *Maastricht Journal of European and Comparative Law* 1997, p. 178.

¹⁴¹ WOUTERS, J., "Conflict of Laws and the Single Market for Financial Services", *Maastricht Journal of European and Comparative Law* 1997, p. 178.

the protection he enjoys under the mandatory rules of law of his state of residence. Moreover, in the absence of an explicit contractual choice of law clause, the law of the consumer's state of residence applies despite the guiding principles above. The consumer protection rules apply when the following conditions are met. Firstly, where the conclusion of the contract was preceded by a specific invitation to the consumer or by advertising in his state of residence and the consumer took all the steps necessary to conclude the contract in that country. Secondly, where the other party or his agent received the consumer's order in his state of residence¹⁴².

The Convention includes special rules regarding a country's mandatory rules i.e. rules that cannot be disregarded no matter what law otherwise applies to the contract. Firstly, the parties cannot by choosing the law of another country derogate from the mandatory rules of the country to which all other elements of the contract at the time of the choice of law are connected¹⁴³. Secondly, the Convention does not restrict the application of the mandatory rules of the forum state even where the law of another country is applicable to the contract. Thirdly, when applying the law of one country according to the Convention, the mandatory rules of the second country to which the situation is closely considered can be given effect by the forum court.

A similar situation arises in relation to the public policy of the forum. If the application of the chosen law according to the Convention is manifestly incompatible with the ordre public rules of the forum country, it may be refused.

Lastly, the Convention stands aside for EU harmonisation measures on choice of law, for example the choice of law rules that have been adopted in the field of insurance.

¹⁴² The Convention's consumer protection rules encompass a third situation of little relevance for the on-line provision of investment services that is where a contract for goods was concluded in another country than the consumer's state of residence where the seller of the good organised the travel of the consumer to the other state with the purpose of selling the good to the consumer there.

¹⁴³ Such situations would probably not come within the scope of Article 49 as they would probably be considered as purely internal cf. WOUTERS, J., "Conflict of Laws and the Single Market for Financial Services", *Maastricht Journal of European and Comparative Law* 1997, p. 179.

Chapter 5 The Problems and Impediments to the Free Movement of Investment Services Arising from the Current Regulatory Framework

As a part of the debate on the Financial Services Action Plan and the reform of the regulatory framework on the provision of investment services, a number of problems and shortcomings of the existing framework have been identified. These regulatory shortcomings stand in the way of the attainment of a single market for investment services.

It should be noted that these problems were identified in relation to the current standing regulatory framework for the provision of investment services in general. They do therefore not encompass the effects of the introduction of the E-commerce Directive on the provision of on-line investment services specifically.

5.1 Three Problems arising from Investment Service Directive Article 11 on Conduct of Business Rules

The three most discussed problems arise from the Investment Service Directive article 11 on conduct of business rules.

“(1) Member States shall draw up rules of conduct which investment firms shall observe at all times. Such rules must implement at least the principles set out in the following indents and must be applied in such a way as to take account of the professional nature of the person for whom the service is provided. The Member States shall also apply these rules where appropriate to the non-core services listed in Section C of the Annex. These principles shall ensure that an investment firm:

- acts honestly and fairly in conducting its business activities in the best interests of its clients and the integrity of the market,
- acts with due skill, care and diligence, in the best interests of its clients and the integrity of the market,
- has and employs effectively the resources and procedures that are necessary for the proper performance of its business activities,
- seeks from its clients information regarding their financial situations, investment experience and objectives as regards the services requested,
- makes adequate disclosure of relevant material information in its dealings with its clients,
- tries to avoid conflicts of interests and, when they cannot be avoided, ensures that its clients are fairly treated, and
- complies with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of its clients and the integrity of the market.

(2) Without prejudice to any decisions to be taken in the context of the harmonisation of the rules of conduct, their implementation and the supervision of compliance with them shall remain the responsibility of the Member State in which a service is provided.

(3) Where an investment firm executes an order, for the purposes of applying the rules referred to in paragraph 1 the professional nature of the investor shall be assessed with respect to the investor from whom the order originates, regardless of whether the order was placed directly by the investor himself or indirectly through an investment firm providing the service referred to in Section A (1) (a) of the Annex.”

The problems arise from three concepts in the article. First, the obligation in article 11(3) in relation to the application of conduct of business rules “to take due account of the professional nature of the person for whom the service is provided”. Second,

the national implementation of the broad principles listed in the article. Third, the concept of the Member State “in which a service is provided” in article 11(2).

5.1.1 The Concept of Due Regard to the Professional Nature of the Investor

The concept of due regard to the professional nature of the investor obliges host Member States to consider the need of protection within a spectrum of investors ranging from the sophisticated financial firm to the less sophisticated retail investor. This distinction is in line with the ECJ’s observations on the need for protection of investors in the German Insurance case¹⁴⁴. The ratio underlying this obligation is that host states should apply their conduct of business rules to home state investment firms only in so far as this is necessary to protect the investor. Professional investors are capable of making informed investment choices without too much guidance. Accordingly, the full application of host country conduct of business rules to protect professional investor is likely to constitute a disproportional impediment to the principle of home state control and freedom to provide services¹⁴⁵. A survey¹⁴⁶ of the national implementation of this principle shows that the definition of what constitutes a professional investor varies from Member State to Member State. The categorisation of non-financial corporate investors is a particular point of divergence. In some Member States these investors are considered professionals. In others they are granted the same protection as retail investors.

The survey also shows that only a few Member States have specific rules on the conduct of business rules provisions that should be waived in relation to professional investors. Most Member States’ laws only include general statements to take due regard to the professional nature of the investor.

Member States’ implementing laws vary significantly as regards the option of investors to opt for less stringent protection¹⁴⁷. In sum, the broad obligation to have regard to the nature of the investor has resulted in very different national implementations of the same concept. This diversity results in legal uncertainty and increased costs as cross-border investment firms have to examine and comply with the divergent regulation on this ‘harmonised’ concept of all the Member States in which they provide their services.

5.1.2 The Content of the Conduct of Business Rules

The second problem related to article 11 is the content of the conduct of business rules. Article 11 enumerates seven very broad principles. National implementation of these principles has led to a divergent legal landscape within the EU¹⁴⁸. The Member States have introduced legislation on advertising, marketing, on the information to be given and to be obtained from the investors, on fees and on fair dealing such as ‘best

¹⁴⁴ Case 205/84, *Commission vs. Germany*, ECR 1986, p. 3755.

¹⁴⁵ COM (2000) yyy provisional, *Commission Communication, The Application of the Conduct of Business Rules under Article 11 of the Investment Service Directive (93/22/EEC)*, paras 2 and 17.

¹⁴⁶ The results of this survey are summarised in *Commission Communication COM (2000) yyy provisional, The Application of the Conduct of Business Rules under Article 11 of the Investment Service Directive (93/22/EEC)*, p. 8-11. As regards the “requirement to take account of professional nature” of the investor, see p. 9 of the Communication.

¹⁴⁷ COM (2000) yyy provisional, *Commission Communication, The Application of the Conduct of Business Rules under Article 11 of the Investment Service Directive (93/22/EEC)*, p. 9.

¹⁴⁸ COM (2000) yyy provisional, *Commission Communication, The Application of the Conduct of Business Rules under Article 11 of the Investment Service Directive (93/22/EEC)*, p. 8-9.

execution'. Others have limited the implementation to the verbatim reproduction of the article 11 principles¹⁴⁹. Moreover, national rules on separation of activities to avoid conflicts of interest and internal controls to ensure due care of diligence have been introduced. Although these national rules pursue the same objectives and include similar provisions, there are differences. Investment firms providing services in different Member States are obliged to comply with the detailed provisions in the conduct of business rules of these host Member States, despite the fact that similar provision in their home state conduct of business rules might already ensure the attainment of the same objectives and the same level of investor protection. The result is as seen above legal uncertainty and increased compliance costs for investment firms offering their services in other Member States despite harmonisation.

5.1.3 The Concept of the Member State “in Which a Service is Provided”

A third problem arising from article 11 is the interpretation of the concept of the Member State “in which a service is provided”. The Member States employ a range of different tests for determining whether their conduct of business rules should apply¹⁵⁰. Some Member States apply a ‘characteristic obligation’ test as known from the Rome Convention on choice of law. Other Member States rely on a test based on the residence of the consumer or whether prior solicitation took place. Yet other Member States decide the question of applicability on a case by case basis. A particularly delicate problem arises where the host state applies a ‘characteristic performance’ test and the home state applies an investor residence case. In this case neither the host nor the home state conduct of business rules apply. Despite these different approaches, it can be observed that host Member States as a rule of thumb routinely apply their conduct of business rules to all incoming investment firms¹⁵¹. As home Member States also routinely apply their conduct of business rules, investment firms find themselves having to comply with two sets of conduct of business rules. This duplication evidently leads to increased costs.

5.2 Advertising

Article 13 of the Investment Service Directive provides:

“This Directive shall not prevent investment firms authorised in other Member States from advertising their services through all available means of communication in their host Member States, subject to any rules governing the form and the content of such advertising adopted in the interest of the general good.”

As a point of departure advertising should hence be regulated by home state law. The application of host state general good rules on the form and content of advertising of cross-border services should be the exception. The proportionality of application of host state rules should be closely scrutinised as it constitutes an exception from the principles of mutual recognition and free movement of services sought by the directive and the Treaty. Despite the wording of article 13 and its separation from article 11, many Member States have included provisions of advertising in their

¹⁴⁹ This is the case in Luxembourg cf. WYMEERSCH, E., “The Implementation of the ISD and CAD in National Legal Systems” (chap. 1) in FERRARINI, G. (Ed.), *European Securities Markets The Investment Directive and Beyond*, Kluwer 1997/98, p. 14.

¹⁵⁰ COM (2000) yyy provisional, Commission Communication, The Application of the Conduct of Business Rules under Article 11 of the Investment Service Directive (93/22/EEC), p. 10.

¹⁵¹ COM (2000) yyy provisional, Commission Communication, The Application of the Conduct of Business Rules under Article 11 of the Investment Service Directive (93/22/EEC), p. 11.

conduct of business rules¹⁵². As these are routinely applied to incoming investment firms, the result is the dual compliance with both home and host state rules, and consequently legal uncertainty and increased costs¹⁵³.

It should be noted that some of the uncertainty will be eliminated with the adoption of the proposed Directive on the Distance Marketing of Consumer Financial Services¹⁵⁴.

5.3 Contract Law

The contract law of a Member State shapes its financial services. The content of the financial services or 'financial products' that investment firms provide is determined by their home state contract law "in much the same way in which standards and designs are shaping physical goods"¹⁵⁵. The Koestler case¹⁵⁶ provides an example in this regard. The disputed financial products, contracts for time-bargains on transferable securities, were shaped according to the home state contract law of the French investment firm.

Because of tradition and experience some Member States have an endowment for providing specialised financial products. This can be compared to a quasi-natural resource for the countries in question¹⁵⁷. Moreover, as in the Koestler case financial products, which are allowed in some Member States, may be disallowed in others. The possibility of obtaining specialised products i.e. investment opportunities which are not available in their state of residence, is an incentive for investors, including private investors, to purchase these products from investment firms in other Member States.

The applicable contract law and accordingly the content requirements to a financial product is determined according to the Rome Convention. The applicable contract law determines the detailed requirements to financial products. The financial products listed in section B of the annex to the Investment Service Directive¹⁵⁸ will be shaped by the applicable contract law.

Attention has been drawn to the problem that home investment firms are hindered from providing home state financial products to host state investor be they

¹⁵² COM (2000) yyy provisional, Commission Communication, The Application of the Conduct of Business Rules under Article 11 of the Investment Service Directive (93/22/EEC), p. 8.

¹⁵³ Financial Services Action Plan Forum Group on Retail Financial Services: Overcoming the Remaining Barriers, Issues Paper for the First Meeting of the Group, p. 6. This paper can be consulted at www.europa.eu.int/comm/finances.

¹⁵⁴ COM (2000) yyy provisional, Commission Communication, The Application of the Conduct of Business Rules under Article 11 of the Investment Service Directive (93/22/EEC), p. 8, footnote 10.

¹⁵⁵ Financial Services Action Plan Forum Group on Retail Financial Barriers: Overcoming Remaining Barriers, Issues Paper for the First Meeting of the Group, p. 6. The Paper is available at www.europa.eu.int/comm/finances.

¹⁵⁶ Case 15/78, Société Générale Alsacienne de Banque SA mod Walter Koestler, ECR 1978, p. 1971.

¹⁵⁷ Financial Services Action Plan Forum Group on Retail Financial Services: Overcoming the Remaining Barriers, Issues Paper for the First Meeting of the Group, p. 3. This paper can be consulted at <http://www.europa.eu.int>.

¹⁵⁸ The instruments covered by section B are transferable securities, units in collective investment undertakings, money-market instruments, financial futures contracts, forward interest-rate agreements, interest-rate, currency and equity swaps, and options.

professional or retail¹⁵⁹. The exact extent of this problem is difficult to estimate. The Commission will carry out a review in the autumn 2001 identifying the risk of market fragmentation arising from different national contract laws on the consumer financial products, which are most likely to be traded on a cross-border basis¹⁶⁰. On the basis of this review a programme for convergence may be introduced in the future¹⁶¹

5.4 The Concept of General Good

As described above the construction of the concept of general good is of imperative importance to the free movement of investment services. National measures on conduct of business rules¹⁶², advertising, contract law etc. constituting a non-discriminatory restriction can only be upheld if they are justified with reference to a general good objective and proportional. The proportionality requirement encompasses an obligation to have due regard to the rules that investment firms comply with in their respective home states. The construction of the general good and the proportionality requirement hence determines the extent to which host Member States can apply their national rules to incoming service providers. This follows from the Investment Service Directive¹⁶³ and the case law.

It follows from the description of the problems relating to host state conduct of business, advertising and contract laws that host Member States are generally very eager in applying their national rules to incoming investment firms. This has led to the dilution of the principle of home state control¹⁶⁴. The routine application indicates an extensive interpretation of the concept of general good. Rather than considering whether the application of host state rules to incoming investment firms is justified and proportional, host Member States as a rule of thumb apply host state rules fully without making allowance for home state requirements. This has the result that investment firms must comply with both home and host state regulation on the same matter.

¹⁵⁹ This was most recently pointed out by the comments from market participants on the Commission Communication on Up-grading the Investment Service Directive COM (2000) 729 cf. Investment Service Directive Feedback Synthesis of Responses to COM (2000) 729, Working Document of Services of DG Internal Market, p. 11. This working document is available at <http://www.europa.eu.int/comm/finances>.

¹⁶⁰ COM (2001) yyy Final, Communication from the Commission to the Council and the European Parliament, E-commerce and Financial Services, p. 13. This communication is available at <http://www.europa.eu.int/Commission/finances>. This also follows from Report on E-commerce and Financial Services to the Financial Services Policy Group, August 2001. This report is available at <http://www.europa.eu.int/Commission>.

¹⁶¹ COM (2001) yyy Final, Communication from the Commission to the Council and the European Parliament, E-commerce and Financial Services, p. 2. This communication is available at <http://www.europa.eu.int/Comm/finances>.

¹⁶² Although this is not explicitly stated in article 11, it follows from the overall structure of the Investment Service Directive and particularly article 18(2) on notification of host state rules applicable to incoming investment firms that also the application of conduct of business rules must take place with respect of the general good requirement.

¹⁶³ The most important references to the general good in relation to the provision of services are found in article 13 on advertising and article 18(2) on the information on applicable general good rules host Member States shall indicate where appropriate to incoming investment firms following notification of their intention to provide services in the host state. Moreover, reference to the general good is found in the Preamble of the Investment Service Directive.

¹⁶⁴ Communication from the Commission to the European Parliament and the Council, Upgrading the Investment Services Directive (93/22/EEC), provisional version. Available at www.europa.eu.int/comm/.

Albeit the extensive application of host state general good rules the number of complaints brought by incoming investment firms is negligible, most likely due to the uncertain gains from challenging host state rules and the risk of establishing an antagonistic relationship with host state authorities. The absence of investment firms' complaints does little to change the current extensive interpretation of the general good.

The Commission has issued a communication¹⁶⁵ on its interpretation of the concept of general good in relation to the Second Banking Directive¹⁶⁶. As this directive to a large extent mirrors both the structure and wording of the Investment Service Directive, the Communication constitutes an authoritative source for the construction of the general good in the field of investment services. The Communication makes a similar description of the concept of general good as the one given above.

5.5 Additional Legal Problems

Investment Service Directive article 19(3)-(5) requires host Member States to turn to home Member States for the sanctioning of infringements of host state rules on matters where the directive confers power on the host Member States. Only where the home state fails to take adequate steps to prevent continued infringement, can the host Member States take action against the home state investment firms. Article 19(6) allows host Member States to take appropriate measures to prevent or to penalise infringement of their conduct of business rules or other general good rules within their territories. Given that all host state rules must satisfy the general good requirement, it is difficult to establish which of the two enforcement procedures must be followed when host state rules are infringed. One possible interpretation is that the infringement of host state rules adopted on the basis of the directive should follow the article 19(3)-(5) procedure. The article 19(6) procedure should apply to infringements of host state conduct of business rules or other host state general good rules, which do not have their basis in the directive¹⁶⁷. Considering that the directive includes such broad provisions as article 13 that cover all host state rules on advertising the proposed interpretation is difficult to apply. The two enforcement procedures have in fact been interpreted and implemented very differently in the Member States thereby creating more legal uncertainty in a field presumably harmonised.

Investment services article 19(8) allows host Member States to defer from the enforcement procedure described above in case of emergencies. This clause has been interpreted differently in the Member States leading to another point of legal uncertainty of the regulatory framework¹⁶⁸.

¹⁶⁵ SEC (1997) 1193 Final, Commission Interpretative Communication, Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive.

¹⁶⁶ Second Council Directive 89/646/EEC on the Co-ordination of Laws, Regulations and Administrative Provisions Relating to the Taking-up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, as amended by Directive 92/30/EEC.

¹⁶⁷ HOLDT, H., *Aktiehandel og Informationsteknologi i EU Udfordringer for Nationale Tilsynsmyndigheder*, DJOEF, 1999, p. 110.

¹⁶⁸ Communication from the Commission to the European Parliament and the Council, Upgrading the Investment Services Directive (93/22/EEC), provisional version, p. 9. Available at www.europa.eu.int/comm.

The Investment Service Directive includes two provisions with the objective of avoiding conflicts of interest. One provision is a part of the conduct of business rules which host states apply to incoming investment firms. Concurrently, these investment firms are subject to similar requirement under home state prudential rules which require investment firms to be structured in a way to avoid conflicts of interests between different investors or between the investors and the firm. Hence there is a risk that investment firms may be subject to similar home and host state rules on conflicts of interest when providing cross-border services.

The Investment Service Directive requires investment firms planning to offer their services in host Member States to notify their home state authorities. The home state authorities then pass this information on to the authorities of the target host states. In its Communication on the general good in the Second Banking Directive the Commission has asserted that the provision of services on the Internet does not require notification. The Commission emphasises that this construction applies only to the notification requirement and is without prejudice to the application of host state contract law. This Commission's construction of the notification requirement has been challenged for being too narrow¹⁶⁹. Particularly with the object of enhancing investor protection the on-line provision of services should be subject to notification. Even if this latter construction is adhered to whereby the on-line provision of services is subject to notification in all the host states where the services will be available, this creates only minor problems for investment firms. First, because it is within investment firms discretion for reasons of legal certainty to expand the list of target host Member States even when they do not have any immediate plans to provide services there¹⁷⁰. Secondly, because this can easily be done by including additional host states in the notification to the home state authorities. Third, because the lack of notification to a host Member State will not allow its authorities to bar the investment firms provision of services as this would be a disproportional action. The broad interpretation will however have an impact on on-line investment firms that operate only nationally. They could be obliged to make the necessary notification prior to offering services on the Internet.

As for the conduct of business rules a fourth problem has been identified. The status and the extent to which the conduct of business rules can found the basis for a claim against the validity of a contract for investment services or give rise to a claim under tort law differs significantly from Member State to Member State¹⁷¹. This gives rise to additional uncertainty in relation to cross-border provision of investment services.

5.6 General Problems of the Procedure for Adopting Regulation in the Field of On-line Investment Services

In connection with the focus on specific substantive problems described above, a more general critique has been directed at the procedures which are employed for

¹⁶⁹ HOLDT, H., *Aktiehandel og Informationsteknologi i EU Udfordringer for National Tilsynsmyndigheder*, DJOEF, 1999, p. 108.

¹⁷⁰ SEC (1997) 1193 Final, Commission Interpretative Communication, Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive, p. 7.

¹⁷¹ WYMEERSCH, E., "The Implementation of the ISD and CAD in National Legal Systems" (chap. 1) in FERRARINI, G. (Ed.), *European Securities Markets The Investment Directive and Beyond*, Kluwer 1997/98, p. 36.

adopting new and modifying the existing parts of the regulatory framework for the provision of investment services.

The critique departs from the fact that financial markets are characterised by continuous and rapid development of new financial services and methods for providing them. This rapid development starkly contrasts with the lengthy and cumbersome legislative procedure for amending the regulatory framework, which in the field of investment services is primarily the co-decision procedure¹⁷². Even where political consensus can be reached fast, which is not always the case, the procedure is likely to last for years. This applies for fundamental changes of the regulatory framework as well as small adjustments. Moreover, once the hurdles of the legislative process have been overcome, time will pass before the directives, which are the most commonly used instruments in the field, are implemented. Due to delayed transposition it may take even longer before the regulatory changes take effect.

The current regulatory framework is also criticised for including many unclear and broad provisions, which in turn lead to divergent national implementation. The above-mentioned examples of the Investment Service Directive's rules on conduct of business and advertising illustrate this point.

Also the co-operation between national supervisors has drawn upon this critique. Despite provisions in the directives in the field, the mutual reliance and necessary exchange of information for efficient enforcement has not taken place. This applies on the level of communication, national interpretation and implementation, and enforcement.

5.7 Additional Non-legal Problems

A number of problems which are not legal in a strict sense have been identified. These problems are however connected with the regulatory framework. It is believed that the adoption of legislative measures can contribute to solving these non-legal problems¹⁷³.

There is a lack of consumer confidence in investment services from other Member States. Retail investors in particular have long been accustomed to obtaining their investment services from domestic investment firms. The prospect of obtaining services from other Member States contains many elements of uncertainty, especially as regards the home state laws that could apply and the remedies in case of dispute. Given the high cost of pursuing a claim in the home state, host state investors are likely to refrain from cross-border services.

National law and particularly contract law is closely intertwined with national traditions and culture. This legal-cultural diversity adds to the problems of lack of consumer confidence and is likely to be one of the underlying reasons for the lack of mutual recognition.

¹⁷² Most directives in the field have been or will be adopted on the basis of article 47(2), which makes reference to article 251.

¹⁷³ COM (2001) yyy Final, Communication from the Commission to the Council and the European Parliament, E-commerce and Financial Services, p. 15. This communication is available at www.europa.eu.int/comm.

5.8 The Impact and the Problems Arising from the E-commerce Directive on the Provision of On-line Investment Services

The problems just examined all arise from the current regulatory framework for the provision of investment services. In the following section the impact that the E-commerce Directive will have on these problems will be discussed. Secondly, some special problems arising when investment services are provided on-line are examined.

5.8.1 The Impact of the E-commerce Directive on the Problems examined above in relation to the Provision of On-line Investment Services

The prevailing feature of the E-commerce Directive is the 'internal market clause' i.e. a strong emphasis on home country and mutual recognition. In comparison with the Investment Service Directive these principles are articulated more clearly and the exemptions are less and more specific.

Firstly, there are the general exceptions i.e. areas that are exempted from the scope of the directive. These include rules on the contractual autonomy of the parties, specific obligations concerning consumer contracts, the advertising of UCITS¹⁷⁴ and the permissibility of unsolicited commercial communications¹⁷⁵.

Secondly, there are the special derogations resembling the general good exemptions although with a narrower scope. Special derogations from the principle of home country control in the form of national measures can only be made against specifically identified services which prejudices or presents serious and grave risks to the attainment of one of the objectives specifically listed in the directive. This list of objectives includes investor protection. The measures taken must fulfil the proportionality requirement. Besides the comparatively rigid substantive conditions for deferring from the principle of home country control, the E-commerce directive also established procedural conditions. Before taking measures against specific services, host states must ask the home state authorities to take measures against the infringing service provider. Only where the home state does not take any steps or these are inadequate, can the host Member States take action against the service provider. The host Member States must also notify the Commission of its intention to do so, prior to taking such measures. In sum, the scope for special derogations from the principle of home country control is both substantively and procedurally more narrow than the general good exemptions in the Investment Service Directive and the case law.

The E-commerce directive article 1(3) states that it complements existing regulation on services without prejudice to inter alia the level of consumer protection established by Community acts and national implementing law in so far as this not restrict the freedom to provide information services. Recital 11 mentions both the Investment Service Directive and the future Directive on Distance Marketing of Consumer Financial Services as directives establishing levels of protection will not be

¹⁷⁴ Article 44(2) of Council Directive 85/611/EEC of 20 December 1985 on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJ 1985, L 375 provides: "Any UCITS may advertise its Units in the Member States in which they are marketed. It must comply with the provisions governing advertising in that state".

¹⁷⁵ Moreover, the Directive does not apply to tax law, competition law, the public activity of notaries, lawyers relations to their clients before courts, gambling activities nor questions relating to information society services covered by Directives 95/46/EC and 97/66/EC on data protection.

prejudiced. Moreover, the E-commerce complements any sector-specific information requirements¹⁷⁶.

The relationship between this provision and the principle of home country control with limited derogations is difficult to establish. The provisions could be interpreted as to mean that the E-commerce Directive does not imply any changes to the standing law as regards the concept of general good and the division of powers between home and host Member States.

The Commission 's communication on e-commerce and financial services does however indicate that the principle of home country control prevails. Host Member States can only apply their national rules to incoming on-line investment firms only when these are covered by either the general or specific derogations¹⁷⁷. In a recent report¹⁷⁸ by the Financial Services Policy Group¹⁷⁹ this interpretation is adhered to even for retail financial services. In an annex to the report an example is given of how the on-line provision of financial services to consumers under the E-commerce Directive is subject to home country laws as regards pre-contractual matters such as advertising. As regards contractual matters the applicable law is determined in accordance with the Rome Convention. It follows from the report that also the application of home state conduct of business rules to on-line services must be covered by the general or special derogations¹⁸⁰.

From the structure and provisions of the directive it follows that also advertising of investment services is subject to home state rules. This follows conversely from the explicit exemption from the scope of the Directive of rules on advertising of UCITS which following the UCITS Directive fall within the scope of host state powers. If rules on advertising of investment services in general were not subject to home state control, there would be no reason to make an explicit exemption clause where the opposite applies.

The Majority of the Financial Services Policy Group held that the full application of the home country principle even in the field of retail investment should be rapidly complemented by a further convergence of retail investor protection rules. A minority in the Group found a high level of harmonised investor protection rules should be a prerequisite for the full move towards home country control. Moreover, the minority found that pending further harmonisation a choice of law provision should be included in the Directive on Distance Marketing of Consumer Financial Services.

¹⁷⁶ An example is promotional sites which do not offer the possibility to transact on-line. The future Distance Marketing of Consumer Financial Services does not apply to such sites which will be solely covered by the E-commerce Directive cf. COM (2001) yyy Final, Communication from the Commission to the Council and the European Parliament, E-commerce and Financial Services, p. 6 This communication is available at www.europa.eu.int/comm.

¹⁷⁷ COM (2001) yyy Final, Communication from the Commission to the Council and the European Parliament, E-commerce and Financial Services, p. 7-8 and 13. This communication is available at <http://www.europa.eu.int/commission>.

¹⁷⁸ Report on E-commerce and Financial Services to the Financial Services Policy Group, August 2001. The report is available at www.europa.eu.int/comm.

¹⁷⁹ The Financial Services Policy Group is a committee established in connection with the Financial Services Action Plan. The Report mentioned in the footnote above does not include information on the composition, functions or procedures of the committee.

¹⁸⁰ Report on E-commerce and Financial Services to the Financial Services Policy Group, August 2001, p. 16.

There exists a “fundamental difference of views” as to whether prior harmonisation is necessary for the full application of the principle of home country control¹⁸¹

Both the Commission Communication and the Financial Services Policy Group Report deal with the content a Commission guideline on the application of the special derogations in the field of investment services to be issued in the near future. This Guidance will summarise the Commission’s positions on commonplace host state rules applicable to on-line service providers, which would be accepted by the Commission as satisfying the requirements for special derogations. Host Member States authorities and on-line service providers will hence be able to determine in advance whether a disputed host state rule would be accepted by the Commission under the special derogations without a previous notification. Despite the guideline having this effect, both the Commission Communication and the Financial Services Policy Group Report stress that the guideline, will not add additional exemption grounds to the directive, partially because it is time-limited and that it will also have the function of identifying divergent national rules in need for harmonisation. The guidance will be drawn up following consultation of Member States. The consultation will require the Member States to make an inventory of the rules they intend to apply to on-line service providers including the conduct of business rules.

In sum, the coming into force of the E-commerce Directive will mean a considerable move towards home state law for the regulation of on-line investment services and a limitation of exceptions. This applies for retail investment services as well, although ‘a fundamental difference of views’ exists as to whether this should be conditional on prior harmonisation.

5.8.2 The Problems Arising from Investment Services Being Provided On-line

As shown above one of the problems in the field of the regulation of the provision of investment services is that host Member States as rule of thumb apply their national rules to all incoming investment firms thereby diluting the principle of home country control. This applies particularly for conduct of business rules because of a wide construction of the concept of the “Member State in which a service is provided”.

The provision of investment services on the Internet gives rise to specific problems. A Web-site offering investment services in one Member State can be reached from all Member States. The risk of an on-line investment firms becoming subject to the regulation of all 15 Member States is therefore manifest¹⁸². Such an application would thoroughly dilute the principle of home country control.

Member States’ regulatory authorities are applying host state rules laying down requirements to investment firms and their marketing extensively to investment services provided on the Internet¹⁸³. National rules are applied to all communications in the form of emails or web-sites for investment services, which are directed at or

¹⁸¹ Report on E-commerce and Financial Services to the Financial Services Policy Group, August 2001, p. 6.

¹⁸² COM (2001) yyy Final, Communication from the Commission to the Council and the European Parliament, E-commerce and Financial Services, p. 7.

¹⁸³ The following description is based on RICE, D. T. “Jurisdiction in Cyberspace: Which Law and Forum apply to Securities Transactions on the Internet”, *University of Pennsylvania Journal of International Economic Law*, no. 3 2000, p.585-657 which describes the positions of the securities regulators in the U.K., Netherlands, Belgium and Germany.

made available to residents of a host state. The tests of 'directed at' or 'made available to' are interpreted broadly. First of all on-line investment firms, which solicit host state residents by email, are made subject to host state rules. As for web-sites the de facto point of departure is that these are made subject to host state rules unless adequate measures are taken to exclude host state investors from obtaining a site's services¹⁸⁴. The required measures include clearly phrased disclaimers excluding particular Member States and procedures identifying investors from certain Member States with the purpose of denying them information and access to the site. The form and content of the web-site is also of great importance for deciding whether a host state's rules apply. Information in the language of a particular Member State, special information on its tax or contract law, or the listing of prices in its currency indicate that the web-site is directed at or available in a particular Member State.

The home country principle in the E-commerce Directive should alleviate the impact on on-line investment firms of being subject to the laws of all the host states at which a web-site is targeted or made available. As described above it is strongly disputed whether the home country principle of the E-commerce directive fully applies to retail investment services. As long as this dispute is not solved, it cannot be ruled out that on-line investment firms providing services under the e-commerce directive will find themselves subject to the retail investor protection rules of all the host states, the investors of which they have not taken specific and adequate measures to exclude.

Moreover, the E-commerce Directive's home country principle does not apply to contract law. If host states' contract laws are applied in the same extensive manner as described above, on-line investment firms will be subject to the contract laws of all the Member States from which the access to their web-sites is not specifically excluded.

As the characteristic obligation of an on-line contract for investment services will still be the service provided by the investment firms, it is unlikely that host states' contract laws will be applied to on-line investment firms as extensively as host states' conduct of business rules and advertising rules are.

The mandatory consumer protection provisions of the Convention are triggered when advertising has taken place in the investor's country of residence prior to the conclusion of the contract. It is unclear whether the presence of an on-line investment firm on the Internet in the form of website is sufficient to constitute advertising into the investor's country of residence and thereby trigger the application of mandatory host state consumer protection rules.

In sum, the extensive application of national rules to on-line investment services enforces the application of host state rules to home state investment firms. In the off-line environment some link however tenuous between the home state investment firms and host state investors had to be established to apply host state rules. In the on-line environment the opposite applies. Unless investment firms take specific and adequate measures to exclude certain host Member States, the rules of these Member States will apply to their on-line provision of services.

¹⁸⁴ RICE, D. T. "Jurisdiction in Cyberspace: Which Law and Forum apply to Securities Transactions on the Internet", *University of Pennsylvania Journal of International Economic Law*, no. 3 2000, p. 634, 636 and 637.

In particular, this creates problems for investment firms wishing to offer their services in a limited number of Member States only. These investment firms must take specific and adequate measures to avoid being subject to laws of the Member States in which they do not intend to provide their services.

For the investors of 'excluded' Member States this translates into limited choice of investment services and financial products from other Member States. Investors from small Member States are particularly disadvantaged. On-line investment firms are likely to market their services only in larger Member States for reasons of scale and exclude smaller Member States where the additional regulatory compliance costs will be relatively higher. It cannot be ruled out that some investors in the off-line environment were and are excluded from obtaining home state investment services out of similar concerns of being subject to host state law on the side of the investment firms. This exclusion in the on-line environment is however explicit and absolute because of converse point of departure, namely that unless on-line investment firms must take special measures, they will be subject to the rules of all fifteen host states' rules. Moreover, the application of host state rules to on-line services impedes the making optimal use of the opportunities for cross-border provision of investment services offered by the Internet.

For on-line investment firms which intentionally market their services in all Member States there will be little difference. They operate on the basis of home state regulation in so far as this follows from the Investment Service Directive and the E-commerce directive. As for the contract law applicable to their transactions with host state investors this will be decided according to national choice of law rules based on the Rome Convention.

Chapter 6 Analysis of the Current Regulatory Framework for the Provision of Investment Services from the Perspective of Mutual Recognition and Competition among Rules

In the previous chapter the EU regulatory framework on the cross-border on-line provision of investment services has been examined and specific problems have been identified.

In this chapter the regulatory framework will be analysed with the objective of establishing to what extent it is in accordance with the regulatory strategy of mutual recognition. The analysis will be conducted along the lines of the four categories of regulation on 1) authorisation, 2) Prudential supervision, 3) Conduct of business supervision, 4) Product control¹⁸⁵.

On the basis of this analysis of the degree of mutual recognition, it will be considered whether the current regulatory framework potentially facilitates competition among rules. Lastly, it will be briefly examined whether competition among rules has in fact taken place on the basis of the current regulatory framework.

First, the essentials of mutual recognition and competition among rules described earlier will be summarised.

6.1 Definition and Conditions for Mutual Recognition and Competition among Rules

Mutual recognition is defined as the state where country A accepts the legislation of country B in a given field as equivalent to its own. Businesses complying with the legislation in their home country B do therefore not in addition have to comply with the legislation of country A where it is performing economic activity. Mutual recognition hence prevents the duplication of regulatory requirements. The term home country control covers the same reality, namely that a certain regulatory aspect is regulated and supervised solely by home state authorities.

Competition among rules is defined as the process leading to alteration of national regulation in response to the actual or expected impact of the mobility of economic factors as goods, services, and factors of production on national economic activity¹⁸⁶.

There are three basic conditions which, must be satisfied at least partially before competition among rules can take place.

First, there must be both unrestricted de jure and de facto mobility.

Second, the condition of mutual recognition based on minimum harmonisation must be satisfied. The fulfilment of this condition is a prerequisite for the fulfilment of the first basic condition of unrestricted mobility. The countries between which competition among rules takes place require a certain minimum regulatory level to be

¹⁸⁵ DALHUISEN, J.H., "Liberalisation and Re-Regulation of Cross-border Financial Services", *European Business Law Review*, May/June 1999, p.158-192 (part I.), July/August, p. 284-305 (part II.), September/October 1999, p. 354-370 (part III.), p. 158.

¹⁸⁶ SUN, J.-M. and PELKMANS, J., "Regulatory Competition in the Single Market", *Journal of Common Market Studies* March 1995, p. 68-89.

in place to mutually recognise foreign rules as equivalent and allow the unrestricted mobility foreign services and service providers. This is the case in the EU where mutual recognition on the basis of minimum harmonisation is often a prerequisite for unrestricted mobility.

Lastly, market participants must have a reliable informational basis on which to conduct their regulatory arbitrage. This condition can be divided into the sub-conditions of perfect information about regulatory differences, discreteness (i.e. the ability to assess the effect of these differences) and enforcement (i.e. coherence between the substantive rules and the way they are enforced).

If all three basic conditions are fulfilled, the scene is set for competition among rules to take place. Regulatory competition between Member States will however not take place before it is triggered by the pressure from the regulatory arbitrage conducted by market participants in response to regulatory divergences.

While minimum harmonisation hence facilitates unrestricted mobility and competition among rules, it also limits its scope to the matters that have not been fully harmonised and on which Member States freely can set their own rules.

The field of on-line provision of investment services is *prima facie* an environment in which competition among rules can thrive because of its factual circumstances. Firstly, the investment services and securities can be easily provided on the Internet due to their intangible and dematerialised nature¹⁸⁷. Second and equally important, this can be done at a very low cost. Third, the information necessary for regulatory arbitrage is easily disseminated on the Internet.

6.2 Analysis of the Degree of Mutual Recognition in the Standing Regulatory Framework

6.2.1 The Regulatory Categories

The following analysis of the degree of mutual recognition is carried out along the lines of the four categories of regulation on 1) authorisation, 2) Prudential supervision, 3) Conduct of business supervision, 4) Product control¹⁸⁸. The first two categories are focused on the investment firm and the two latter on the service itself.

6.2.2 Regulation on Authorisation

Regulation on authorisation encompasses requirements to the reputation, capital, infrastructure and business plan of an investment firm and its management.

Rules on authorisation play a central role in the Investment Service Directive. The European passport allowing investment firms to provide services solely on the basis of home country control is conditional on home state authorisation. The extent of the home state authorisation determines the extent of the passport. Only the services that

¹⁸⁷ COM (1999) 385 Final, Amended Proposal for a European Parliament and Council Directive concerning the Distance Marketing of Consumer Financial Services and Amending Directives 97/7/EC and 98/27/EC, recital 5.

¹⁸⁸ DALHUISEN, J.H., "Liberalisation and Re-Regulation of Cross-border Financial Services", *European Business Law Review*, May/June 1999, p.158-192 (part I.), July/August, p. 284-305 (part II.), September/October 1999, p. 354-370 (part III.), p. 158.

an investment firm is authorised to provide in its home state can be provided in host Member States under the passport.

The Investment Service Directive confers the power of laying down the authorisation requirements on the home Member State of an investment firm. The home state authorisation requirements must mirror the detailed provisions in the Investment Service Directive on the reputation and experience of an investment firm's management, its decision-making body, its business plan and the disclosure of its owners' identities. Authorisation must also be conditional on the fulfilment of the initial capital requirements in the capital adequacy directive. Moreover, home Member States are obliged to ensure that investor compensation schemes are set up. The carrying out of investment business is conditional on adherence to a compensation scheme.

The only additional requirement for an authorised investment firm to provide cross-border services is prior notification to its home state authorities of its intention to do so in specified host states. The notification procedure is easily complied with and does not constitute a considerable regulatory burden. The notification procedure only has the objective of providing host state authorities with information on incoming investment firms. The non-compliance with the procedure does not influence the legality of the cross-border provision of services.

In sum, rules on authorisation fall solely within the power of the home Member States. The home state authorisation rules must be in accordance with the detailed provisions of the Investment Service Directive, Capital Adequacy Directive and the Directive on Investor Compensation schemes. The mutual recognition in the field is close to perfect. This is supported by the fact that the recent regulatory debate has not identified any dilution of the principle of mutual recognition and barriers to the free movement of investment services in this field.

The introduction of the E-commerce Directives enforces the mutual recognition in the field. Its internal market clause on home country control and law applies within the field co-ordinated by the directive unless one of the general or special derogations apply. The co-ordinated field encompasses requirements in respect of "the taking up of the activity of an information society service, such as requirements concerning qualifications, authorisation or notification"¹⁸⁹.

6.2.3 Prudential Supervision: Prudential Rules, Capital Requirements, Supervision and Enforcement

6.2.3.1 Prudential Rules

The prudential rules mirror and supplement the authorisation requirements. The basic conditions for authorisation as well as other measures to ensure the integrity of the investment firm and the protection of its investors must be fulfilled as long as the firm conducts investment services activity. The prudential rules are accompanied by rules on supervision and enforcement.

According to the Investment Service Directive the field of prudential rules is regulated by home state law. Home state rules must secure that domestic investment

¹⁸⁹ Cf. article 2(h)(i) first indent.

firms continue to satisfy the authorisation conditions including the capital requirements and requirements to the management and owners.

Home state law includes a set of specific prudential rules which investment firms must comply with at all times. The prudential rules influence the structures of the home state investment firms by requiring the establishment of sound administrative and accounting procedures, electronic data processing control and safeguard arrangements and adequate internal control mechanisms. Moreover, the prudential rules require the establishment of arrangements to secure the safeguarding of the investors' ownership rights to specific funds and instruments. Lastly, they require investment firms to be structured in a way to avoid conflicts of interests.

6.2.3.2 Capital Requirements

According to the Capital Adequacy Directive home Member States are obliged to require that home investment firms maintain capital reserves corresponding to the risks they are exposed to from their investment service activity. The calculation of the adequate capital requirements is done on the basis of the very detailed annexes of the Capital Adequacy Directive. It follows from the Investment Service Directive and the Capital Adequacy Directive that capital requirements is the sole responsibility of the home state and that host states are prohibited from laying down additional requirements.

6.2.3.3 Supervision

Supervision of prudential rules is the responsibility of the home state. To facilitate supervision home state prudential rules require investment firms to keep records of all transactions.

As an exemption to home state supervision, host Member States can require an incoming service provider to furnish it with the information on its activities necessary for monitoring its compliance with host state rules. The requirements must not be more stringent than those applying to host state investment firms.

6.2.3.4 Enforcement

The procedures for the enforcement and the sanctioning of infringements of the rules regulating investments firm are also based on the home state approach. The home state is competent to withdraw the authorisation in case of breach of home or host state rules implementing the Investment Service Directive.

The home state enforcement approach also applies for infringement of host state rules based on the Investment Service Directive. As described above host state authorities cannot sanction infringing home state investment firms without awaiting prior action by the home state authorities. The home state enforcement approach is deferred from for infringement of the conduct of business rules, host state general good rules, which are not based on the directive, and in emergency cases.

In sum, as regards prudential requirements, capital requirements, supervision and enforcement the prevailing approach is one based on home state control. This applies with a few exceptions, particularly for supervision and enforcement. The regulatory approach in the field is predominantly based on mutual recognition.

6.2.4 Conduct of Business Supervision: Advertising and Conduct of Business Rules

The regulation of conduct of business can be divided into rules on advertising to the public at large and conduct of business rules, which regulate the relationship between the investment firms and the investor. The two categories overlap particularly as regards the information that investment firms must give investors.

6.2.4.1 Advertising

According to article 13 of Investment Service Directive investment firms are allowed to advertise their services in host Member States through all available means of communication subject to host state general good rules on the form and content of advertising.

Prima facie the principle of home country control and mutual recognition hence extends to rules on advertising. This is supported by a number of directives on advertising¹⁹⁰. The harmonisation of these aspects of advertising prejudices host Member States recourse to the general good and hence enforces the home country approach for rules on advertising.

This is however only the formal point of departure. First, the unclear definition of general good and the commonplace application of host state general good rules without due consideration for whether the proportionality requirement is satisfied, leads to a situation where the advertising of investment services is in fact regulated both by home and host state law. Second, in some Member States rules on advertising are included in the conduct of business rules¹⁹¹ and as these they are imposed routinely on incoming service providers, the home country approach in the field is diluted.

The directive on the distance selling of consumer financial services does not indicate a general move towards more home country control in the field of advertising. It deals mainly with the information to be given to retail investors, their withdrawal rights and the conclusion of contracts for financial services. It does however include a rule on unsolicited communications by other communication means than automated calling systems and fax machines for example by email. The permissibility and use of such unsolicited email communications for cross-border advertising is regulated by the law of the home Member State. Member States allowing this marketing method must ensure that investors either give their prior consent or that these communications may only be employed if the investor does not express his manifest objection. The regulation of unsolicited email communications to investors is clearly based on the home country approach and excludes general good host state rules.

¹⁹⁰ SEC (1997) 1193 Final, Commission Interpretative Communication, Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive, p. 21 mentions Council Directive 84/450/EEC relating to the approximation of the laws, regulations and administrative provisions of the Member States concerning misleading advertising, OJ 1984, L 250, p. 17, as amended by Directive 97/55 of the European Parliament and of the Council amending Directive 94/450/EEC concerning Misleading Advertising so as to include comparative advertising, OJ 1997, L 290, p. 18, as one directive which prejudice host Member States' recourse to the general good. As mentioned in the introduction this horizontal directives on consumer protection are not examined in the thesis.

¹⁹¹ Commission Communication COM (2000) yyy provisional, The Application of the Conduct of Business Rules under Article 11 of the Investment Service Directive (93/22/EEC), p. 8.

The strong internal market clause in the E-commerce Directive also has an impact on the advertising of on-line investment services. Its article 6 requires commercial communications to be identifiable as such. Implicitly it allows the use in cross-border advertising of promotional offers and competitions in accordance with home state law. It must however be recalled that the E-commerce Directive article 1(3) explicitly states that it does not deflate the level of protection of consumer interest already established by Community acts as long as measures securing *this* objective is compatible with the Treaty principles of free movement.

In sum, albeit a vaguely termed provision prescribing mutual recognition the current legal situation in the field of advertising is in fact quite different as compliance with both home and host state rules is often required. Despite harmonisation at least in principle, the mutual recognition approach is not adhered to in the field of advertising.

6.2.4.2. Conduct of Business Rules

Conduct of business rules – the rules regulating investment firms behaviour towards the investors – are regulated in article 11 of the Investment Service Directive. Conduct of business rules require investment firms to act fairly, competently and diligently towards the investors. Conflicts of interest must be avoided. Further, investment firms must obtain information about the investor's background and disclose any relevant material information to the investors. The obligation to disclose relevant material information is supplemented by a list of specific information requirements in the Directive on the Distance Marketing of Consumer Financial Services and the E-commerce Directive as regards on-line investment services.

The field of conduct of business rules constitutes an exception from the principle of home country control by requiring the application of the rules of the Member State "in which a service is provided". Although not explicitly mentioned in article 11 the general good test must be satisfied when applying host state conduct of business rules to incoming investment firms. As described above this is not always the case as the entire set of conduct of business rules is applied routinely to incoming investment firms. In relation to professional investors the need for protection and accordingly the proportionality of applying the entire set of host state conduct of business rules is often not considered. In relation to investors in general, the possible duplication of similar provisions in the home and host state conduct of business rules is also rarely considered.

In sum, the implementation and application of the conduct of business rules according to the Investment Service Directive is only based on mutual recognition to a very limited extent.

The introduction of the Directive on the Distance Marketing of Consumer Financial Services will strengthen the home country approach for the information that investment firms must provide to investors before and after the conclusion of the contract. The directive requires the provision of specific information of particular relevance in distance contracts. In relation to the provision of investment services as defined by the Investment Service Directive a number of information requirements are deferred from. The reason for exempting investment firms from these information

obligations was to align the proposed directive with the existing sectoral directives including the Investment Service Directive¹⁹².

For on-line investment services the E-commerce Directive requires that information on inter alia the contact details of the investment firms and the prices for the services are easily accessible. The scope of the E-commerce Directive is broader than the Directive on the Distance Marketing of Consumer Financial Services as it the latter does not apply to for example promotional sites that do not allow an investor to conclude contracts¹⁹³. These sites will therefore have to comply with the E-commerce Directive information requirements.

In sum, in the field of conduct of business rules the principle of mutual recognition is weak as the Investment Service Directive confers the power in this field on host Member States. The home country control is further diluted by little consideration given to whether the proportionality requirement of the general good test is satisfied. Recent developments have strengthened the use of the home state approach as regards the information to be provided to investors. This does however not change the picture of the field of conduct of business rules where mutual recognition is all but perfect.

6.2.5 Product Control Regulation

The category of product control regulation encompasses all rules that shape the financial services an investment firm offers or in other words the content of its financial products. These rules are often found in national private law requiring financial products to have certain characteristics and prohibiting others. These rules particularly apply to the financial products provided to retail investors, whereas the products offered to professional investors seldom are subject to specific content requirements. The category of product control regulation can not be equalled with national contract law as it for example does not include rules on the conclusion of contracts. On the other hand product control rules are often found in national contract law.

The question can be asked whether differences in the Member States' product control regulation in fact constitute barriers to cross-border provision of investment services. The examples of barriers arising from differences in product control regulation identified in legal writings are mainly found in the field of banking¹⁹⁴. The Koestler case regarding the differences in French and German law on the legality of contracts for time-bargains on transferable securities shows that barriers also arise in the field of investment services. Considering that the Investment Service Directive's annexes lists complex financial products such as financial futures contracts, forward interest-rate agreements, interest-rate, currency and equity swaps, and options, it cannot be ruled out that barriers arise because of host state product control rules on these instruments. This applies especially if services regarding these instruments were offered to retail investors.

¹⁹² COM (1999) 385 Final, Explanatory Memorandum, Amended Proposal for a European Parliament and Council Directive concerning the Distance Marketing of Consumer Financial Services and Amending Directives 97/7/EC and 98/27/EC, p. 5.

¹⁹³ COM (2001) yyy Final, Communication from the Commission to the Council and the European Parliament, E-commerce and Financial Services, p. 6.

¹⁹⁴ For example SUN, M.-J. and PELKMANS, J., "Regulatory Competition in the Single Market", *Journal of Common Market Studies* 1995, p. 80.

As a result of recent debate the Commission will launch a review of the differences in national product control regulation that are likely to hinder the free provision of investment services. This shows that differences between Member States' product control regulation are perceived as barriers to the free provision of investment services and that the magnitude of the problem has yet to be identified.

The Investment Service Directive includes no specific provisions on the mutual recognition of financial products. However, the preamble reads:

“Whereas the Member States must ensure that there are no obstacles to prevent activities that receive mutual recognition from being carried on in the same manner as in the home Member State, as long as they do not conflict with laws and regulations protecting the general good in force in the host Member State”¹⁹⁵

This broadly termed recital indicates that mutual recognition extends to all aspects of the provision of cross-border investment services including product control regulation. Conversely, it can be argued that the mutual recognition only applies for the authorisation and prudential rules explicitly harmonised by the Investment Service Directive.

Wouters argues that the broad construction of the recital should be avoided¹⁹⁶. He refers to the debate preceding the adoption of the almost identical provision in the Second Banking Directive. In the Commission's initial proposal the recital explicitly provided for the mutual recognition of “financial techniques” i.e. product control regulation. The choice of the more ambiguous wording shows that political agreement on extending the principle of mutual recognition to this field far could not be reached.

Wouters proposes that the recital should be construed with regard to the substantial provisions of the Investment Service Directive. The recital hence reiterates the content of the directive, namely the mutual recognition and freedom to provide the services regarding the securities listed in the annexes save for general good limitations. In other the words, the Investment Service Directive does not provide for a universal principle of mutual recognition encompassing product control regulation, but it clarifies that host states' regulation in this field must satisfy the general good test and its the proportionality requirement. This interpretation is adhered to here.

In sum, despite the lack of conclusive information it can be assumed that differences in Member States' product control regulation constitute a hindrance for the EU-wide provision of investment services. It is equally difficult to determine the degree to which mutual recognition is adhered to in the field. Given the extensive imposition of host state rules in other fields, which are not harmonised in detail, it is not unlikely that host state product control regulation is imposed on incoming investment firms. This assumption builds further on the fact that product control regulation mainly

¹⁹⁵ The Council directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ 1993, L 141, p. 27-46, recital 33.

¹⁹⁶ WOUTERS, J., “Conflict of Laws and the Single Market for Financial Services”, *Maastricht Journal of European and Comparative Law* 1997, p. 186. The discussion of the recital is part of a broader discussion of the existence of implicit choice of law rules in the Investment Service Directive which will not be summarised here.

exists in relation to retail investors where host state protection is often conceived to be necessary. It should be added that the provision of conventional services such as transmitting and executing orders for simple instruments such as listed shares and bonds is not hindered by product control regulation.

6.3 Comparison with the Principle of Judicial Mutual Recognition

Judicial mutual recognition as defined by the case law facilitates competition among rules in so far as exceptions with reference to imperative requirement of general interest can not be made.

There are however at least two important differences between judicial and regulatory mutual recognition based on prior harmonisation. Firstly, harmonisation clarifies how host state rules must be structured to be in compliance with EU law and hence helps to identify host state rules that are not. Secondly, host states rules on matters that are fully harmonised can not be justified with reference to imperative requirement of general interest. Where the directives exceptionally allow for derogations from the principle of home country control and mutual recognition, the scope for derogations is limited due to the foregoing harmonisation.

This is illustrated by the relationship between older case law and later harmonisation. In the German Insurance case the host state was allowed to maintain restrictive national measures with reference to the sensitive issue of consumer protection. In the Parodi case it was recognised that host Member States were not prohibited from imposing national authorisation and capital requirements on an incoming bank. The disputed questions have since been harmonised and the scope for host state rules limited accordingly.

The introduction of the rigid procedure for allowing special derogations from the principle of home country control in the E-commerce Directive, moves the principle of regulatory mutual recognition in the field of on-line provision of services further away from judicial mutual recognition.

In sum, in comparison with the case law mutual recognition based on harmonisation offers a legal environment with less uncertainty and less exceptions from the principles of mutual recognition and home country control.

6.4 Interim Conclusion: The Mutual Recognition in the Current Regulatory Framework for the Provision of Investment Services

The principle of mutual recognition is adhered to in all the four categories of regulation. It stands strongest in the categories that regulate the service provider, namely authorisation and prudential supervision. In the categories of conduct of business supervision and product control where the focus is on the service itself the principle of mutual recognition has less strength. The dilution of the mutual recognition and home country control approach in these categories is caused by reliance on general good exceptions, ambiguous directive provisions, and the lack of clear mutual recognition provisions.

The coming into force of the E-Commerce Directive will affect the regulatory framework for the on-line provision of investment services. Its strong internal market clause will re-enforce the mutual recognition and home country control approach in

all the four categories. The E-commerce directive both procedurally and substantively narrows the scope for general good exceptions in comparison with the standing regulatory framework. This will result in intensified evaluation of host state rules and their proportionality in comparison with the current situation where host state rules are imposed on incoming investment firms as a rule of thumb.

As for reliance on general good exceptions the proportionality requirement is particularly difficult to satisfy in relation to professional investors. For on-line investment services to professional investors a move towards exclusive application of home state law can be expected. "Fundamental differences" exist as to whether retail on-line investment services should follow suit or if more harmonisation has to put in place before a definite move towards home state law can be made. It should be noted that the E-commerce Directive does not have any impact on choice of law rules. The narrower scope of general good does therefore not affect product control requirements in host state contract law, which continue to apply to on-line financial products where the conditions under the Rome convention are fulfilled.

6.5 The Potential for Competition among Rules in the Current Regulatory Framework

Three basic conditions must be fulfilled for competition among rules to take place. Their fulfilment will enable market participants to conduct regulatory arbitrage – investors purchasing their services from or investment firms moving to the Member States with the most favourable regulatory 'packages' – thereby triggering regulatory competition between Member States.

The basic conditions for competition among rules are unrestricted mobility (*de jure* and *de facto*) facilitated by mutual recognition on the basis of prior minimum harmonisation, and a reliable informational basis (perfect information, discreteness and enforcement).

In the following firstly the fulfilment of the conditions of unrestricted mobility of investment services as a consequence of the degree of mutual recognition will be examined. Secondly, the fulfilment of the basic condition of a reliable informational basis in relation to investment services will be examined.

As described above the 1985 White Paper endorsed the use of the mutual recognition approach in the field of investment services but it did not explicitly promote competition among rules. The proposal for the Investment Service Directive was based on the mutual recognition approach without promoting competition among rules¹⁹⁷.

The directives in the field of investment services include statements, which can be interpreted as being in favour of competition among rules. Recital 34 of the Investment Service Directive states that host Member States should not hinder investors from availing themselves of any investment service from home state investment firms provided that these act "outwith" the host Member State. Recital 4 of the future Directive on Distance Marketing of Consumer Financial Services states "it is in the interest of consumers to have access without discrimination to the widest

¹⁹⁷ COM (1988) 776 – SYN 176 Proposal for Council Directive on Investment Services in the Securities Field.

possible range of financial services available in the Community so that they can choose those that are best suited to their needs". A precondition for investors exercising their right of choice and purchasing their investment services in other Member States is that divergences in law exist making home state services either cheaper, better suited or simply more attractive because of the diversity for the individual investor¹⁹⁸.

The Investment Service Directive's preamble recital 4 points in the opposite direction. It states that investment firms should not be allowed to opt "for the legal system of one Member States for the purpose of evading the stricter standards in force in another Member States within the territory of which it intends to carry on or does carry on the greater part of its activities".

There is hence no evident promotion of competition among rules articulated in the current regulatory framework for investment services. In the following it will be examined whether the conditions for market participants to conduct regulatory arbitrage and thereby trigger regulatory competition are fulfilled.

The first and the second basic conditions for competition among rules are de facto and de jure unrestricted mobility and mutual recognition based on minimum harmonisation.

6.5.1 The Fulfilment of the Conditions of Unrestricted Mobility and Mutual Recognition based on Prior Harmonisation

6.5.1.1 Unrestricted de Facto Mobility

There are only comparatively insignificant restrictions on the de facto mobility of on-line investment services in comparison with services that presuppose the simultaneous physical presence of the service provider and recipient, for example medical services. In comparison investment services and securities can be easily provided in the Internet due to their intangible and dematerialised nature¹⁹⁹. Very importantly, this can be done speedily and at a very low cost. In particular for professional investors the emergence of the Internet and specialised software applications makes it possible to examine a range of investment opportunities in different Member States in little time.

It is hard to generalise about the de facto mobility of investment firms. They are likely to have incurred large fixed costs in their home Member States. They are also likely to have strong ties to their host state due to tradition and employees. Lastly, the continued presence in the home state might be necessary to maintain their home state client base. The de facto mobility of the individual investment firm will therefore depend on a trade-off between the benefits from moving to another Member States and the losses from leaving their current Member States. Some of the investment firm's activities might be less tied to the home Member States and therefore have a higher de facto mobility.

¹⁹⁸ Financial Services Action Plan Forum Group on Retail Financial Services: Overcoming the Remaining Barriers, Issues Paper for the First Meeting of the Group, p. 6. The paper can be consulted at www.europa.eu.int.

¹⁹⁹ COM (1999) 385 Final, Amended Proposal for a European Parliament and Council Directive concerning the Distance Marketing of Consumer Financial Services and Amending Directives 97/7/EC and 98/27/EC, recital 5.

6.5.1.2 Unrestricted de Jure Mobility

The unrestricted de jure mobility of services depends on the degree of mutual recognition. If mutual recognition is perfect i.e. without any exceptions, investment services can be provided without restrictions to all Member States subject only to the law of the home Member State. The more aspects of investment service regulation that are subject solely to home state law, the larger the importance of which home state regulation applies. In a climate of perfect mutual recognition investors will purchase their investment services from and investment firms will move to the Member States with the most favourable regulatory climates. Market participants will however only conduct this regulatory arbitrage if divergences between Member States' laws exist. If all Member States' laws have the same content there will be little won from purchasing investment services from or moving to other Member States.

The current regulatory framework analysed above is partially based on mutual recognition and provides accordingly only partially for unrestricted de jure mobility. Mutual recognition and unrestricted mobility is well developed in the categories of authorisation and prudential control. The perfect mutual recognition in these categories is however accompanied by a detailed set of substantive rules creating a minimum regulatory floor and leaving little room for regulatory invention and competition. The diversity that would make regulatory arbitrage attractive does not exist due to the very same rules that were a pre-condition for regulators accepting mutual recognition and unrestricted mobility.

The mutual recognition in the category of conduct of business rules is weak which limits the mobility of services. Moreover, it is unclear to what extent 'attractive' regulatory diversity exists in the field. National conduct of business rules implementing the broad principles of the Investment Service Directive are likely to contain many and very specific rules²⁰⁰. Some Member States' conduct of business rules might provide for significantly higher or lower levels of investor protection than others. This would make Member States with high standards of consumer protection in their conduct of business rules attractive in the eyes of the investors from Member States with conduct of business rules with low level investor protection. The attractiveness could induce investment firms to move to Member States with high protection conduct of business rules. Investors purchasing their services from a Member States with a high level of protection, would not only be protected by the rules of their residence Member State. In addition, they would be protected by the high protection level conduct of business rules of the investment firm's home state. Home state investment firms would be able to use the higher level of investor protection in their advertising. This could lead Member States with low levels of protection to come up with a regulatory response and result in a regulatory race. Although the Investment Service Directive conduct of business rules only includes very broad principles they do lay down a certain minimum level of protection. This minimum level of protection limits the scope for competition among rules.

In relation to professional investors only home state conduct of business rules should apply as the additional application of host state conduct of business rules to protect

²⁰⁰ Consultative Paper on Standards and Rules for Harmonising Core Conduct of Business Rules for Investor Protection, FESCO/00-124b, February 2001. The Paper is available at www.fescoeurope.org.

well-informed expert professional investors must be considered disproportional²⁰¹. Applying host state conduct of business rules in relation to professional investors will be increasingly difficult with the intensified control of derogations from the home country approach under the E-commerce Directive. Home country control for conduct of business rules in relation to professional investors will result in one restriction less on the mobility of investment services. This will leave scope for regulatory competition between Member States. Individual Member States will have the option of adopting conduct of business rules that are particularly suited in relation to professional investors by providing the right balance between them and their professional counterparts, the home state investment firms. The Member State that adopts the conduct of business rules that best reflects the needs of professional parties, is likely to attract increased investment service activity i.e. professional investors purchasing their services from and investment firms moving to this Member State.

In the category of product control regulation mutual recognition is also weak. On the other hand, the diversities that make regulatory arbitrage interesting are often found in this field. The possibility of obtaining cheaper, more well suited or innovative financial products is a likely reason for investors to purchase the services in other Member States. Investment firms in Member States with a long tradition for financial products, the technical expertise and the flexible national regulators have an advantage for inventing and offering new and competitive financial products²⁰².

The de jure unrestricted mobility in this field depends on the applicable contract law, which would often be the law of the investor's host state. Retail investors are protected against complex financial products by mandatory host state general good rules. The Rome Convention's consumer protection rules exclude the option of opting out of host state contract law protection when the services have been offered or advertised in the host state. For on-line investment services this applies with even stronger force due to the extensive application of host state rules to commercial websites. For professional investors the situation is different. They are less likely to be protected by host state law on complex financial products as they are deemed capable of evaluating their content and the related risks. Moreover, the Rome Convention allows professionals full contractual autonomy with the exception of the mandatory rules and the ordre public rules of the forum state. In relation to professional investors there is therefore unrestricted mobility in the field of product control regulation as well as the regulatory diversity that makes financial products from other Member States and regulatory arbitrage attractive.

In sum, the standing regulatory framework for investment services does potentially facilitate competition among rules by providing for some degree of unrestricted mobility of investment services. The combination of mutual recognition and 'attractive' regulatory diversities can instigate regulatory arbitrage by investors purchasing services or investment firms moving to the Member States with the most favourable regulatory climates. This applies particularly for professional investors in relation to whom the mobility of investment services is unrestricted. In relation to

²⁰¹ Commission Communication COM (2000) yyy provisional, The Application of the Conduct of Business Rules under Article 11 of the Investment Service Directive (93/22/EEC), p. 17.

²⁰² Financial Services Action Plan Forum Group on Retail Financial Services: Overcoming the Remaining Barriers, Issues Paper for the First Meeting of the Group, p. 3. The paper can be consulted at www.europa.eu.int.

retail investors substantial restrictions to the mobility of services and accordingly the opportunities for regulatory arbitrage exists.

The close link between mutual recognition and minimum harmonisation does have an adverse effect on the scope of regulatory competition. The minimum regulatory floor established by harmonisation prevents Member States' regulators from engaging in a regulatory race to the bottom. Home state rules that do not satisfy the harmonised minimum requirements are not subject to mutual recognition. The minimum harmonisation does however not prevent a race to the top with Member States' regulators introducing additional or more burdensome regulation.

6.5.2 The Fulfilment of the Condition of a Reliable Informational Basis

The third basic condition for regulatory arbitrage and consequently competition among rules is the existence of reliable informational basis on which investors can decide from what Member State to purchase their investment services. The condition of a reliable informational basis is divided into the subcategories of perfect information, discreteness and enforcement.

The informational basis requirement differs from the condition of unrestricted mobility as regards how and by whom the condition is fulfilled. The unrestricted *de jure* mobility is fulfilled when host states allow services from other Member States to enter freely. Conversely, the fulfilment of the informational basis requirement is mainly the task of private market participants. Investment firms wishing to provide their services in other Member States must convince host investors by providing the necessary and comprehensible information to satisfy the sub-conditions of perfect information and discreteness. The fulfilment of the information requirement can also take place through the active investor himself 'going abroad' and examining home Member States services. The public regulators play a less significant role for the fulfilment of the condition. They do however indirectly contribute to fulfilling the condition by laying down mandatory information requirements that market participants must satisfy and by not limiting the provision of any supplementary information.

6.5.2.1 The Sub-condition of Perfect Information

The current regulatory framework does not include provisions with the direct objective of increasing the level of information in order to facilitate competition among rules. However the current regulatory framework's provisions indirectly influences the level of available information both in a positive and a negative direction.

The obligation to provide potential investors with information in the Investment Service Directive, the Directive on Distance Marketing of Financial Services and the E-commerce Directive all work to increase the level of information on home state services. Moreover, home state investment firms have a strong self-interest in providing the information needed to convince host state investors to switch to home state services.

The regulatory framework does however not only affect the fulfilment of the informational basis requirement positively. Article 10 of the Investor Compensation Scheme Directive requires Member States to limit investment firms' use of the

information on the applicable compensation scheme in their advertising in order to prevent such use from affecting the stability of the financial system and investor confidence. Investment firms are hindered from drawing attention to the advantages of the compensation scheme they adhere to and the level of information on home state investment services and their advantages is adversely affected.

The regulatory framework hence influences the level of information, but this does not change the fact that the fulfilment of the sub-condition ultimately depends on market participants' actions. The recent debate shows that this might not have been sufficient. The lack of host state investor confidence in home state investment services is identified as one of the primary obstacles for creating a fully integrated market for investment services²⁰³. The lack of confidence is strongest among retail investors. This indicates that home investment firms have not been sufficiently good at promoting their services. On the other hand, it can be argued that the investment firms are up against an impossible challenge. Host state investors may not want to rely solely on the information provided to them by their commercial counterparts. Additional information from or endorsement of the information provided by investment firms by home or host state authorities might therefore be necessary to achieve the informational level investors require.

In sum, despite of action by investment firms and provisions indirectly influencing the informational level, the sub-condition of perfect information does to appear not to be fulfilled. This is evidenced by the identified lack of investor confidence.

6.5.2.2 The Sub-condition Of Discretness

The sub-condition of discretness is closely related to the sub-condition of perfect information. The latter requires the necessary information about regulatory differences to be available, the first requires that market participants are able to assess the effects of these regulatory differences.

The current regulatory framework includes no provision with the objective of enforcing market participants' capabilities for assessing the effects of regulatory differences, nor does its provisions indirectly have this consequence. The fulfilment of this condition is hence even more dependent on the information provided by market participants. This entails the same problem as described above, namely that investors do not want to rely solely on information from their commercial counterpart without some kind of public endorsement of the information.

It is unlikely that public authorities will engage in conducting and publishing comparisons on the effects of regulatory differences. What they might do, is to train investors or make the tools available that would enable them to make these assessments themselves. The use of the Internet offers an inexpensive way for this kind of investor training.

In sum, as with the sub-condition of perfect information the sub-condition of discretness does not appear to be fulfilled. This is also evidenced by the lack of investor confidence in home state investment services.

²⁰³ COM (2001) yyy Final, Communication from the Commission to the Council and the European Parliament, E-commerce and Financial Services, p. 4.

6.5.2.3 The Sub-Condition of Enforcement

The third sub-condition for guaranteeing a reliable informational basis is effective enforcement. If enforcement is not efficient, certainty to the nature and effect of regulatory differences is lost. Businesses and consumers will not be able to conduct their regulatory arbitrage in a regulatory climate of uncertainty.

In the recent debate there has been some attention drawn to the fact the co-operation between Member States' supervisors is not adequate in the light of increased trans-national investment services activity. This indicates that enforcement is not always consistent with the formal substantive provisions. This creates uncertainty among investors as to the informational basis on which they base their investment decisions.

One particular problem has however been pointed out in the recent debate in relation to enforcement and the lack of investor confidence. Although enforcement might be efficient, the prospects of pursuing a complaint in another Member State are unpredictable in terms of time and money. This applies in particular for retail investors. As a result investors are deterred from obtaining their services from other Member States.

In sum, problems have been identified as regards the efficiency of the current enforcement mechanisms. Moreover, the costs and the unpredictability of making use of enforcement mechanisms in other Member States to pursue a claim influences negatively the provision of investment services, particularly for retail investors. The sub-condition of enforcement is therefore only partially fulfilled.

6.5.3 An Additional Condition: The Free Movement of Investment Firms

In the analysis above the EU regulatory framework for the free movement of investment services has been considered. Conditional on the fulfilment of the basic conditions, market participants will engage in regulatory arbitrage and thereby trigger regulatory competition. Investors conduct regulatory arbitrage by purchasing their services from the Member States with the most favourable regulatory climates. Investment firms conduct regulatory arbitrage by moving to the Member States with the most favourable regulatory climates. An investment firm can 'move' to another Member State by re-establishing, branching, or establishing or acquiring a subsidiary.

The free movement of firms must be distinguished from the free movement of services. Albeit firms enjoy the right to freedom of establishment as physical persons under the Treaty, the exercise of this right is connected with uncertainty. Particular attention has been drawn to the risk of investment firms of one Member State evading national rules by establishing in another Member State and providing services back into their initial state of origin under the freedom to provide services.

The preamble recital 4 of the Investment Service Directive states that investment firms should not be allowed to make use of the European passport in order to evade the rules the Member State in which they carry out the greater part of their activities.

Recital 4 of the preamble is directed at the situation where an investment firm moves across the border to another Member State but maintains the bulk of its activities in the initial state of origin, when this is done with the intention of evading the rules of

the initial state of origin. The recital is not directed at the situation where an investment firm chooses to move to another Member State because this Member State offers the most favourable regulatory environment for the provision of investment services in general, that is to investors in the Member State of origin, its new home state or third Member States.

Moreover, the Investment Service Directive includes a rule requiring investment firms to have their head office in the same Member State as their registered office²⁰⁴. The purpose of this provision is to avoid that investment firms establishing 'letter box' head offices in the Member States with the most lenient regulatory regimes while having activities mainly in others Member States²⁰⁵.

As for the rule against 'letter box' headquarters, the recent Centros judgement²⁰⁶ that allowed the use of a 'letter box' headquarter in the UK and the establishment of the real head office in Denmark as a branch, indicates that this requirement should not always be upheld.

A thorough analysis of the freedom of movement of companies in general and of investment firms in particular falls outside the scope of this thesis. It should be noted that the regulatory arbitrage and consequent pressure on home state regulators to enter into a regulatory race ultimately depends on the significance of the restrictions to the mobility of investment firms. If the mobility of investment services is significantly restricted pressure on home state regulators will only be exerted by the regulatory arbitrage conducted by investors purchasing the services in other Member States.

6.6 Interim Conclusion: The Potential for Competition among Rules of the Current Regulatory Framework

The current regulatory framework does not fulfil the conditions for competition among rules fully. On the other hand, by fulfilling them partially it does not exclude competition among rules altogether.

The degree of unrestricted de jure mobility is proportional to the degree of mutual recognition. Unrestricted de jure mobility exists in the categories of authorisation and prudential rules, whereas a number of restrictions are encountered in the categories of conduct of business and product control regulation. As for de facto mobility of investment services there are only very limited restrictions.

It is difficult to determine whether the condition of a reliable informational basis is satisfied since this depends less on the regulatory framework and more on the actions of market participants. Despite the provisions in the regulatory framework that indirectly influence the level of information, the sub-conditions of perfect information and of discreteness do not appear to be satisfied. The sub-condition of enforcement is also only partially satisfied as problems regarding co-operation and pursuing claims in

²⁰⁴ This problem only arises in relation to Member States that in their international private law adhere to the registered seat theory. In Member States that adhere to the main seat theory only one connecting factor is considered, namely the location of the head office.

²⁰⁵ COM (1988) 776 – SYN 176 Proposal for Council Directive on Investment Services in the Securities Field, p. 4.

²⁰⁶ Case C-212/97 Centros Ltd vs. Erhvervs- og Selskabsstyrelsen.

other Member States exist. The lack of investor confidence in investment services from other Member States evidences this.

A common feature of the current regulatory framework is the use of minimum harmonisation. Minimum harmonisation is a precondition for mutual recognition and unrestricted de jure mobility. Minimum harmonisation does however also have the effect of limiting the scope for competition among rules. In the field of investment services this prevents a downward regulatory race. If regulatory competition between Member States was to take place in the field of investment services, it is therefore more likely that this would take the form of a race to the top²⁰⁷. The introduction of detailed rules in the E-commerce and the Directive on Distance Marketing of Financial Services²⁰⁸ further limits the scope for competition among rules.

The potential for competition among rules provided by the current regulatory framework differs for rules in relation to retail and professional investors. The mobility of investment services to retail investors is limited by the rules protecting them in the EU directives and the Rome Convention. The condition of a reliable informational basis is also satisfied to a lower degree in relation to retail investors. Conversely, the mobility of investment services to professional investors is subject to fewer restrictions. In relation to professional investors neither the EU directives nor the Rome Convention create insurmountable restrictions to mobility. Complex financial products provide a particular inducement for cross-border investment services activity in relation to professional investors because of both the unrestricted mobility and 'attractive' regulatory diversity in this field. The basic conditions of a reliable informational basis is also easier satisfied in relation to professional investors as these have the resources and skills to obtain perfect information on regulatory divergences, assess the effect and ensure cross-border enforcement if necessary.

6.7 The Actual Competition among Rules on the Basis of the Current Regulatory Framework

The current regulatory framework has been in place for some years. It should therefore be possible to observe whether competition among rules has in fact already taken place.

It must be recalled that market participants' regulatory arbitrage must have a certain impact before it is likely to trigger regulatory competition between Member States. Market participants are further not able to pick and choose between the individual provisions in the Member States' laws but must subscribe to the full regulatory 'package' of one Member State. Market participants will therefore not conduct regulatory arbitrage unless significant advantages can be identified from choosing the 'package' of one Member State as opposed to another. Where unjustified obstacles to mutual recognition and unrestricted mobility exist, regulatory arbitrage and competition among rules further depends on market participants finding it worthwhile

²⁰⁷ HERTIG G., "Regulatory Competition for EU Financial Services", in ESTY, D. and GERARDIN, D., *Regulatory Competition and Economic Integration*, Oxford University Press 2001, pp. 222 and 227.

²⁰⁸ The Directive of Distance Marketing of Financial Services lays down a minimum as well as a maximum level for the scope of Member States implementation, as Member States "may not adopt provisions other than those laid down in this Directive in the Fields harmonised by this Directive" cf. Recital 9.

to challenge these barriers instead of simply complying with the additional unjustified requirements.

Hertig²⁰⁹ states that so far no empirical evaluation of the impact of the mutual recognition harmonisation on the cross-border flow investment services has been made. He points out that in the neighbouring field of banking, foreign activity only accounted for a small percentage of the aggregate assets in 1999. The cross-border activity that does take place cannot be definitely linked to the introduction of the harmonisation based on mutual recognition. It is expected that the level of cross-border activity will increase due to the more and more common use of the Internet and the introduction of the Euro. A survey among major banks shows that the future across-the-board use of the Euro is expected to cause a "cultural revolution" in the provision of financial services²¹⁰. Hertig also notes that even if a regulatory framework that does facilitate competition among rules is in place, it will take some time before such a development can be observed.

Actual competition among rules on the basis of the current regulatory framework has not yet been observed. Admittedly, the threat of potential regulatory arbitrage can have had a disciplining effect on regulators. This is at least as difficult to measure as actual competition among rules. Since the current regulatory framework does facilitate competition among rules to a certain extent and particularly in relation to professional investors it cannot be excluded that this will happen over time. The increasingly use of the Internet and the across-the-board use of the Euro may add and contribute to this development.

A further conclusion is that competition among rules in the field of investment services has not worked as the superior policy-creating strategy it was claimed to be. Limited by imperfect mutual recognition and restricted mobility on one side and minimum harmonisation on the other, the competition among rules approach has been unable to provide the promised tailor-made and inexpensive legislation corresponding to market needs.

²⁰⁹ HERTIG G., "Regulatory Competition for EU Financial Services", in ESTY, D. and GERARDIN, D., *Regulatory Competition and Economic Integration*, Oxford University Press 2001, p. 222ff.

²¹⁰ HERTIG G., "Regulatory Competition for EU Financial Services", in ESTY, D. and GERARDIN, D., *Regulatory Competition and Economic Integration*, Oxford University Press 2001, p. 224.

Chapter 7 The Current and Future Use of Committees in the Field of Investment Services

In the previous chapters the current regulatory framework for the provision of investment services were examined. An analysis was made of the use of the mutual recognition approach in field and how this facilitates competition among rules. Ideally, the result of competition among rules is that Member States through the regulatory race adapt their regulations to match the needs of the regulatory 'consumers', the market participants. Competition among rules hence provides a method of creating a policy finely in tune with the needs of the market.

An alternative and more efficient strategy for achieving an equally detailed and finely tuned policy is 'regulation through committee'. By bringing together representatives of public authorities as well as market participants and facilitating a deliberative dialogue between them the best possible regulatory solutions can be found.

In this chapter the current and future use of committees and networks in the field of regulation of cross-border investment services provision is examined. This will include a description of the use of committees in the current regulatory framework and with the establishment of two new committees, the European Securities Committee (ESC) and The Committee of European Securities Regulators (CESR), following the proposal of the recent Lamfalussy report.

Secondly, on the basis of description of 'regulation through committee' in a previous chapter, the legal problems likely to arise from this use of committees will be pointed out. Moreover on the basis of the studies on committee in the EU, an attempt will be made to predict how the committees in field will function and how they can address the barriers to free movement identified above.

The chapter is concluded with an assessment on whether the regulatory strategy based on 'regulation through committee' will be able to facilitate free movement and form a European policy in the field.

7. 1 The Use of Committees in the Current Regulatory Framework

Several of the directives in the current Regulatory framework contemplate the establishment of comitology committees²¹¹. A proposal for the establishment of a comitology committee for both the Investment Service Directive and the Capital Adequacy Directive was made by the Commission in 1995²¹². Despite a long debate consensus on the proposal was not reached. The legislative procedure was terminated in the spring 1998 due to disagreement of the choice of comitology procedure²¹³.

²¹¹ Investment Service Directive article 29 and Capital Adequacy Directive article 10.

²¹² COM (1995) 360 Final, Proposal for European Parliament and Council Directive Amending Council Directive 93/6/EEC on Capital Adequacy of Investment Firms and Credit Institutions and Council Directive 93/22/EEC on Investment Services in the Securities Field.

²¹³ Cf. Commission PRE-LEX homepage and European Parliaments OEIL homepage. Both homepages are accessible via www.europa.eu.int/eur-lex.

The Commission issued a report in January 2000 on the use of committees in the field of financial services²¹⁴. Its chapter on investment services lists the following committees: The High Level Securities Supervisors Committee, the Securities Contact Committee, the Forum of European Securities Commissions (FESCO) and the International Organisation of Securities Commissions (IOSCO)²¹⁵.

The High Level Securities Supervisors Committee was established in 1985 by the Commission. It does not have any formal legal basis. The committee is composed of high level representatives of Member States' supervisory authorities, finance ministries and central banks. Its function is primarily to advise the Commission on broad policy issues and new legislation on inter alia authorisation and operating requirements for investment firms (organisation, requirements for directors and major shareholders, conduct of business rules, minimum initial capital and on-going capital requirements) and investor compensation schemes. The committee does not advise on detailed technical matters. Moreover, the interpretation and disputes over individual Member State's implementation of directives is discussed in the committee. The committee's interpretations are however not legally binding. The Commission chairs the committee and provides its secretariat.

The Securities Contact Committee was established in 1979 following the Directive on the Conditions for the Admission of Securities to Official Stock Exchanges²¹⁶. The committee was given additional functions by later directives²¹⁷. The committee does not have any functions relative to the directives examined in previous chapters. Its members are representatives of Member States' securities supervisory authorities and finance ministries appointed on a case-by-case. The function of the committee is to facilitate the implementation of the directives within the scope of the committee's powers. Moreover, the committee is used to establish common positions on the additional or more stringent measures that these directives allow the Member States to introduce. The committee also acts as an advisor to the Commission on proposals to change these directives. Lastly, the committee has limited comitology powers in relation to one of the provisions of the Directive on the Conditions for Admissions of Securities to Official Stock Exchanges. The Commission chairs the committee and functions as its secretariat. The Commission meets at the initiative of the Commission when this is deemed necessary. Its last meeting was in the Autumn 1998.

The Forum of European Securities Commissions (FESCO) was founded in 1997 by the statutory securities commissions of the European Economic Area, mainly the EU Member States. Although it counts the EU countries as its members it is not formally an EU body. It is composed of representatives of the statutory securities commissions of the EU and other members of the EEA. The Member States are represented by the chairmen of the national authorities. The Commission has observer status. According to its charter, FESCO's function is to promote co-operation between its members with

²¹⁴ European Commission Internal Market Directorate General, Institutional Arrangements for Regulation and Supervision of the Financial Sector, January 2000. The report is available at www.europa.eu.int/comm/.

²¹⁵ The report also covers the UCITS Contact Committee. Since UCITS (Undertakings for Collective Investment in Transferable Securities) are not examined in the dissertation, this committee will be not be described here.

²¹⁶ Directive 79/297/EEC.

²¹⁷ The listing Directive 80/390/EEC as amended, on half-yearly report 82/121/EEC, major holdings 88/627/EEC, public offer 89/298/EEC, Insider dealing 89/592/EEC.

the objective of realising a European single market for financial services including investment services. It functions as a forum for co-operation and mutual assistance in surveillance and enforcement matters. Further, FESCO develops common standards for regulation and supervision. FESCO is chaired by one of its members for a period of two years. Meetings are held on a quarterly basis. In addition work is carried out in experts groups. Its secretariat is situated in Paris and staffed by employees from the Member States' national authorities.

The International Organisation of Securities Commissions (IOSCO) is an international standard setting body founded in the early eighties. Its members are the world's securities regulators. Its current members represent 90 countries. IOSCO is a forum for co-operation, exchange of information, and mutual assistance. It establishes common standards and facilitates effective surveillance and enforcement in relation to international securities transactions. This work is carried out in different committees, working parties and special task forces including a special regional committee for Europe.

7.2 The National Authorities in the field of Investment Services and Current Co-operation between Them

The regulatory framework for the provision of investment services includes a number of provisions on national competent authorities and co-operation between them. The implementation of particularly the Investment Service Directive and the Capital Adequacy Directive has influenced the national institutional structures for the regulation and supervision of investment services considerably²¹⁸.

The regulatory framework does allow for the delegation of regulatory supervisory to non-public bodies. The development following the Investment Service Directive and Capital Adequacy Directive has however been towards increased importance of public authorities with varying degrees of independence and less self-regulation. Moreover, a clearer distinction between the regulation of 'prudential supervision' and 'transactional supervision' including inter alia conduct of business supervision has emerged, often with the responsibility for two fields given to separate national authorities²¹⁹. Alongside the need for trans-national co-operation, a need for national co-operation and co-ordination therefore exists.

The need for co-operation, co-ordination and information exchange between Member States' authorities stems from the regulatory framework's structure according to which most supervisory matters fall with the ambit of home state power with a few exceptions where host state rules apply. Home state authorities need information regarding investment firms' activities in host states, host state authorities need information on investment firms established in home states. The necessary co-operation between Member States' authorities is facilitated by the provisions in the regulatory framework which enable and oblige national authorities to exchange information. The regulatory framework also addresses potentially sensitive issues

²¹⁸ WYMEERSCH, E., "The Implementation of the ISD and CAD in National Legal Systems" (chap. 1) in FERRARINI, G. (Ed.), *European Securities Markets The Investment Directive and Beyond*, Kluwer 1997/98, p. 40.

²¹⁹ WYMEERSCH, E., "The Implementation of the ISD and CAD in National Legal Systems" (chap. 1) in FERRARINI, G. (Ed.), *European Securities Markets The Investment Directive and Beyond*, Kluwer 1997/98, p. 14-15.

such as the exchange of information covered by secrecy obligations. The existence of EU rules on co-operation has eliminated the immediate need for the adoption of memorandums of understanding which are otherwise the recommended and preferred method for facilitating international supervisory co-operation²²⁰

On the basis of the current regulatory framework co-operation has developed from a traditional 'static' reciprocal flow of data to the dynamic co-operation between two or more national supervisory authorities with a shared competence towards the same investment firms²²¹. The co-operation involves requesting and providing specific and qualified information to one another, particularly in connection with the imposition of sanctions on investment firms, and potentially conducting joint inspections. The success of dynamic trans-national co-operation and supervision ultimately depends on the importance given to it by the individual Member States authorities.

7.3 The Lamfalussy Reports

The Lamfalussy report is the work of a group of financial experts established by the ECOFIN council in the Summer 2000 with a mandate to examine the current conditions for regulation of European financial services and propose a new model for regulation in the field including the adaptation of current practices. The work of the group supplements the Financial Services Action Plan – the catalogue of substantive financial market legislation to be implemented by 2005 in order to cover the lapses in the current patchwork of EU legislation.

The Lamfalussy group issued its initial report²²² in November 2000 and its final report²²³ in February 2001. The reports are based on information collected from market participants. The proposal of the group is to adopt a four-level regulatory approach including the establishment of a comitology committee and a network of national regulators and supervisory authorities.

7.3.1 The Initial Report November 2000

The initial report describes the recent financial developments in Europe and the across-the-board benefits that EU investors and businesses will be able to reap from integrated financial markets, such as cheaper capital for industry and more efficient intermediation of savings to investment. It further describes the shortcomings of the current approach in the field and presents a draft proposal for a new four-level regulatory approach. The new approach builds on the work carried out in FESCO. The annexes of the report include a summary of a recent market survey and an introduction to comitology.

7.3.2 The Final Report February 2001

The final report restates the grounds for reforming the regulation of European financial services and markets, and elaborates the four level approach. In the annexes

²²⁰ BERGSTRÄSSER, S., "Cooperation between Supervisors" (chap. 24) in FERRARINI, Guido (Ed.), *European Securities Markets The Investment Directive and Beyond*, Kluwer 1997/98, p. 378-379.

²²¹ BIANCHERI, C., "Cooperation among Supervisory Authorities under the ISD" (chap. 23) in FERRARINI, Guido (Ed.), *European Securities Markets The Investment Directive and Beyond*, Kluwer 1997/98, p. 364.

²²² Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets, 9 November 2000. The Report is available at www.europa.eu.int/comm.

²²³ Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, 15 February 2001. The Report is available at www.europa.eu.int/comm.

to the report a summary of market participants' responses to the initial report and two examples of model directives based on the proposed four-level approach are included.

7.3.3 The Proposed Four-level Regulatory Approach

The proposed four-level regulatory approach can be summarily described under the following headings:

- Level 1: Framework principles laid down in directives/regulations by the Council and the European Parliament according to normal legislative procedures
- Level 2: Implementation details in framework directives and regulations decided by the Commission and the newly established European Securities Committee (ESC) and Committee of European Securities Regulators (CESR).
- Level 3: Enhanced co-operation and networking of national securities regulators within the CESR to ensure common implementing standards
- Level 4: Strengthened enforcement of Community Law by the Commission with the help of Member States, their regulators and market participants.

The four-level approach is claimed to be the most efficient way of adopting the regulation necessary for facilitating free movement of investment services and creating an integrated market. It is speedy and flexible enough to meet future market developments. To function well, the four-level approach must be transparent, and respect the institutional balance and the Treaty.

7.3.3.1 Level 1 Framework Principles

Framework principles are defined as essential regulatory principles reflecting political choices. The report refers to art 202 and ECJ case law on "essential elements" as guidelines for the distinction between level 1 and 2 measures. The framework principles should be included in directives/regulations that clearly specify the nature and extent of the technical implementing measures and their limits.

The level 1 approach would ensure a legislative process that is speedy as well as democratic in as much as the scope of the implementing powers is determined by the Council and the European Parliament. Moreover, it allows the Commission to draw on the expertise of national regulators and market participants by consulting them via the ESC and CESR before drafting new level 1 proposals. To increase the speed further the reports opts for the use of fast track procedures and regulations instead of directives.

7.3.3.2 Level 2 Committee Implementation

Institutionally, level 2 is constituted by the Commission, the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR).

The report proposes that the European Securities Committee (ESC) members should composed of high level civil servants (the rank of state secretaries) nominated by the Member States and be chaired by the Commission. Considering the high rank of the ESC members the Commission chairman should be the responsible commissioner. The report emphasises the importance of attendance and the creation of a "esprit de

corps" among ESC members. The ESC should primarily be a regulatory comitology committee. Additionally, it should act as an advisor to the Commission regarding proposals for new level 1 measures. When acting as a comitology committee voting should be done by qualified majority with the same relative weight of the Member States votes as in the Council.

The report proposes that the Committee of European Securities Regulators (CESR) should be composed of the heads of the national regulatory or supervisory authorities. The CESR is to continue the current work and structure of FESCO. The function of the CESR on level 2 should be to act as an advisor to the Commission (see below regarding level 3). Strong links for the exchange of information and secretarial help from the Commission is foreseen. Voting is to be done by qualified majority to avoid the danger of reaching consensus only on the lowest common denominator²²⁴.

The level 2 implementation procedure should begin with the Commission in co-operation with the ESC establishing a mandate for the consultation of the CESR on technical details in a specific field. The CESR members then gather information from market participants in their respective countries. The consultation must be carried out in accordance with a pre-set body of procedural rules ensuring transparency, the involvement of all relevant interests and of professional expertise. This consultation model made the establishment of a European 'practitioner's forum' unnecessary²²⁵. On the basis of this technical advice the Commission forwards a legislative proposal to the ESC. If the proposal is passed with qualified majority, the Commission can decide to enact the proposal. If the proposal is not passed, it is submitted to the Council that votes on the proposal within a given time limit. In the case of opposition, the Commission must re-examine the proposal. In the case of no opposition within the time limit, the Commission may enact the proposal.

The European Parliament is given the following role. It receives all documents related to the ESC's and the CESR's work. If it finds the Commission is transgressing its mandate, it may pass a resolution. Faced with a European Parliament resolution the Commission is obliged to re-examine its proposal taking the utmost account of the EP's position. This possibility of EP supervision was chosen instead of the more far-reaching option of a parliamentary callback mechanism.

7.3.3.3 Level 3 Strengthened Co-operation

The co-operation between national regulatory and supervisory authorities on level 3 is done within the CESR, albeit in a slightly different configuration. Instead of the heads of national regulatory authorities the level 3 CESR is to be composed of representatives of these. Decision-making is done by consensus, not qualified majority as on level 2.

The purpose of the work is to ensure equivalent transposition and interpretation. Secondly, level 3 CESR is to agree on common standards on issues not regulated by EU law. Lastly, comparison and peer review of national rules and practices is to be carried out on level 3. Level 3 standards and guidelines will not be legally binding.

²²⁴ Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, 15 February 2001, p. 32.

²²⁵ Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, 15 February 2001, p. 33.

7.3.3.4 Level 4 Strengthened Enforcement of Community Law

The Commission is responsible for the enforcement of the Community law in the field of investment services. The report recommends that it should act more aggressively in this capacity. The strengthened enforcement must be underpinned by Member States', national regulatory authorities', market participants' and the European Parliament's support.

7.3.4 Other Points of Interest in the Lamfalussy Reports

One striking feature in particularly the initial Lamfalussy report is the comparison and reference to American financial markets and regulation. The characteristics of the US market such as a high degree of company financing through equity markets and a high ratio of equity market capitalisation to GDP are held up as objectives the EU should strive to achieve. Further, the report warns of the danger of capital flowing from the EU to US due to low-quality regulation.

Secondly, parallels are drawn between the importance of the 1992 creation of the internal market and the current necessity to create an integrated European financial market as a sine qua non for growth and employment. The perceived importance of integrated financial markets is evidenced by the current momentum in the legislative work in this field.

Thirdly, the option of establishing a single European securities regulator is rejected because of the current divergence between the Member States' legal systems and the lack of Treaty basis for such an authority.

Fourthly, the divergence of national regulatory and supervisory structures is identified as one of the reasons for the current fragmented picture of European regulation of financial services and markets. This divergence further constitutes an obstacle to the optimal functioning of the proposed regulatory model. The convergence of national structures is therefore seen as a necessary development for the achievement of an efficient regulatory system. The convergence should go beyond institutional issues and cover questions relating to the autonomy of regulators and the involvement of market participants.

Fifthly, the importance of increased resource allocation to financial market regulation and training of European and national civil servants as well as private market participants is emphasised.

Sixthly, the four-level regulatory approach should be monitored through half-yearly reports prepared by a group of Council, EP, Commission representatives and external members. The entire four-level approach is up for full review in 2004.

7.4 The European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR)

The recommendations of the Lamfalussy report were endorsed by the Stockholm European Council in the spring of 2001. Despite disagreement with the European Parliament, the Commission established the two recommended committees, the European Securities Committee (ESC) and the Committee of European Securities

Regulators (CESR) on 6 June 2001²²⁶. The preambles of the decisions underline the importance of the committee for “building a genuine internal market for financial services in accordance with the principle of an open market economy with free competition”²²⁷

The ESC is to function as “a body for reflection, debate and advice for the Commission in the field of securities”²²⁸. It will advise the Commission on policy issues and proposals for new legislation. In this respect it takes over the advisory functions of the current High Level Securities Supervisors Committee²²⁹. For the time being the ESC only has advisory functions. Its function as a comitology committee is contemplated and is to be introduced in future directives. The ‘upgrading’ to regulatory comitology committee is stalled by disagreement with the European Parliament over the latter’s powers to review the activities of the ESC²³⁰. The ESC will be composed of high-level representatives of the Member States. It will establish its own rules of procedure. It may invite outside experts and observers to participate in its meetings and establish working groups. It should be noted that the establishment of the ESC will not require additional funding to the field of securities. The cost of the ESC will be covered by the existing budget allocation for the High Level Securities Supervisors Committee²³¹.

The CESR is to serve “as an *independent* body for reflection, debate and advice for the Commission in the securities field”²³². In this capacity the CESR will in particular assist the Commission in the preparation of draft implementing measures. Before communicating its advice to the Commission on draft implementing measures, the CESR must at an early point consult market participants, consumers and end-users in an open, transparent and extensive manner²³³. Moreover, the function of the CESR is to “contribute to the consistent and timely implementation of Community legislation in the Member States by securing more effective co-operation between national supervisory authorities, carrying out peer reviews and promoting best practice”²³⁴. The CESR will be composed of high-level representatives of the national public authorities competent in the field of securities where appropriate accompanied by experts. It can invite experts and observers to participate in its meetings and set up

²²⁶ Commission Decision 2001/528/EC establishing the European Securities Committee, OJ 2001, L 191 p. 45 and Commission Decision 2001/527/EC establishing the Committee of European Securities Regulators, OJ 2001, L 191 p. 43.

²²⁷ Recital 2 of both the decisions.

²²⁸ Commission Decision 2001/528/EC establishing the European Securities Committee, OJ 2001, L 191 p. 45, recital 9.

²²⁹ COM (2001) 1493 Final, Draft Commission Decision establishing the European Securities Committee, p. 4.

²³⁰ WILMAN, J., “New Pledge on Securities Plan”, *Financial Times On-line Version*, 19 June 2001.

²³¹ COM (2001) 1493 Final, Draft Commission Decision establishing the European Securities Committee, p. 4. The total annual budget allocation amounts to 196.800 Euro cf. p. 13

²³² Commission Decision 2001/527/EC establishing the Committee of European Securities Regulators, OJ 2001, L 191 p. 43, recital 8, my emphasis.

²³³ The CESR will employ inter alia: Concept releases, consultative papers, public hearings and roundtables, written and Internet consultations, public disclosure and summary of comments, and national and/or European focused consultations cf. FESCO Press Release of 19 June 2001, Agreement on the Charter of the Committee of European Securities Regulators, ref. no. FESCO/01-095, p. 2.

²³⁴ Commission Decision 2001/527/EC establishing the Committee of European Securities Regulators, OJ 2001, L 191 p. 43, recital 10.

working groups, including a market participants group²³⁵. The members of the CESR are obliged to keep their national members of the ESC informed of the on-going discussions and co-ordinate the national position where more than one authority for securities exists nationally²³⁶. The CESR organises its own operational arrangements and draws up its own rules of procedure. It is headed by a full-time secretary general elected by the FESCO members who is supported by a secretariat financed by the members. A charter for the CESR has been drawn up within FESCO and is to be officially approved on its first meeting²³⁷. The CESR will continue the work of FESCO. All understandings, standards, commitment and work agreed within FESCO will have the same consequences for present and future members of the CESR²³⁸.

The decisions foresee close co-operation between the ESC, the CESR and the Commission. The ESC's chairman and secretariat will be provided by the Commission. The Chairman of the CESR will participate in the ESC's meetings. The CESR is required to maintain close operational links with the Commission and the ESC inter alia by Commission representatives participating in its meetings.

²³⁵ Draft Commission Decision Establishing the Committee of European Securities Regulators, C(2001) 1501 Final, p. 4.

²³⁶ Cf. article 1.3 of Charter of the Committee of European Securities Regulators (Final Draft), ref. no. FESCO/01-070e.

²³⁷ FESCO Press Release of 19 June 2001, Agreement on the Charter of the Committee of European Securities Regulators, ref. no. FESCO/01-095 and Charter of the Committee of European Securities Regulators (Final Draft), ref. no. FESCO/01-070e. The documents are available at <http://www.fescoeurope.org>.

²³⁸ cf. Article 9.3 of Charter of the Committee of European Securities Regulators (Final Draft), ref. no. FESCO/01-070e.

Chapter 8 Analysis of the Current and Future Use of Committees in the Field of Investment Services

Above the current and future use of committees in the field of investment services has been described. In this chapter an analysis of these committee structures will be made on the basis of the description of the 'regulation through committee' strategy in chapter 3.

8.1 General Remarks on Current and Future Use of Committees in the Field of Investment Services

The Lamfalussy report and the establishment of the ESC and the CESR provide undisputed evidence of the increasing importance of committees in the field of investment services.

In comparison with the current sporadic use of committees, the four-level approach presents a well-elaborated and consistent regulatory plan for the creation of a network of committees and national authorities for the regulation of the field of investment services. This plan encompasses both rules for the individual knots of the regulatory network and for the co-operation between them.

Both the ESC and the CESR will be involved on the policy implementation as well as on the policy development stages in the field of investment services. The envisaged co-operation between the ESC and the CESR will facilitate co-operation and policy creation across the formal stages of EU policy making.

The hub of the regulatory network envisaged by the Lamfalussy report is the ESC, which once agreement is reached with the European Parliament, will be granted powers as a regulatory comitology committee. In comparison with the standing High Level Securities Supervisors Committee the ESC will have more formal powers and a stronger say in the regulatory tasks of the Commission.

The CESR is an expert committee according to the terminology employed in chapter 3. It is composed of the heads of the national regulatory authorities and headed by the Commissioner of DG internal market. It hence secures that the latest and most advanced technical knowledge is available for the development of new European regulation and that even far-reaching new changes are discussed by the people who will ultimately be the ones to adopt them. The involvement of technical advice is further secured by the mandatory consultation of market participants on the basis of common guidelines, although these in the draft charter of the CESR only have the status of recommendations for appropriate consultation methods²³⁹.

The CESR continues the work of FESCO, which has established a strong position for itself in the field of investment services. This is evidenced by its participation in the work on the Lamfalussy report and the issuing of recommendations and standards, which will form the basis for future EU regulation²⁴⁰. As a forum for developing

²³⁹ Article 5.9 of Charter of the Committee of European Securities Regulators (Final Draft), ref. no. FESCO/01-070e.

²⁴⁰ These include FESCO Paper on the Categorisation of Investors for the Purpose of Conduct of Business Rules, (00-FESCO-A), March 2000, and Consultative Paper on Standards and Rules for

common regulatory standards the FESCO has, and hence the CESR will have, a strong influence on the outcome of future regulatory debates. It is evidently difficult to estimate what the effect of formally moving the FESCO work into the EU committee structures will have. From the decision on the establishment of the CESR and its draft charter, it follows that it will remain an independent advisory body financed by direct contributions from its members. It must be presumed that it will also continue to be staffed by employees of the national authorities that constitute its members. It is not known whether it will move its secretariat closer to the EU institutions in Brussels from its current location in Paris.

Besides the establishment of the two committees, the four-level approach addresses specifically the establishment or strengthening of the network of national authorities in the field. The institutional framework for the network co-operation will be the level 3 CESR. The tasks that the CESR is expected solve on the level 3 are very similar to the tasks that 'regulation through committee' identified by the case studies is particularly suited to address. The level 3 CESR will be used for the adoption of common interpretation and implementation of EU harmonisation measures, the peer review of disputed national interpretations, the discussion of emerging problems, and the adoption of common standards on matters which are not regulated in EU law.

Strengthened enforcement of Community law constitutes the last part of the four-level strategy. Considering the uncertainties connected with the enforcement of Community law when this depends on investment firms challenging national rules that are incompatible with the Treaty, strengthened enforcement will contribute strongly to the success of the four-level approach in facilitating free movement for investment services.

Lastly, it should be noted that although the Lamfalussy report identifies a need for increased allocation of resources to both EU and national authorities in the field of investment services, the only decision so far on resource allocation has been to transfer the existing budget allocation from the High Level Securities Supervisors Committee to the ESC, despite the fact that the latter is expected to solve a larger number of assignments.

8.2 The Legal Problems Arising from the Use of Committees in the Field of Investment Services

In the following the legal rules on EU committees that will apply to the ESC and the CESR are described, and problems, that are likely to arise, are identified.

One fundamental point in the rules on committees is the distinction between essential requirement and implementing measures known from the Köster case²⁴¹. Only the competence to adopt implementing measures can be delegated to the Commission. This point has been raised in the Lamfalussy Report²⁴². The distinction between level 1 framework legislative measures and level 2 implementing measures repeats the distinction. The report states that the level 1 framework legislative measures should

Harmonising Core Conduct of Business Rules for Investor Protection, FESCO/00-124b, February 2001. The Papers are available at www.fescoeurope.org. They will be discussed later in this chapter.

²⁴¹ Case 25/70, Einfuhrstelle vs. Köster, ECR 1970 p. 1161.

²⁴² Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, 15 February 2001, p. 22ff. The Report is available at www.europa.eu.int/comm.

include all essential elements reflecting political choices, whereas the level 2 implementing measures should include detailed technical provisions. This statement is not very operative. More informative is an annex²⁴³ to the Report in which the distinction between level 1 and level 2 measures is illustrated by a draft model for regulation in the field of conduct of business rules. The draft model for regulation of conduct of business rules includes a framework directive that repeats the conduct of business rules principles now found in article 11 of the Investment Service Directive. The accompanying implementing measures supplements the framework directive's conduct of business rules principles with detailed requirements to the behaviour of investment firms towards the investors.

The detailed requirements to investment firms are based on a consultative paper on conduct of business rules issued by FESCO²⁴⁴. This is an example of how the adoption in committees of detailed technical rules in the field of investment services already takes place despite the fact that the formal EU committee structure is not operative yet.

The legal rules described in the previous chapter poses certain limitations to the exercise of the delegated power to the Commission outside the field of agricultural policy. The legal rules also make certain requirements to the specificity of the enabling provisions in the basic level 1 framework acts. No evident problem arising from the application of these requirements to the four-level approach can be identified, but the requirements will have to be observed.

In sum, both the newly established committees, the ESC regulatory comitology committee and the CESR expert committee, are active on the policy development as well as on the policy implementation stages in the field of investment services. They are both established by formal Commission decisions. The delegation of comitology powers to the ESC does however depend on future Council and European Parliament directives conferring such powers on it. The consultation of the ESC will be compulsory when it acts in its capacity as a regulatory comitology committee. It is not clear if the consultation of the CESR and the procedure for adopting new legislative and implementation measures described by the Lamfalussy report will be obligatory. In general, the involvement of expert committees in the decision-making process is not obligatory, unless specific provisions to the opposite are adopted by either the Commission itself or the Council.

8.3 Analysis of the Use of Committees on the Basis of the Non-legal Studies

The non-legal studies summarised in chapter 3 help to give a full picture on how committees in the EU work. In the following section some comments on how the ESC and the CESR are likely to function will be made on the basis of the non-legal studies.

One characteristic of the use of committees in the EU identified by several of the studies is the extensive personal overlap between the committees. It is common that the same national officials participate in different committees within a given field. It cannot be ruled out that similar personal overlaps will occur between the ESC and the

²⁴³ Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, 15 February 2001, p. 58.

²⁴⁴ Consultative Paper on Standards and Rules for Harmonising Core Conduct of Business Rules for Investor Protection, FESCO/00-124b, February 2001. The Paper is available at www.fescoeurope.org.

CESR. However, according to the Lamfalussy report and the Commission decisions establishing the committees, the members of the ESC and CESR should be representatives of respectively the national ministries and the national regulatory authorities competent in the field of investment services. The stronger the separation on the national level between the ministries and regulatory authorities, the less likely it is that personal overlaps will occur.

A comparison can be made between the case study in the field of telecommunications and the committee structure in the field of investment services. In both fields strong regulatory authorities with varying degrees of independence exist on the national level. In the field of telecommunications there is a high level of committee activity and as a consequence thereof an elaborate network of committees and national authorities has emerged. In the field of investment services there will be a similarly high level of committee activity, and the strengthening of the current network of committees and national authorities is not only a likely consequence but also an integrated part of the regulatory plan. It is too early to say how the EU network of committees and authorities will co-operate with other regional and global networks in the field of investment services.

Formally, decision-making in both the committees will take place by qualified majority. In relation to the CESR the Lamfalussy Report states that it has been necessary to avoid unanimity voting rules in order to eliminate the risk of only being able to adopt rules that reflect the lowest common denominator²⁴⁵.

The studies show that other factors than the formal rules usually are decisive for how decisions are in fact adopted in EU committees. Van der Knaap's study indicates that the technical expertise of a given committee, its internal consensus and a clear task definition is decisive for its influence. Joerges and Neyer find that committee decisions are adopted following deliberative processes on the basis of consensus decision-making, technical argumentation and the development of common problem solving philosophies and cultures.

It is difficult to predict whether a similar deliberative culture and community will emerge in the investment services committees. It is a field where different normative-political and national economic interests must be balanced against the free movement objective. It is also a field where highly specialised technical knowledge must be drawn upon to develop the best regulatory solutions. It is not unlikely that a committee 'community' will emerge because of the ability of this mode of regulation to conciliate the inherent tension between the different interests in the field. This 'community feeling' is perhaps what the Lamfalussy report has in mind when it refers to the importance of establishing a sense of "esprit de corps" among the members of the ESC²⁴⁶.

One important condition for 'regulation through committee' to provide the detailed and finely tuned regulatory solutions it promises is that a plurality of interests are represented in the deliberative process. Considering that the future committee

²⁴⁵ Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, 15 February 2001, p. 32.

²⁴⁶ Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, 15 February 2001, p. 30.

structure builds on the work by FESCO, it can be doubted whether this condition will be satisfied. This is shown by the following example.

FESCO has recently adopted a paper on the definition of professional investors in relation to the application of national conduct of business rules²⁴⁷. The definition of professional investors proposed in the FESCO paper has been strongly criticised for being too narrow by investment firms²⁴⁸ as well as the European Parliament²⁴⁹. The example shows all interests in the field of investment services are not represented in FESCO which is composed only of national officials. If regulatory solutions balancing all relevant interests in the field of investment services are to be adopted, the plurality of interests represented in the committees must be ensured. The option of inviting private experts and establishing working groups provided for by both the ESC and the CESR establishing decisions facilitates the involvement of other interests than those of the permanent committee members from the national authorities.

Whether a committee community and culture and whether the necessary degree of plurality will be involved in the decision-making can only be determined once the committees have initiated their work. The non-legal studies indicate that this is a likely outcome of the current development.

8.4 How the Identified Problems in the Field of Investment Services Can and Are Being Solved by 'Regulation through Committee'

In chapter 5 the problems relating to the implementation of article 11 of the Investment Service Directive on conduct of business rules were identified. One problem arises from the obligation to take due regard to the professional nature of the investor when applying host state conduct of business rules – the definition of the professional investor. A second problem arises from the implementation of the broad conduct of business principles in article 11.

Attempts have been made to solve these two problems in the Investment Service Directive and thereby dismantle the barriers to the free movement of investment services by using 'regulation through committee'. These attempts have been made within FESCO.

As for the problem of adopting a definition of professional investors a FESCO Paper was issued in March 2000²⁵⁰. As mentioned above the Paper's definition has been

²⁴⁷ FESCO Paper on the Categorisation of Investors for the Purpose of Conduct of Business Rules, (00-FESCO-A), March 2000. The Paper is included in the Consultative Paper on Standards and Rules for Harmonising Core Conduct of Business Rules for Investor Protection, FESCO/00-124b, February 2001. The Papers are available at www.fescoeurope.org.

²⁴⁸ Investment Service Directive Feedback Synthesis of Responses to COM (2000) 729 Working Document of DG Internal Market, p. 10. The Working Document is available at www.europe.eu.int/Commission.

²⁴⁹ European Parliament Resolution on the Commission Communication on the Application of Conduct of Business Rules under Article 11 of the Investment Service Directive (93/22/EEC) (COM(2000) 722 – C5-0068/2001- 2001/2038(COS)), para 8. The Resolution is available at www3.europarl.eu.int, and European Parliament Report on the Commission Communication on Upgrading the Investment Services Directive (93/22/EEC) (COM(2000) 729 – C5-0069/2001-2001/2039 (COS)), p.7, para 8..

²⁵⁰ FESCO Paper on the Categorisation of Investors for the Purpose of Conduct of Business Rules, (00-FESCO-A), March 2000. The Paper is included in the Consultative Paper on Standards and Rules for Harmonising Core Conduct of Business Rules for Investor Protection, FESCO/00-124b, February 2001. The Papers are available at www.fescoeurope.org.

strongly criticised for being too narrow as it encompasses only financial firms. Even large corporate investors whose primary activity is outside the field of investments are not covered by the FESCO Paper's definition of professional investors. Because of the critique it is uncertain whether the Paper, which is not legally binding on Member States, will be an adequate measure for solving the identified problem.

Another example of 'regulation through committee' in the field of investment services is the FESCO's consultative paper on standards for conduct of business rules adopted in February 2001²⁵¹. The Paper is based on the broad principles in the Investment Service Directive. It proposes a series of detailed operational requirements to the behaviour of investment services towards the investors supplementing the broad principles. As mentioned above, the Lamfalussy Report based its model of future regulation of conduct of business rules on this FESCO consultative paper. This exemplifies how 'regulation through committee' is likely to work in the field of investment services.

In sum, the two recent FESCO papers show how 'regulation through committee' in the field of investment services can be used and is in fact already used to adopt detailed regulation. Other identified problems, such as the uncertain interpretation of the concept of general good in the Investment Service Directive, constitute challenges which are evidently well-suited for being debated and solved by 'regulation through committee'. The mutual recognition of financial products could also be addressed. By moving the work from FESCO into the comitology structure the decisions made following the comitology procedure will become binding Commission directives instead of standards without binding legal effect. The question can be asked whether this will not make the adoption of detailed regulation less flexible and more cumbersome than the current FESCO 'regulation through committee' approach.

8.5 Interim Conclusion: Can 'Regulation through Committee' Facilitate Free Movement and Create a European Policy in the Field of Investment Services

The Lamfalussy Report and the establishment of the ECS and the CESR signal the increasing importance of 'regulation through committee' and the strengthening of the regulatory network in the field of investment services.

The function of this committee structure will be to adopt the detailed regulation on the provision of investment services. This regulation must be based on the latest technical knowledge and the involvement of all relevant interests. Some doubt remains as to whether all interests are duly considered in the current FESCO committee structure.

If the non-legal studies hold true, a 'community feeling' will emerge within the committee structure in the field of investment services. This is perhaps the underlying objective of the Lamfalussy Report's stress on the importance of the creation of a 'esprit de corps' among committee members. This committee community in the field of investment services will develop common problem definition and solution philosophies and adopt regulation that incorporates both the free movement objective and the normative-political interest in the field. In time the committee community will develop a concept of common 'weal' in the field of investment services which will be

²⁵¹ FESCO Consultative Paper on Standards and Rules for Harmonising Core Conduct of Business Rules for Investor Protection, FESCO/00-124b, February 2001.

manifest itself in the way that the long-term policy in the field of investment services is shaped.

The case studies lead to the prediction that committee community in the field of investment services will emerge as a result of the on-going developments. Whether this will in fact take place and how such a committee community will work can only be established by further research once the committee structure in the field of investment services has been operational for some time.

Chapter 9 Conclusion

The thesis departed from the assumption that a change of regulatory strategy is taking place in the field of investment services. On the basis of the examination carried out in the thesis, this assumption can be confirmed.

The directives that constitute the larger part of the current regulatory framework for the provision of investment services are based on the principle of mutual recognition, the Investment Service Directive being the primary example. These directives were adopted in the early and mid nineties. The recent Lamfalussy Report and the establishment of the European Securities Committee and the Committee of European Securities Regulators in June 2001 evidence that 'regulation through committee' is on the rise in the field of investment services. This indicates that the future regulatory framework for the provision of cross-border investment services will be based on a 'mix' of the two regulatory strategies.

To describe in detail and test the assumption of a change of regulatory strategy in the field of investment services, the thesis set out to answer the following three questions.

1. What is the underlying regulatory strategy of the current EU regulation on the provision of investment services?
2. What is the underlying regulatory strategy of the future EU regulation on the provision of investment services?
3. In the future regulation of the provision of investment services, will the choice of regulatory strategy differ depending on whether a given piece of regulation has the objective of protecting retail or professional investors?

On the basis of the examination in the thesis, the following answers can be given to the three questions.

Question 1: What is the underlying regulatory strategy of the current EU regulation on the provision of investment services?

The thesis shows that although the current regulatory framework for the provision of cross-border investment services is based on mutual recognition, this mutual recognition is imperfect in the sense that it does not cover all aspects of the provision of investment services.

Particularly in the categories of conduct of business rules supervision and product control regulation, the mutual recognition approach is diluted by 'islands' of host state competence, lack of clear mutual recognition provisions and an extensive interpretation of the concept of the general good. The coming into force of the E-commerce Directive's strong internal market clause will strengthen the mutual recognition approach for the provision of on-line investment services, but it will not alter the conclusion that mutual recognition in the field of investment services is imperfect.

The imperfect mutual recognition in the field of investment services results in restrictions of the free movement. The first basic condition for competition among rules to take place is unrestricted mobility. The restricted mobility of investment services because of imperfect mutual recognition means that the condition of unrestricted mobility is only partially fulfilled. The second basic condition for competition among rules is a reliable informational basis. The thesis shows that this condition for competition among rules is also only partially fulfilled. Since both conditions for competition among rules are only partially fulfilled, it is concluded that the current regulatory framework only facilitates competition among rules in the field of investment services halfway. This explains the fact that so far no actual competition among rules in the field of investment services has been observed.

In conclusion, the underlying regulatory strategy of the current EU regulation on the provision of investment services is mutual recognition and competition among rules. The mutual recognition is however imperfect. As a consequence, competition among rules is only facilitated halfway by the current EU regulation on the provision of investment services

Question 2: What is the underlying regulatory strategy of the future EU regulation on the provision of investment services?

The thesis shows the increasing importance of the 'regulation through committee' strategy in the field of investment services. This is evidenced by the Lamfalussy Report and the establishment of the ESC and the CESR.

On the basis of the studies on the use of committees, the emergence of a 'committee community' with a strong 'esprit de corps' and a shared understanding of the common weal can be predicted. This should result in the shaping of a long-term European policy in the field of investment services incorporating both normative-political interests and the free movement objective. An important condition for the success of the 'regulation through committee' strategy is that all relevant interests are included in its deliberative decision-making process. The example of the FESCO paper on the definition of professional investors raises doubt to whether the interests of investment firms are adequately represented in the current 'regulation through committee' structure. Moreover, the inclusion of both professional and retail investors' interests in the deliberative process must be ensured. This can be achieved by inviting investors' organisations to participate in the committee structure. It is yet too early to tell how the 'regulation through committee' strategy will work in the field of investment services. This can only be revealed through future studies once the investment service committee structure has become operational.

The increased importance of 'regulation through committee' in the field of investment services will not change the current regulatory framework or replace its underlying strategy of mutual recognition and competition among rules overnight. The two regulatory strategies will at least for the immediate future continue to exist side by side.

The underlying regulatory strategy of the future EU regulation on the provision of investment services will hence be a mix of the regulatory strategy of mutual recognition and competition among rules and the strategy of 'regulation through committee'.

Question 3: In the future regulation of the provision of investment services, will the choice of regulatory strategy differ depending on whether a given piece of regulation has the objective of protecting retail or professional investors?

The current regulatory framework for the regulation of investment services makes a strong distinction between retail and professional investors. The distinction is particularly clear in the case law on free movement. Professional investors are considered to need less protection than retail investors. Accordingly, it is more difficult to demonstrate the proportionality of applying host state rules to incoming investment firms providing services to professional investors. The provision of investment services to professional investors is or should at least be therefore solely be regulated by home state law in accordance with the principle of mutual recognition. In other words, the mutual recognition of the regulation on provision of investment services to professional investors is perfect.

From the perspective of competition among rules, perfect mutual recognition translates into unrestricted mobility. This means that the basic condition of unrestricted mobility is fulfilled in relation to investment services to professional investors. In addition, the condition of a reliable informational basis is also fulfilled in relation to professional investors. Since both conditions for competition among rules are fulfilled, the current regulatory framework does facilitate competition among rules in relation to professional investors. Moreover, professional investors have the necessary resources and skills for assessing and purchasing their investment services in other Member States when this is advantageous because of regulatory diversities.

In sum, the current regulatory framework is based on a distinction between retail and professional investors. In relation to the latter group of investors, the regulatory strategy of mutual recognition and competition among rules is fully adhered to in the current regulatory framework.

It is an open question whether the distinction between professional and retail investors will be upheld in the future regulatory framework for the provision of investment services. There is a risk that the adoption of detailed common rules by 'regulation through committee' will have the effect of eliminating the current regulatory diversities between Member States which is one of the incentives for professional investors to purchase their investment services in other Member States.

The adoption of common detailed rules without due consideration for the fact that professional investors do not need the same level of protection as retail investors and the fact that the adoption of common detailed rules could eliminate the regulatory diversities which induce professional investors to purchase investment services in other Member States, could adversely affect the current cross-border provision of services.

This speaks in favour of upholding the professional and retail investor distinction. It also speaks in favour of employing different regulatory strategies for the regulation of the provision of investment services to the two distinct groups of investors. In relation to retail investors, detailed common rules should be adopted by 'regulation through committee'. In relation to professional investors, the regulatory strategy of perfect mutual recognition facilitating competition among rules, which is adhered to in the

current regulatory framework in relation to professional investors, should remain unchanged.

The following points indicate that the distinction between the two groups of investors will most likely be upheld in the future regulatory framework for the provision of investment services.

First, as pointed out above, the increasing importance of 'regulation through committee' will not result in an overnight change of the current regulatory network or the complete disposal of the regulatory strategy based on mutual recognition and competition among rules.

Second, the adoption of the FESCO Paper on the definition of professional investors in relation to the application of host country conduct of business rules shows that the issue of the extent to which professional investors should be protected by host state rules is already discussed within the investment service committee structure. The adoption of a clearer definition of professional investors for the application of conduct of business rules by 'regulation through committee' has the effect of clarifying the law in the field. It further strengthens the current approach of perfect mutual recognition in relation to the provision of investment services to professional investors.

Third, both the ESC and CESR have the option of involving private market participants in their decision-making processes through working groups or consultations. This should guarantee that the arguments for maintaining the distinction between professional and retail investors and the benefits of applying different regulatory strategies in relation to the two groups of investors are at least brought to the committee fore.

In conclusion, several factors indicate that the distinction between professional and retail investors will be upheld in the future regulatory framework for the provision of investment services. The same arguments indicate that this will and should result in the use of different regulatory strategies depending on whether a given piece of regulation has the objective of protecting retail or professional investors.

The Future Regulation of Investment Services: Joint Regulation of the General Good?

The thesis has described the change of regulatory strategy in the field of investment services from mutual recognition and competition among rules to 'regulation through committee'.

One reason for this change is the fact that the mutual recognition and competition among rules strategy has not succeeded in bringing about free movement and creating an integrated market for investment services. A likely reason for the failure of the mutual recognition and competition among rules strategy is the fact that host state authorities do not want to rely solely on home state authorities and home state rules for the protection of their national investors. Host state authorities prefer to apply national rules to incoming investment services with reference to the national understanding of the general good in the host state. The national understandings of the general good have a common basis in the case law and the Investment Service Directive. The common basis includes such broad objectives as the protection of

investors and the integrity of financial markets. Despite the common basis, there are significant differences between the operational contents of the national understandings of the general good. These differences are spelled out when a host state rule is claimed to constitute an impediment to the free movement of services. The host state will opt for a broad interpretation of the general good. The incoming investment firm and its home state will favour a narrow interpretation.

In this light the introduction of 'regulation through committee' in the field of investment services can be seen as the joint regulation of the general good. As opposed to upholding national rules with reference to the general good, Member States join together in committees and agree on a shared understanding of the general good. The fact that national rules are built on the shared understanding of the general good adopted by 'regulation through committee' leads to a situation where host state authorities find that the need for imposing national rules on incoming investment firms in order to protect host state investors is unnecessary. Host state authorities will find that compliance with home state rules based on a shared understanding of the general good provide sufficient protection for national investors.

This establishes a link between the regulatory strategies of mutual recognition and competition among rules, and of 'regulation through committee'. By providing a shared understanding of the general good, 'regulation through committee' provides what minimum harmonisation was not able to provide, namely a basis for perfect mutual recognition and free movement.

This indicates that the relationship between the regulatory strategies of mutual recognition and competition among rules, and of 'regulation through committee' should be seen as complementary. This observation could lead to the recasting of the relationship between the three concepts of mutual recognition, competition among rules and 'regulation through committee'. The discussion on the possible recasting of the relationship between these three concepts is very extensive and will not be opened in this thesis.

While the two regulatory strategies are complementary, it is on the other hand clear from the above that the adoption of detailed common rules by 'regulation through committee' risks eliminating the regulatory diversities that induce competition among rules. The relationship between the two regulatory strategies hence also includes an element of potential conflict.

The use of a mix of the two regulatory strategies in the future regulatory framework for the provision of investment services will surely bring the complementary and the conflictual nature of the relationship between the two strategies to the light. The success of the mix of the two regulatory strategies in the field of investment services will depend on how this inherent tension is balanced.

Future research on the regulation of the provision of investment services could attempt to identify the balance which will emerge between the mutual recognition and competition among rules strategy and the 'regulation through committee' strategy. This could be linked to a study of the 'committee community' which is likely to emerge in the field of investment services. Lastly, a question for future research would be to examine if the mix of the two regulatory strategies will be successful in

facilitating the free movement of investment services within the EU, creating integrated European markets and establishing a common European policy in the field of investment services.

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