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THE "ROUGH GUIDE" TO THE EUROPEAN FINANCIAL SERVICES INDUSTRY :
- its evolution, traditions and future prospects,
in the light of the European Community's
1992 programme.

SEPTEMBER - 1990

BRIAN McDERMOTT

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LLM thesis

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INTRODUCTION :

Cast your mind forward a few years and the European financial markets could seem something like this. The share prices of Fiat, Peugeot and Volkswagen flash up side by side on dealing screens from Dublin to Athens. Computers click and instantly a deal is completed - ownership shifts from a Dutch dentist to a Portuguese actuary. Italian investors pour into Spanish mutual funds, while Daimler Benz chooses Credit Lyonnais to lead-manage its latest D-mark bond issue. Germans take out British life insurance, Danes take out Italian mortgages, Spaniards open bank accounts in Belgium. Investors and speculators alike strategically buy an ECU interest rate future here, a promising bond with an equity warrant there.

Does this scenario belong with Alice in Wonderland or is this the shape of things to come ? A single European market for financial services is envisaged as a necessary consequence of the completion of the internal market, now defined in the Treaty of Rome as "...an area without internal frontiers in which the free movement of goods, services and capital is ensured."¹ Article 8a of the Treaty provides that the Community shall adopt measures with the aim of progressively establishing this internal market over a period expiring on the 31st December 1992.

The object of the single market is to remove the remaining barriers that exist to these four freedoms and the barriers that exist to greater competition and economies of scale within

1. Article 8a EEC Treaty as inserted by Article 13 of the Single European Act.

European business, while at the same time, for the financial services sector, creating a common framework of prudential rules which will underpin the stability of the financial system and provide a satisfactory level of protection for consumers.² If Europe's muddle of financial markets were truly one, it would rival the world's largest : the total of Europe's banking deposits together are one and a half times those of America and three quarters the size of Japan's. The market value of the shares of domestic companies quoted on European stock exchanges, one fifth of the world's total, is three fifths as big as that of shares quoted in New York and almost half that of Tokyo. Europeans pay three fifths as much in insurance premiums as even insurance obsessed Americans do. The European financial market has as its hinterland a joint gross domestic product almost equal to that of America and two thirds more than that of Japan. In terms of population Europe has 325 million citizens, compared with 246 million Americans and 123 million Japanese.³

If these statistics are not revealing, the results of the Cecchini Report on the benefits of a single financial services market⁴ certainly have to be acknowledged. The comparative cost approach utilised indicated some vast differentials in the costs of basic financial transactions between member states. For example, the

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2. G.Fitchew, Director General DG 15 - Financial Institutions and Company Law, "1992 - Completion of the Single Market in Financial Services " : Commission office London 9/9/1988.
 3. Statistics drawn from The Economist 16/12/1989 : "A survey of Europe's Capital Markets" from p.58 .
 4. P.Cecchini with M.Catinat & A.Jacquemin "The European challenge 1992 : the benefits of a single market" (1988) Wildwood House, which is based on research carried out on behalf of the Commission and published in Volume 9 of the Research on the Cost of Non - Europe Series (1988), Commission of the EC.

cost of purchasing a commercial bank draft for 30000 ECUs in The Netherlands was 22 ECUs, whereas in Spain such a draft cost 120 ECUs. Stock Exchange commission costs on equity bargains of 1440 ECUs amounted to 9 ECUs in France and to 23 ECUs in Britain. Not surprisingly, the Report concluded that there were significant potential gains to be secured in terms of increases in consumer surplus and economic welfare resulting from the dynamic effect of economic integration, and not simply as a result of removing the costs of meeting some of the existing regulations. It estimated that these gains could be in the region of 22 billion ECUs. It also predicted that the removal of barriers between and within the markets, and of the costs linked to them, would have three interlocking effects : a surge in the competitiveness of the sector itself ; a knock-on boost to all business using its increasingly efficient services ; and, more generally, a new and positive influence on the conduct of macro-economic policy in the Community.

Insurance, banking and the marketing of securities add up to a sector of the economy that accounts for around 7% of European gross domestic product, a share which is growing strongly.⁵ In Britain alone, between 1980 and 1985, the sector experienced a growth rate of 7.7% per annum, employment therein increased by 18% and real wages increased by 31%.⁶ The economic importance of the financial services sector is even greater when account is taken of the size of capital flows that it intermediates, the risk of

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5. See T.Padoa-Schioppa (ed) "Efficiency, stability and equity" (1987), a report produced by a study group and presented to the Commission in April 1987. Subsequently published by Oxford University Press.
 6. See C.Mayer, "The assessment : financial innovation : curse or blessing ?" Vol.2 No.4 Oxford Rev. of Economic Policy p.i-xix .

instability that is inherent in financial markets and the links between finance and all the other fields of economic activity. Indeed, one eminent economist stated that :

"It may not be an exaggeration to say that the crucial role in a growing economy based on the division of labour is actually played by the financial sector. The efficiency of the allocative process and the stability of the economy are heavily dependent on the ability of this sector to combine efficiency and stability in the performance of its monetary, credit and payment functions."⁷

In this thesis, I attempt to portray a European financial services sector which is undergoing something of a metamorphosis. Thus far, the impetus for this change has come from competitive pressures within the markets themselves. Now, however, the European Community is throwing its not inconsiderable weight behind the development of a more integrated and consequently, more streamlined marketplace, in a bid to tackle the problems of fragmentation and protectionism that continue to dog the markets. I have focused my attention on Community stock exchanges and other financial markets, and their participants, without commenting on the specific area of insurance, which would merit a separate analysis. My principal concern has therefore been with the provision of investment services, which necessarily entails a consideration of the increasing role played by credit institutions in this field.

7. T.Padoa-Schioppa "The blurring of financial frontiers : in search of an order" a contribution to a Conference on Financial Conglomerates, organised by the Commission (DG 15/A-4), held in Brussels 14-15/3/1988, at p.17-36 of the proceedings thereof.

The thesis is divided into four chapters. In the first, I consider the recent evolution of the financial markets, which has seen the transformation of a formerly institutionally compartmentalised, geographically segmented and traditionally conservative industry into a sophisticated, innovative and truly global business. Such progress has inevitably been accompanied by an increase in the risks and strains exerted on the system, and has placed increased pressures on the supervisory structure.

The second chapter examines the reasons why the European Community has hitherto been unable to realise the gains offered by an integrated financial services market. Adopting an institutional approach, I relate this particular failure to the difficulties encountered by the Community in establishing the Internal Market per se. The breakthrough came with the renewed enthusiasm shown for European integration in the 1980s, which mood was captured in the Single European Act and the Commission's White Paper. The latter specifically targeted financial services as an area for liberalisation, and breathed new life into the federalist conception of the Community. The Court of Justice, too, has contributed to the winds of change blowing around the marbled halls of the financial Community. I analyse, in some detail, the Court's judgement in the 'insurance cases', where it sought to define the Treaty enshrined Community freedoms to provide services and of establishment, as they relate to this sector.

The Court's approach has been respected and reflected in the specific legislative measures, adopted or proposed by the Council and the Commission, in the financial services field. These are discussed in chapter three. I critically assess the proposed Investment Services directive and highlight the difficulties encountered in preparing the legislation, due to the diversity of financial markets and capitalistic traditions within the

Community. At this point, I consider the moves afoot among the various exchanges, to develop a European stock market and prepare themselves for the greater volume of business and competition anticipated as a consequence of the 1992 programme.

The fourth chapter seeks to explain the theoretical reasoning behind the regulation of financial markets, and uses an economic perspective to warn of the dangers of piecemeal regulation and of overregulation. I draw on American regulatory practice and question whether its latest 'trend', the Efficient Capital Market Hypothesis, could usefully be adopted into European systems of regulation.

In the conclusion, I turn to the implications of the foregoing for the European financial services consumer, and ask whether his deeply entrenched habits and attitudes are likely to change in the aftermath of 1992. I conclude that it is the retail services sector which is likely to see the most changes over time and that a degree of consolidation and rationalisation within the industry is inevitable. However, it is difficult to attempt to predict the future evolution of this industry, because it is susceptible to dramatic change, due to technological advances and man's financial ingenuity, and because it is highly sensitive to the conditions of the economic environment.

CHAPTER 1 : Financial Services - a moving target ? .

The European financial services market has undergone a progressive transformation in the recent past, a process whose origins can be traced back to the economic upheavals of the early 1970s. This revolution has deeply affected the different financial markets, the types of financial instruments available and the institutions and intermediaries involved in the industry. It has supported economic growth and capital formation and has benefitted both the professional and non-professional investing public. They have been provided with a vast array of investment vehicles from which to choose, new ways of hedging exposures and the tactical ability to adjust their portfolios rapidly in response to changing economic conditions. What has made the present situation unprecedented is not the intensity and pervasiveness with which the changes have taken place, but, more fundamentally, the fact that they reflect a deep-seated modification in the behaviour of all the market participants in general - investors, borrowers, intermediaries, governments and regulatory authorities.¹

Financial Innovation :

This process has become known as financial innovation, being a description of the manner in which the financial system adapts itself to new conditions.² Most financial change has therefore

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1. See R.Pecchioli "Openness or protectionism ?", a contribution to a symposium on "Europe and the future of financial services", organised by DGs XII & XV of the Commission, Brussels 5-7/11/1986, at p.503-518 of the proceedings.
 2. J.Forsyth "Financial innovation in Britain" an essay in M.De Cecco (ed) "Changing money : financial innovation in developed countries" (1987) Basil Blackwell Ltd., p.141-157 .

reflected a reaction to broader economic and political developments as well as to other factors such as technological advances. It is not a continuous process but one that tends to come in waves, which vary in their impact on different financial systems. A brief study of this phenomenon will illustrate how the European financial markets have become increasingly internationalised and integrated into the global financial machine. It is now virtually impossible to isolate the European markets from their global background without ignoring some of their most influential and shaping forces. An understanding of this process also helps one to appreciate the difficulty and complexity of the task facing Community and national legislators and regulators in their efforts to legislate for, and to control, this swiftly moving target.³

The process of financial innovation has been fuelled by the interaction of several combusive elements. The principal catalysts however were the following :

1. Changing economic conditions :

Innovation has been to some extent provoked or promoted by economic factors such as accelerating and variable rates of inflation, fluctuating interest rates and unexpected bouts of massive government borrowing. These became widespread in the wake of the oil crises of the 1970s, when the size of the oil price increases and the short time span in which they were carried out, caused exceptional and huge financial disequilibria, both domestic

3. See generally J.Delmas-Marsalet "Déterminants structurels de la mutation financière récente", a contribution to the symposium cited supra note 1 at p.13-34.

and international. This resulted in unprecedented balance of payments imbalances, large increases in public sector borrowing requirements and rises in the financial deficits of the corporate sector. Governments were increasingly forced to resort to financial markets to attract funds to satisfy their financing needs. In some countries, such as Italy and France, this led to the development of the gilt market through the issue of securities whose maturity, coupon, options or warrants attached represented substantially innovative features. In financial markets which were largely dominated by fixed interest long term instruments, the sudden leap in inflation and subsequently in interest rates consequent on these imbalances, led to a substantial fall in the value of financial assets held by investors, such as equities and shares in pension funds.⁴ This encouraged the expansion and refinement of speculative and hedging activities in money, capital and exchange markets.

Exchange rates were also prone to bouts of excessive volatility in the 1970s. By 1973, the Bretton Woods system under which world currency values had been closely fixed in terms of each other had broken down. Exchange rates were thus freed to float and find their own level. Previously currency values over time could have been predicted with reasonable accuracy, now they could not. The demand for reducing the uncertainty of financial flows denominated in different currencies led to rapid innovation in the foreign exchange markets and the arrival of a myriad of new types of exchange rate instruments to serve the needs of those involved in

4. See A.Desiata "Financial innovation and the development of a European financial market", another contribution to the symposium cited supra note 1 at p.83-97 .

international financial transactions.⁵ The increased unpredictability required businesses to cover currency risks by transferring them to specific institutions and in this way a marketplace evolved for the exchange of standardised future exchange rate contracts.

2. Changing customer attitudes :

(a) There have been sweeping changes in the demands of wholesale or corporate consumers for financial services. Large companies have strengthened and broadened their cash management policies. Corporate treasurers are now ready to look for the best terms available when they raise cash or place funds. The old-fashioned long term dependence of a company on a single bank increasingly resembles the more modern commercially oriented relationship with an investment bank due to the greater mobility and flexibility of borrowers.⁶ That has been paralleled by the expansion of corporate arbitrage activities within and between markets and across the spectrum of fund raising techniques. Cost considerations have provided strong incentives for corporations to tap the financial markets directly as an alternative to traditional bank borrowing. This has contributed to a rise in the number of marketable credit instruments, such as bonds, notes and certificates of deposit, a tendency which has become known as securitisation.⁷ A corporate borrower will now be prepared to use a series of swap and other transactions to borrow in whichever

5. See generally, D.Ayling "The internationalisation of stockmarkets" (1986) Gower Publishing Co. Ltd.

6. See Mayer, cited supra in the Introduction note 6.

7. As will be illustrated in chapter 4, companies are still relatively reluctant to raise funds by issuing equity on the securities markets.

market, currency and form gives it the greatest comparative advantage, and then to transform those funds into whatever currency, maturity and interest rate pattern best meets the needs of its business.⁸ In some instances, large corporations have even begun to perform intermediary functions in a number of capital market segments and to provide other financial services themselves through financing subsidiaries and affiliates.

(b) Faced with the increased uncertainty and markedly more volatile market climate of the 1970s and early 1980s, private investors have become more yield and liquidity conscious which has had an attendant impact on their savings patterns and portfolio structures. Households have progressively become acquainted with policies of financial asset diversification and active portfolio management as a means of protecting their savings, earning a better income on them and for seeking capital gains. From 1970 to 1984, the share of current account deposits of total liabilities in Britain decreased from 18.8% to 6.6% and in France from 34.8% to 19% , as individuals drifted away from captive savings to more rewarding forms of investment.⁹ The rise in private personal incomes and the accumulation of financial wealth as standards of living increased across Western Europe, together with the changes in the market environment, created a demand for an increased variety of financial assets and a wider spectrum of retail financial services. Notable among the latter were asset management, brokerage and related advisory services. Quality of service, more personalised relationships with intermediaries,

8. See C.Goodhart "Financial innovation and monetary control" (1986) Vol.2 No.4 Oxford Rev. of Economic Policy p.79-102 . Goodhart describes the term securitisation as "hideous jargon" !

9. Desiata supra note 4 at p.88 .

availability of information on market trends and opportunities, efficiency and promptness have all become major considerations amongst customers in this newly enlightened climate.

(c) One of the most significant portfolio changes observed during the 1970s was the substantial switch by the personal investor from equity investment towards institutional saving. Investors have been giving up self-managed savings and substituting them with shares in portfolios managed by institutional investors such as pension funds, insurance policies, mutual funds and unit trusts (the new fast-food of investment). This has been in no small part due to the tax advantages of certain types of institutional saving. As one commentator has suggested, nowadays overall tax effects are as important in deciding the optimum portfolio structure as is the underlying market rate of return on different assets.¹⁰ Portfolio diversification and more sophisticated asset management have been cited as the other principal reasons for the phenomenal growth of these contractual forms of savings. In 1963 the main institutional investors owned less than 28% of UK shares, by 1986 this figure had risen to 65%. Over the same period, the stake of the direct private shareholder had slumped from 59% to 18%.¹¹

Institutionalisation of savings has had a profound effect on the financial markets. The need to produce consistently good returns has focused fund managers' attention on short term results which punish poor corporate performers and, in turn, has helped facilitate the growth in corporate takeover activity. The trend

10. D.Llewellyn "The evolution of the British financial system" (1985) The Institute of Bankers at p.20 .

11. For these and other noteworthy statistics, see M.Reid "All change in the City" (1988) The Macmillan Press Ltd at p.193 .

has stimulated increases in trading volumes in all financial markets and has generated a fertile feeding ground for new financial instruments and innovative trading techniques. The impressively expanding institutional presence is sophisticated, demanding and not overly loyal, either to corporate management, domestic markets, individual banks or to particular securities firms. It has vastly accelerated the process of market growth and dramatically altered the balance of power in financial markets.

Due to their sheer size, the portfolio behaviour of the institutions has an allocative effect upon the economy which cannot be disregarded. This has prompted a large volume of criticism of short-termism, ie. the willingness of those handling investment funds to engage in 'churnover' of shares in the quest for maximum returns. It has even been suggested that this could have a detrimental effect on long term research and development in industry. Companies may be forced to increase their dividends to satisfy the demands of powerful institutional shareholders, rather than ploughing the additional resources back into research activities.¹² The institutions' presence on the register of members of so many sizeable companies has also raised questions as to the role they should perform as shareholders. Usually, the size of an individual institution's shareholding and the constraints of its operation would preclude it from being more than a passive shareholder. However, collectively, institutional shareholders often hold a majority or a sizeable percentage of a company's shares, which could give them a substantial bargaining weapon at company meetings. In this environment, conflicts between management and institutions will always be likely, as will be the

12. For an example of such criticisms, see M.Fagan "Call to counter short-termism" The Independent 26/6/1990 p.20 .

possible disregard of smaller or minority shareholders' interests. Reid opined that, thus far, the concerted influence of the institutions as shareholders has been remarkable for its absence rather than for its presence. She noted, though, that as time has gone on, institutions have become more accustomed to exerting discrete concerted pressure in conditions where change seemed essential to restore a company's fortunes.¹³

3. Technological developments :

Undoubtedly, the process of financial innovation would have been slowed down considerably without the concurrent explosion of the new telecommunications and computer technology. This has made it possible to flash information on prices, trading conditions and companies swiftly around the globe. When such data and orders to deal can be passed instantly, any distance, frontiers shrink in importance - they are simply skipped by an electronic beam. Technology cannot predict the future direction of stock prices or interest rates but it does have an unrivalled capacity to do three things : analyse large masses of data quickly and precisely, handle complex interrelationships systematically and process vast amounts of information efficiently.¹⁴ The cost of doing all of this has been declining steadily. Some observers contend that the costs of international information flows have come down by 98% in the last twenty years.¹⁵ As today's technology becomes available to a wider group of potential users and tomorrow's technology adds

13. Supra note 11 at p.198 .

14. R.Kubarych "International regulatory harmonisation : the economic and financial environment" (1988) Vol.14 no.2 Brooklyn Journal of International Law 255-269 at p.267 .

15. See C.Goodhart "The economics of Big Bang" (1987) Midland Bank Review 6-15 .

greater capabilities, the markets and their users will become increasingly sophisticated.

Technology entails more than just computer hardware, although the power and speed of computers has been indispensable to the growth of securities trading. It also means software that allows machines to do valuable work, assists in the development of financial engineering and facilitates the evolution of strategies like programme trading. The latter is based on the almost simultaneous completion of transactions on different financial markets. Index arbitrage, for example, entails trading on identified differences between the current price of a stock index future and the market price of the underlying stocks themselves. Programme trading was developed on the American exchanges where it relied on the technological structure of the New York Stock Exchange for the appropriate computational capacity and split second execution capability.

This technological capacity will exist, and continue to be refined, irrespective of economic, political and regulatory forces. Its usage will also spread between markets, as they compete among themselves to attract business by offering state of the art facilities. The two factors of competition and technology are linked in that new technology offers new competitive opportunities, but the intensification of competitive pressures is likely to speed the application of new technology.¹⁶ How technology will evolve in the future is an open question. Technological revolutions, it has been suggested, do not come and go indefinitely, and we may well be entering a phase of consolidation, development and refinement rather than experiencing

16. See Llewellyn supra note 10 at p.43 .

a further quantum jump in information technology.¹⁷ However there remain ample opportunities for improvement of, for instance, payment and settlement systems, customer linkage capabilities and automated management systems.

4. Changes in governments' policies :

The implementation of government policies towards domestic financial markets has been another source for much of the liberalisation and development of these markets in recent times. This is one area where one can point to express legal measures as the impetus for change, as distinct from commercial or market pressures. Nevertheless, many such measures have been prompted by the knowledge of governments that in the absence of a reduction in the excess burden that existing regulatory laws were felt to be imposing, the institutions and markets which they were seeking to regulate would simply have moved to another more conducive environment.¹⁸

It is possible, at the risk of generalising, to identify three considerations that have inspired government policies in recent years. Firstly, more emphasis has been placed on policies supporting a structural change towards more flexible and dynamic economies. Secondly, it has become widely accepted that greater reliance should be placed on market forces as determinants of prices and market conditions. Thirdly, in the light of the growing financial interdependence worldwide, the preservation of the

17. See Pecchioli supra note 1 at p.509 .

18. See C.Goodhart "Structural changes in the British capital markets" an essay in D.Currie, C.Goodhart and D.Llewellyn (eds) "The operation and regulation of financial markets" (1987) The Macmillan Press Ltd., p.31-53 .

international competitiveness of a country's financial system has become an important policy objective. These considerations imply that government action should aim at promoting the efficiency of financial markets by fostering innovation, reducing structural rigidities and granting the necessary scope for the working of competitive forces.

Obviously government approaches will differ depending on the strengths and weaknesses of national markets. However, the initiatives that have been taken can be classified according to whether they were aimed at the liberalisation of international capital movements, the opening up of domestic markets to foreign financial institutions, the removal of constraints on financial diversification, the strengthening of price competition or the authorisation of innovative financial techniques.¹⁹

So far as international capital movements are concerned, the most important deregulatory move has been the lifting of foreign exchange controls whether it was done unilaterally or in response to European Community initiatives in the field (see chapter 3). So long as exchange controls are preserved, authorities may continue to maintain the existence of protected, cartelised, high cost financial markets and institutions because dissatisfied domestic customers cannot easily transfer their business abroad.²⁰ Once these controls are lifted, the pressures on all countries to adapt to best practice, or find that their own markets and national financial institutions will wither, are intense. In this

19. This classification is adopted from R.Dale's Introduction to R.Dale (ed) "Financial deregulation : the proceedings of a conference held by the David Hume Institute in May 1986" (1986) Woodhead-Faulkner Ltd, p.ix-xiii .

20. C.Goodhart supra note 18 at p.36 .

context, it is relevant to note that following the end of British exchange controls in 1979, it was estimated that between then and 1985, Britain's annual flow of investment abroad multiplied from one billion to eighteen billion pounds.²¹ Similar flights of funds abroad were feared in France and Italy when their progressive moves to relax their exchange controls culminated in 1988.²² In addition, the removal of tax disincentives and other restrictions to international portfolio investment have played a part in stimulating capital flows. Perhaps the most significant development here was the abolition during 1984 in both Germany and France of certain withholding taxes which discouraged the movement of funds abroad. Notable also, was the relaxation, carried out by the Reagan administration, of restrictions on the making of foreign investments by American pension funds.

The growth in capital movements has been accompanied by the rapid cross border expansion of financial institutions. This has been encouraged by the relaxation of controls on the entry of foreign institutions into national securities markets, such as occurred as part of London's Big Bang and in the deregulation of the Parisian Bourse. Stock market participation in the latter, was opened to outsiders generally, by allowing the incorporation of stockbrokers and permitting the purchase of shares in them by other institutions. By September 1989, two-thirds of France's sixty stock exchange firms had thus opened their capital to participation by outsiders, a quarter of them to foreign firms

21. Stock Exchange Quarterly, London (1987) Spring at p.15 .

22. The French relaxation progressed with the décrets of 29/11/1984 - no.84-1046, 27/11/1986 - no.86-1211, 21/5/1987 - no.87-338 and culminated with the arrêté of the 1/6/1988. In Italy, the process started with the legge del Presidente della Repubblica of 26/9/1986 n.599, and culminated with the decreto del Presidente della Repubblica of 31/3/1988 n.148.

from, inter alia, Britain, Germany, Japan and America.²³ Such relaxation has extended to Tokyo's notoriously protectionist Stock Exchange, which is now gradually admitting foreign firms into membership in exchange for the admission of Japanese securities firms to European markets.²⁴

The diversification of banks into non-bank financial services is another notable institutional feature. Faced with shrinking margins in their corporate lending market and the drift from captive savings by retail customers, banks have been forced to move away from their traditional intermediary role. They have found new areas of business, such as underwriting new market issues and making markets in the instruments used for lending and borrowing by their former corporate clients. In addition, they have increasingly involved themselves in securities markets activities. The interpenetration of the banks in other financial services sectors can be seen in the rash of takeover and merger activity among European financial institutions in recent times. Examples include the purchase by Deutsche Bank of the British merchant bank Morgan Grenfell in 1989 and the efforts of Credit Lyonnais to cover the Continent in branches by stealthily acquiring small or medium sized banks around the Community. It is also reflected in the emergence of the financial conglomerate, which operates as a 'one-stop shop' where a financial services consumer can avail of all his services needs within the one organisation.

23. See The Economist, cited supra in the Introduction note 3 .

24. Take, for example, the admission of James Capel Pacific Ltd., Barclays de Zoete Wedd Securities (Japan) Ltd. and Credit Lyonnais Securities AG to the Tokyo market. Reported in Business Week International, The Irish Times 10/3/1990 .

Constraints on price competition are progressively being removed. In general, protective price fixing arrangements within national markets are being eroded by the intensity of competition between previously distinct sectors of the financial services industry. The abolition of fixed commissions on stock exchange business was a feature of the reforms of the Amsterdam, London and Paris stock markets. In the aftermath of London's reforms, the volume of equity trading almost doubled and commission rates were cut for institutional deals but rose slightly on individual transactions. The resulting price wars between the larger securities houses, while jostling for market position, have severely squeezed the margins of other stockbrokers and a degree of fallout amongst them is seen as inevitable.²⁵ A similar adjustment of rates was predicted for the Parisian market, following the abandonment of fixed commissions in July 1989. However, initially, a consensus seemed to have developed, aimed at avoiding "wild" price competition because of its perceived detrimental effects on profitability and on the quality of services.²⁶ Nevertheless, the market has already had one notable victim. The stockbroker Tuffier et Associes, one of the country's largest independent brokers, filed for bankruptcy in July 1990 after reporting heavy operating losses.²⁷

Stamp duties levied on securities trading have also been reduced, capped or abolished altogether in the increasingly competitive environment. In this light, the continued existence in Germany of

25. See B.Riley "A time of turmoil for the private stockbroker" Financial Times 28-29/7/1990 .

26. See "La Bourse de Paris deux ans après son Big Bang" (1989) 14 4e trimestre Index : Rev. Economique de la Banque Indosuez 12-23 .

27. See W.Dawkins "Tuffier faces bankruptcy after Paris stockmarket volumes fall" Financial Times 18/7/1990 p.1 .

the stock exchange turnover tax, which is levied on all trading on the stock market except that between recognised credit institutions, seems even more anomalous. It has been described as no less than "an indirect subsidy to the London Stock Exchange"²⁸ and pressure is mounting in support of its removal, both to encourage a greater volume of securities trading on the German exchanges and, in particular, to increase the competitiveness of Frankfurt among European exchanges.

Finally, the trend towards liberalisation is likely to be maintained as regards the authorisation by national authorities of innovative financial instruments and techniques. Competition between financial centres ensures that innovations accepted in one major country are soon adopted elsewhere. A clear example is in the sphere of financial futures trading. In April 1989, London's LIFFE introduced a three month Deutsche mark interest rate contract. The following May, MATIF the French futures market launched virtually the same contract and Germany's new futures exchange, the DTB, plans to offer its own D-mark bond contract late in 1990.²⁹ Regulators are often compelled to follow the markets in respect of the development of new, widely practised techniques. They are therefore obliged to restrict their official intervention to the establishment of safeguards, such as additional capital requirements, rather than to order outright prohibition.

28. M.Hauck, former president of Frankfurt's Stock Exchange, quoted in Business magazine, May 1990 at p.119 .

29. Respectively : LIFFE-London International Futures Exchange, MATIF-Marche a terme International de France and DTB-Deutsche Terminborse.

The differing impact of innovation :

Though a global phenomenon, financial innovation has affected different countries in different ways and at different times. This sector is one where legal and economic factors are inextricably intertwined. Each of the innovatory developments referred to in the immediately preceding section involving government policy, entailed the preparation and adoption of new legislation, whether it was to enable banks to become members of stock exchanges, to remove exchange controls or to abolish turnover taxes. Lawyers assisted in drafting these measures, they are called upon to interpret them in court and they are relied upon to assist firms in circumventing or manipulating the wording of the legislation, in order to facilitate further innovation. However, the other catalytic factors have usually been the product of economic conditions or of progress in technological knowhow. In these fields, lawyers are obliged to follow innovation, to spectate rather than to stage-manage it. The role here for the lawyer is to contain innovation, to recognise limits beyond which it should not extend, whether to avoid infringing rules protecting consumers, or regulatory standards established to secure the stability of the financial system. Thus, in attempting to explain the differing impact of innovation, one needs to look beyond the legal system to traditions within national business and financial environments.

For example, it has been suggested that financial innovation in Italy has only been a partial process, which has left areas that have shown high innovative drive elsewhere almost unaffected. These would include, for example, the fund raising techniques of

the enterprise and banking sectors.³⁰ The statistic that the law that introduced investment funds into Italy took twenty-two years to be enacted, after it was first discussed in Parliament, might be thought to be an indictment of the Italian legislative system in this sense. However, this tardiness would be more appropriately attributed to the vagaries of the Italian political system, rather than to those of the legal system. H-J Dudler took an even firmer view of the extent of innovation in Germany. He suggested that general economic conditions, institutional arrangements and public attitudes seemed to have prevented new waves of innovation from reaching the financial markets in Germany.³¹ This opinion dates from 1985 and is, in my opinion, slowly being discredited by the efforts of the Frankfurt Stock Exchange (the sleeping giant of the European markets), to assert its role in the international financial marketplace.³² These moves have seen the extension of trading hours on the exchange from two to three hours a day and the opening, in January 1990, of the DTB, the new futures and options exchange. They illustrate just how far the markets have to go, to catch up with London and Paris for instance, but they should be seen as indications of the growing acceptance of financial innovation in the traditionally conservative German markets.

30. See C.Caranza and C.Cottarelli "Financial innovation in Italy : a lop sided process", an essay in "Changing money..." supra note 2 p.172-211 at p.172 .

31. See H-J Dudler "Financial innovation in Germany" an essay in "Changing money..." supra note 2 p.158-171 at p.160 .

32. See for example, A.Schwarzmann "Frankfurt races to secure hold in global markets" The Independent 26/1/1990, or R.Waters "Foreigners force changes" Financial Times supplement on West Germany 19/6/1990 .

Dudler further observed that contemporary interest in the topic of innovation appeared to owe its specific flavour to the pervasive reasoning with which the leading economists of the English speaking world had been able to translate their countries' national financial experiences into an intellectually fascinating subject for general debate ! In addition, he indicated that the popularisation of new financial products could be partly attributed to the "unique imaginative productivity of the financial services industry in Anglo-American countries and the particular appeal which financial luxury and 'pet' products can acquire in formerly puritan societies, where the public has become accustomed to indulging in unabashed financial greed...".³³ The greed is good sentiment, which emerged from the American financial markets in the 1980s, certainly did not hinder the innovation process. It ensured that those markets and also the post Big Bang London markets, were at the forefront of innovation in this period.³⁴ There were, however, other factors which contributed to the pre-eminence of these markets. These included the highly developed nature and relative importance to their economies of the markets themselves and their traditionally internationally oriented profile. The respective governments and monetary authorities had traditionally supported moves to expand and develop the markets and, in Britain at least, the old, relatively light regulatory regime encouraged innovation. Over time, the markets had attracted to them, a sizeable pool of highly skilled financial services professionals who were well placed to harness

33. Supra note 31 at p.159 .

34. This spirit was perhaps exemplified by Ivan Boesky, the American financier/arbitrageur, who was recently released from imprisonment following an insider trading conviction. He was recalled in the Financial Times of 17/11/1986 as once saying: "Greed is all right by the way. You can be greedy and still feel good about yourself." !

the advances in technology in the push towards more sophisticated and competitive practices.

In contrast, in Germany, the Bonn government has only relatively recently abandoned its indifference to the importance of the financial sector. Its focus had traditionally been on manufacturing industry, which is not altogether surprising, given its historical post-war revival. As late as 1987, one senior government official proclaimed that "the industrial sector produces the goods". There is also the Bundesbank's traditional concern for the sanctity of the Deutsche-mark and its resistance to new instruments that appear likely to weaken its control over the money supply. The Bundesbank's independence from political interference is legislatively assured and it has been able to underpin the stability of the D-Mark without fear or favour of the federal government in Bonn. Authority over the geographically fragmented secondary trading markets is divided between regional authorities, and there are strong symbiotic links between the universal banks and business. Hostile takeovers are virtually unknown in the corporate sector. Risk averse individuals have tended to shun what few equities there were, preferring bonds or savings with the banks. In this climate, it is not surprising that the demand for and consequently the supply of, innovative financial services and products has been markedly different to that experienced elsewhere.

Comment :

In summary, under the combined impact of the heretofore mentioned developments, competition amongst financial intermediaries has intensified sharply and the range of competitive influences has widened dramatically. Reduced market segmentation and the institutions' greater involvement in non-traditional service areas

have heightened the transmission of competitive impulses from market to market and from country to country. As a side effect, the risk has increased that tensions developing in a given market segment can spread quickly to a wide range of institutions operating domestically and across frontiers. The combination of financial interpenetration and of modern technological and telecommunications facilities has made individual markets intrinsically more vulnerable to shocks originating elsewhere in the financial system.³⁵ Indeed, since the global stock market 'crash' of October 1987, questions have been asked about the pace of change and whether the processes of innovation and global integration have gone too far.³⁶

It is thus unfortunate that the recent trend within the European markets has been to try to reorganise and rationalise domestic markets from an outdated view of the modern financial system which envisages the domestic market remaining the core of the system with the European and international markets revolving around it. Such a viewpoint overlooks the processes of innovation and change which have made such divisions somewhat illusory. Blind pursuit of national policies can only heighten the dangers of a market breakdown at an international level. Attempts have been and are being made by the markets themselves to encourage greater co-operation between them, but, as will be seen hereafter, these efforts have been rather half-hearted and have had limited success thusfar. It is in this context that the European Community has, by virtue of the 1992 programme, been offered an opportunity to

35. For a comment on stock market volatility, see M. Brasier "Eat your heart out ! Mars bars markets are still with us" The Guardian 5/2/1990 .

36. See for example, R. Dale "Financial deregulation after the crash" (1988) 158 Royal Bank of Scotland Review 3-17 .

address the Community financial markets as a whole in the course of the creation of a single financial services market. It is clear that the further opening up of these markets envisaged as part of the programme can only encourage the financial innovation process, as technique and technician should find it easier to move between Community markets. Whether it will unite national regulatory authorities in an attempt to bolster the security and competitiveness of the European marketplace is an open question.

In the next chapters I shall discuss why this matter has not been tackled comprehensively by the Community before now and I shall take a closer look at some of the measures which have been taken by it, with a view to creating a genuine European financial market.

CHAPTER 2 : The institutional approach to completion of the Single European Market .

1. The Commission and the Council :

In its 1983 Communication on financial integration, the Commission noted that "the specifically financial dimension of European construction is at present underdeveloped and fragmentary...and contrasts with hard-earned achievements in other fields of Community integration...A European financial market is as necessary as ever : its failure to appear is hampering the reinforcement of the common market and preventing the Community economy from efficiently tapping available savings."¹

The financial services sector is now clearly seen as an integral part of the common market envisaged by the Treaty and amplified by the 1992 programme. This was not always the case. Traditionally, it was regarded separately because of its special association with the free movement of capital. Indeed, Article 61(2) of the Treaty explicitly provides that the liberalisation of banking and insurance services connected with movements of capital should be effected in step with the progressive liberalisation of the movement of capital. This has hindered the development of the European financial market in the past as discussions on the freeing of capital movements came to a standstill in the mid-1960s. However, the failure hitherto to liberalise capital movements, and financial services in general, should be viewed as part of the greater failure of the Community to progress with the creation of the common market itself. This can be attributed to

1. COM (83) 207 final of 18/4/1983 .

the philosophical, economic and political difficulties encountered by the European Community in its recent history.

Community sclerosis :

Article 3 of the Treaty of Rome envisaged, from the outset, the establishment of a common market and the approximation of the laws of member states to the extent required for the proper functioning of that market. By 1968, a customs union was in place with no customs duties within the Community and a common customs tariff, administered by the Commission, applying to imports from non member states. The development of closer economic relations between the member states stimulated growth and accelerated the increase in living standards throughout the Community. Between 1958 and 1972 the economies of the six member states grew much faster than that of America. Britain, which was much more prosperous than any of the six when they started, had been overtaken by all except Italy when she, Ireland and Denmark joined the Community in 1973.² Following the oil crisis in 1973 and the subsequent recessions, progress in Europe slowed down and practically ground to a halt. The protectionist armoury of the member states grew stealthily during this period. National provisions regulating the production and marketing of goods could be, and were in fact used, in order to prevent access to national markets by goods originating from other member states. In this way, non-tariff barriers, based on technical and safety specifications, succeeded in fragmenting the so called common market into twelve separate markets.

2. See E.Wistrich, "After 1992 : the United States of Europe" (1989) Routledge at p.3 .

In response to the economic crises, instead of uniting to safeguard their futures, each country pursued its own protective policies and this led to serious monetary disorders with incessant exchange rate fluctuations. The effect was to inhibit intra Community trade as exporters were denied stable markets for their products. Between 1973 and 1981, industrial output in the Community rose by only 8% compared with 16% in America and 26% in Japan. Employment in the Community actually fell by three million in the 1973-1980 period, although in America it increased by fifteen million. A report commissioned by the European Parliament, the Albert-Ball Report³, which highlighted these statistics, concluded that Europe had been sacrificing its future prosperity by spending money on current consumption, instead of modernising and investing for growth. To overcome such problems, individual countries tried to find national solutions. Yet, as at least 50% of external trade was with each other, the economies of the member countries had become increasingly interdependent. It was clear that uncoordinated action was bound to fail. A good example of this was provided in France between 1981 and 1983, when the Socialist government, at the start of President Mitterand's first term of office, tried to pursue a Keynesian policy of public spending to counter the recession. The resulting inflation and balance of payments difficulties compelled the government to rapidly abandon its independent course and reverse its policies, which were threatening to force it out of the European Monetary System.

3. M. Albert & R. Ball, "Towards European recovery in the 1980s" Working Documents, European Parliament 1983-1984 Luxembourg 31/8/1983 .

By this time, the Community had settled down into one more international organisation in which diplomats and bureaucrats haggled over technicalities, with the sole interest of protecting their own national interests. In this environment, financial services was just another sector where, despite the increasingly international profile of the industry, member states sought to protect their own markets from external competition and were content to preserve high-cost, cartelised practices within those markets.

The Ideology of the Treaty of Rome :

The problems facing the Community were not just economic however. Community policy and legislation were stuck in a rut created by the underlying ideology of the Treaty of Rome, which was based on a functionalist theory of European integration. The framers of the Treaty clearly had in mind something more than economic integration - the elaborate institutional structure, the principle of qualified majority voting, the absence of a withdrawal clause and the numerous common policies provided for therein, were the essentials for a greater degree of European integration. Thus, the Treaties of Rome and Paris have been described as the concrete emanation of the functionalist theory of European unification.⁴ The functionalist approach, of which Robert Schumann and Jean Monnet were keen and politically effective proponents, started from the premise that nation states had to be deprived of their sovereignty gradually and by stealth, as they would never part with it willingly. This could be accomplished by proceeding in

4. V. Curzon-Price, "Three Models of European Integration", an essay in R. Dahrendorf (ed) "Whose Europe ? Competing Visions for 1992" (1989) Institute of Economic Affairs pp.23-38 at p.26 .

small functional steps : firstly, persuade sovereign states to co-operate with one another over a trivial technical issue (like harmonising road signs), or, make them see the wisdom of pooling resources in a particular economic sector (eg. coal and steel). Secondly, if they agreed to let these technical, sectoral matters be managed from the centre by a semi-independent authority, then all one needed to do was to gradually build up a portfolio of such agreements. As nation states got used to the approach, more ambitious projects could be attempted, with an emphasis on technical matters as far as possible. Technicians would be able to agree on technical solutions whereas politicians could never be relied upon to do so.

However General de Gaulle, for one, was not about to be deceived. He saw, in Monnet's design, a danger that French sovereignty would be destroyed by irresponsible European bureaucrats. He thus insisted on the primacy of the Council as the real decision taker and on the principle of unanimity of decisions. His stubbornness reached its apogee in 1965, when he pursued his 'empty chair' policy. This ultimately resulted in the Luxembourg Accord which was to hinder Community decision making for the next twenty years.

The Community nevertheless had to live out the functionalist fantasy in practice. Its institutions, its scope and its philosophy reflected this centralising principle - anything which could conceivably be managed from the centre should be, as it would somehow be existential proof that national sovereignty was withering away.⁵ Thus the 1970s, in particular, marked the era of absurdities, as Community and member state officials toiled to

5. Ibid at p.27 .

harmonise every technical standard detail for specific product types and services. This prompted Lord Diplock to say :

"... sometimes one has the impression that there are directives which deal with harmonisation for harmonisation's sake alone. It seems as if some conscientious civil servant in Brussels, not having enough to do, takes into his head, or is perhaps persuaded by some lobby...that there is some branch of the law which it would be fun to alter, and having started on that course it is difficult getting him to turn back."⁶

Member states resisted this approach, and even where no major political or economic interest was at stake, national administrations would insist that their standard should be adopted at a Community level. The trouble with this unwieldy approach to integration was that it posited harmonisation as a starting point. It was felt that a complete harmonisation of social, institutional and legal parameters would enable free trade in goods, services, capital and labour to also be fair trade. The principle of unanimity reduced any political will the member states may have had to zero, and thus negotiation became a tedious, lengthy process of bargaining between them. Harmonisation attempts necessarily implied a search for uniformity and an interference in the regulatory capacity of the member states. The effect of this system was to retard progress and damage the credibility of the Community in the eyes of its member states.

A New Dawn ? :

It was left to the Court of Justice to open up new perspectives for the Community institutions. In its celebrated Cassis de Dijon

6. Lord Diplock, 22/11/1977, House of Lords Official Report Vol.387 No.9 p.822 .

judgement in 1979,⁷ the Court considered the problems posed by the maintenance in force of different national standards and technical requirements. It ruled that goods produced and placed on the market in the country of origin, in accordance with the requirements in force in that country, cannot be barred as imports by other member states simply on the grounds that they do not conform to similar technical or commercial requirements in the importing country. Therefore, national regulations could only take precedence over the fundamental principle of free movement of goods, in so far as those regulations were necessary, in order to satisfy mandatory national requirements, such as the protection of the public health. This reasoning suggested that the removal of barriers to free movement could be achieved, even in the absence of harmonisation measures, and the Commission was to adopt it as the keystone of its new strategy towards legislating for the internal market.

It was clear by the beginning of the 1980s, that the plan to construct a fully integrated market had run out of steam and fresh initiatives needed to be taken.⁸ In June 1981 the Commission raised the alarm by presenting a communication on the state of the internal market to the European Council.⁹ The heads of state and government at their subsequent meeting echoed the alarm sounded by the Commission but proposed no concrete measures.¹⁰ In November

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7. Case 120/78 Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein (1979) ECR 649.
 8. For a full account of the new momentum of the 1980s, see H.Schmitt von Sydow "The basic strategies of the Commission's White Paper", an essay in Bieber, Dehousse, Pinder, Weiler (eds) "1992 : One European market ?" (1988) Nomos Verlagsgesellschaft pp.79-108 .
 9. COM (81) 313 of 17/6/1981 .
 10. Bulletin EC 6-1981, point 1.1.6 .

1982, the Commission delivered a second communication on relaunching the internal market.¹¹ At its summit meeting in Copenhagen in December of that year, the European Council instructed the Council of Ministers to decide, before the end of March 1983, on the priority measures proposed by the Commission to reinforce the internal market. The Council itself at this stage began to meet in a new formation for dealing with matters relating to the internal market. The European Parliament gave its support to the renewed drive, passing a resolution on the internal market in March 1984, based on an in-depth report by Moreau and Von Wogau.¹² The new Commission, with Jacques Delors at the helm, took office in January 1985. A week after its arrival, the new President went to the Parliament and announced the Commission's intention to ask the European Council to pledge itself to the completion of a fully unified internal market by 1992. Thus it was that at its meeting in March 1985, the European Council called upon the Commission to draw up a detailed programme with a specific timetable for the achievement of a single large market by 1992.¹³

This was the cue for the Commission to publish, in May 1985, its White Paper listing approximately three hundred proposed measures (the final figure was in fact 282), the adoption of which was seen as necessary for the completion of a fully integrated internal market by 1992.¹⁴ The White Paper was endorsed by the heads of state and government at the Milan summit in June 1985. This summit

11. COM (82) 735 of 12/11/1982 .

12. Doc. 1-32/84 of 26/3/1984 .

13. Bulletin EC 3-1985, point 1.2.3 .

14. "Completing the Internal Market" - White Paper from the Commission to the European Council 14/6/1985. COM (85) 310 final.

also agreed to hold an inter-governmental conference, to decide upon a number of amendments to the Treaty of Rome. These were intended to facilitate the achievement of the single market, and to overcome some of the difficulties encountered in Community decision making, as a result of the procedures originally laid down in the Treaty.

The Commission in its White Paper heralded its "new approach" to harmonisation of national measures. A distinction was drawn between the new strategy, which concerns the choice between harmonisation and the principle of mutual recognition, and the new approach, which concerns the possible methods of harmonisation. The new strategy answers the question whether there is a need for harmonisation, the new approach the question how harmonisation can best be achieved. The Commission acknowledged that the objectives of national legislation, such as the protection of public health, were more often than not identical. It followed that rules developed to achieve these objectives came down to the same thing and so should normally be accorded recognition in all member states. Thus it stated :

" The general thrust of the Commission's approach in this area will be to move away from the concept of harmonisation towards that of mutual recognition and equivalence."

In this light, harmonisation would only be pursued where it was considered absolutely necessary as a basic minimum as, for example, in the establishment of prudential rules for banks. Conceived for the free movement of goods (as first used by the Court in the Cassis case), the Commission extended the use of this mutual recognition approach to the services sector and, in particular, to financial services. Here, it foresaw a minimal coordination of rules as the basis for mutual recognition by member states of what each did to safeguard the interests of the

public.¹⁵ Therefore, in principle, the Community was breaking with its centralising past, according to which a single Euro norm had to be agreed upon before trade and services could be allowed to flow freely. From now on, member states would only need to agree on essential requirements in broad terms, leaving the individual countries free to decide on how to satisfy them.¹⁶ The acknowledgement of the importance of financial services, and the proposal to use the mutual recognition technique in legislation relating thereto, marked a turning point for the prospects of securing an integrated European financial market.

The product of the aforementioned inter-governmental conference was the Single European Act, which was signed in 1985, and finally came into force on the first of July 1987.¹⁷ It amended the Treaty by increasing the scope of measures that could be adopted by a qualified majority rather than by unanimity, including measures for the approximation of national provisions which would be essential to the 1992 programme (Article 18 SEA, which was inserted as Article 100a of the Treaty). This endorsed the commitment to a unified market, since two thirds of the White Paper proposals could now be adopted by majority vote. This crucial amendment meant that it was no longer possible for a member state to block proposals by a veto when it felt its vital interests were threatened. The Single Act also gave an increased role in decision making to the European Parliament, in an attempt to reduce the so-called democratic deficit. Although it is only a review function, it strengthens the Parliament's position in the institutional structure of the Community, by virtue of the

15. Ibid at Paragraph 102 . See Chapter 3 for further detail of the specific strategy adopted for financial services.

16. See Curzon-Price, *supra* note 4 at p.31.

17. Single European Act : OJ L169 29/6/1987.

pressure it allows it to exert on the institutions with the legislative power.¹⁸

The White Paper was strategically drafted so as to be as attractive to the member states as possible. Its proposals did not involve any transfers of new competences to the Community or make increased demands on the Community budget. In addition, it did not demand harmonisation of controversial political issues such as educational or fiscal policies.¹⁹ This made the endorsement of its proposals much easier. It was with the seductive objective of the achievement of a unified market glittering on the horizon, that the member states agreed to abandon the Luxembourg accord and extend majority voting in the Single Act. The Council also amended its own procedure, to allow a simple majority in the Council to call for a qualified majority vote. This can be interpreted as a sign that the member state governments did, in fact, intend to resort to voting more often. However, several clauses were inserted into the Single Act to ensure that Community rules to be adopted by majority vote would not be made enforceable against a member states' wishes. These allowed for the grant of temporary derogations or the application of national rules on the grounds of major need. The possibility to opt out was meant to ease the adoption of harmonisation measures, by giving member states the guarantee that these would not imply a renunciation of societal values which they deemed important. These clauses do not make the ideal of majority voting illusory however, because such exemptions are likely to be strictly monitored by both the Commission and the Court of Justice. It has also been argued that market unity is

18. See R. Dehousse "1992 and beyond : the institutional dimension of the internal market programme" (1989) 1 Legal Issues of European Integration 109-136 .

19. Ibid at p.114.

less likely to be impaired by occasional derogations, than by the perpetuation of a fragmentation due to the failure of most harmonisation attempts.²⁰

A European Federation ? :

The White Paper and the Single European Act have potentially much wider implications than those relating to the 1992 programme. The Padoa-Schioppa report²¹ declared that :

"The White Paper marks the transition from a monolithic conception of the Community's integration process in which national legislation and powers are replaced by Community powers, to a pluralistic, pragmatic and federalistic conception in which national legislation will not be replaced but framed in a way that respects Community requirements."

This new direction is consistent with two essentially federalistic principles, namely the principle of subsidiarity on the one hand and a respect for other people's differences on the other. Federalism in this sense, is a means of reconciling a minimum of unity with a maximum of diversity.²² The principle of subsidiarity requires that the higher level of government should only take on functions that deliver public goods that cannot be effectively provided by a lower level of government.²³ Federalism thus emphasises the need to keep the centre weak and the periphery strong, and implies a belief in the ability of lower level institutions to solve most problems - otherwise it would not be

20. See J.Weiler "The White Paper and the application of Community law" in "1992 : One European Market ?" supra note 8 p.337-358 .

21. Cited supra in the Introduction note 5, at p.76 .

22. Curzon-Price, supra note 4 at p.24 .

23. Supra note 21 .

able to accomodate diversity. In the Community context, this would imply that Community action should be limited to fields where it is absolutely necessary for market integration, or where it can reach better results than the member states.

The subsidiarity principle is applied in two aspects of the approach adopted by the Commission in the White Paper. Firstly, the Commission prefers to work through directives, which leave the method and form of implementation of the legislation to the decision of member states.²⁴ The directive thus makes it possible to combine the requirements of unity in terms of ends and diversity in terms of means. Article 100a of the Treaty, which relates to the approximation of laws, provides only for the adoption of 'measures' by the Council, thus leaving the choice of Community legislative tool to the Commission in the first instance. However, the inter-governmental conference which produced the Single Act explicitly invited the Commission to give precedence to the use of directives. It has been argued that this rationale for the use of directives should not apply where the content of harmonisation measures is already governed by the principle of subsidiarity. If post White Paper Community measures are to be restricted to essential minimum requirements, then, ex hypothesi, these objectives are so central that they can be regarded as forming the end of Community action, which should be given full effect by the use of regulations.²⁵ Since regulations do not have to be transposed into national

24. Article 189 of the EEC Treaty provides that :
"A directive shall be binding, as to the result to be achieved, upon each member state to which it is addressed, but shall leave to the national authorities the form and methods."

25. See Dehousse, supra note 18 at p.132 .

law,²⁶ this solution would have significant advantages, especially in light of the increased burden of transposition imposed on member states by the internal market programme. Thusfar, however, an increased use of the regulation does not seem to have been contemplated by the Community institutions. In any event, the directives to be discussed in chapter three in the financial services field, have been based on Articles 54 and 57, which do not allow for the possibility of using regulations.

The second application of subsidiarity is where the Commission decides that the use of a centralised form of harmonisation is still required. In spite of its new strategy in favour of mutual recognition, harmonised rules and standardised products may still be necessary for industry to obtain economies of scale and compatibility in a homogenous market. The new approach stipulates that the Council should limit itself to defining the essential objectives and requirements, and should off load technical and executive matters. These issues are, wherever possible, to be left to non-governmental standardisation bodies preferably at a Europe wide level such as the Comité Européen de la Normalisation (CEN), who are better placed to perform such a task. This reference to standards technique had first been used in the so called 'Low Voltage' directive²⁷ in 1973, and had been recommended by the

26. Article 189 of the Treaty provides that :

"A regulation shall have general application, it shall be binding in its entirety and directly applicable in all member states."

27. OJ L77 26/3/1973. See C.Joerges "The new approach to technical harmonisation and the interests of consumers.." in "1992 : One European Market ?" supra note 8 p.175-226 .

Council even before the White Paper was finalised.²⁸ This is an efficient method of lightening the work load of the Community legislator and a prime example of the application of the subsidiarity principle. However, its effectiveness has been questioned due to the concerns expressed in relation to the delegation of powers by the Community legislator.²⁹ There were at least ninety proposals requiring such a traditional harmonisation in the White Paper itself. A not dissimilar approach has been utilised in the second Banking directive (see chapter 3). Here, the Council has largely adopted the solvency ratios recommended by the Cooke Committee in Basle, rather than attempting to set its own competing standards. It has therefore chosen to follow the advice given by banking specialists, who had conducted a specific international review of banking policy and practice in the area in question.

So a new dawn may be breaking for the prospects of finally achieving an integrated European market. But what pressures prompted this new "renaissance" ? Hoffman points out that, in 1984, disenchantment with Keynesian policies, the wave of economic liberalism spreading from Reagan's America, the recognition by French and Spanish Socialists of the superiority of the market over a command economy, of the futility of nationalisations and of the virtues of competition, all combined to create the right climate for a European revival.³⁰ The main goal was competitiveness of Europe in a world in which the number of

28. Council resolution of 7/5/1985, OJ C136/2 4/6/85, together with the Council's conclusions on standardisation of 16/7/1984 which are annexed thereto : See also Dehousse, supra note 18 at p.125 .

29. See Joerges and Dehousse, supra notes 27 and 18 respectively.

30. S.Hoffmann, "The European Community and 1992" (1989) Vol.68 No.4 Foreign Affairs p.27-47 .

industrial and commercial players had multiplied. The stake was what Helmut Schmidt had once called the struggle for the world product, rather than for traditional power.³¹ The political will needed to harness this spirit was also in place. President Mitterand, after the fiasco of his first economic and social policy, was determined to use the six months of his presidency of the European Council in 1984 to make spectacular progress. The German chancellor, Helmut Kohl, could only view with favour a plan that would, on the whole, benefit West Germany's strong industrial sector. The British prime minister, Margaret Thatcher, as an apostle of deregulation, had no reason to resist, and was also eager to prove that Britain was not the saboteur of the Community it had often seemed, and continues to seem, to be. The Single Act was thus presented to the British Parliament as a Treaty that would make it possible to bring to Western Europe all the benefits of deregulation, whilst preserving, through the requirement of unanimity for certain measures, national sovereignty in areas essential to Britain such as taxation. Above all, the new President of the Commission was Jacques Delors, the former French Minister for Finance. His commitment to a united Europe was very strong, and he acknowledged that economic integration would have to precede social harmonisation and that deregulation had to take priority. However, savage capitalism is not his ideal, his belief is that cooperation must temper competition and that harmonisation must complement the destruction of barriers.

In July 1988, during a speech made to the European Parliament, Jacques Delors declared his conviction that as a consequence of the Single Act, within ten years 80% of economic legislation - and maybe even social and fiscal legislation as well - would be of a

31. Ibid at p.33 .

Community origin. Delors's vision for the new Europe is of a European Parliament with greater powers, a more energetic supervision of Community decisions by national parliaments, more powers of enforcement for the Commission and greater independence for its members. His logic is ultimately that of the construction of a federal state, albeit one that would only deal with issues the member states could not resolve themselves.³² The strident Mrs Thatcher has rejected such a vision of a United States of Europe. Her views, as expressed in a speech in Bruges in September 1988, offer a vision of a European Community based on willing and active cooperation between independent and sovereign states. She clearly shares De Gaulle's view that independence and national sovereignty must not be compromised or shared. It has been suggested, that this similarity in outlook could stem from the dominance which both leaders gained whilst in power in their respective countries.³³ Wistrich suggests that an appropriate explanation could be that advanced by the scientist Sir John Boyd Orr, who, noting the reluctance of some statesmen to delegate sovereignty, suggested in 1940 that "the psychologist should try to find reason for this prejudice...It is probable that the leaders identify the state with themselves and feel that the loss of sovereign power would be a loss of their personal power."³⁴

32. See Hoffmann, supra note 30 at p.41 .

33. See E.Wistrich supra note 2 at p.16. He also makes a spirited criticism of the Bruges speech at pp 12-16.

34. J.Boyd Orr in his essay "Federalism and Science", a contribution to in M.Channing-Pearce (ed): "Federal Union" (1940) London.

2. The Court of Justice :

As full economic and monetary union looms larger on the European horizon, it is clear that the steps taken in the 1980s by the European Community and its member states have greatly increased the likelihood of the achievement of the Single Market, if not by 1993, by the end of the decade. This possibility has been assisted by the Court of Justice, which has endeavoured to give a broad textural interpretation to the Treaty and its application in the cases that have come before it. The cathartic effect of the *Cassis de Dijon* decision has already been noted. Until recently, there were virtually no judgements of the Court specifically concerned with the field of financial services. This was especially so, if one ignored exchange control, and confined discussion of the competition rules of the Treaty to the bare statement that the Court has unequivocally held that they apply to the banking and insurance fields.

In the *Zuchner* case,³⁵ the Court refused to accept that banking services were of such a special nature or of such general economic interest that the rules of Articles 85 and 86 should not be applied thereto. In the *VDS* case,³⁶ the Court held that in the absence of any express derogation to that effect, the Community competition system applied without restriction to the insurance industry. In addition, this case suggested that where an agreement appears to relate only to the national market, if it nonetheless affects branches in that market of companies based in other member states, who could otherwise offer a more competitive service, it

35. Case 172/80 *Zuchner v Bayerische Vereinsbank* (1981) ECR 2021.

36. Case 45/85 *Verband der Sachversicherer*, judgement of 27/1/1987.

may then be capable of affecting trade between member states within the meaning of Article 85(1). It will be interesting to see how the Court applies this reasoning in future competition cases in this sector. Usher raises another issue with regard to the application of the competition rules to financial services, namely the status of inter-bank agreements relating to interest rates.³⁷

It had been suggested by the Commission that such agreements could be considered as monetary policy instruments of the member states and thus excluded from the ambit of the competition provisions. However, in the aftermath of the Zuchner judgement, ex Commissioner Peter Sutherland was reported as having stated that:

"The osmosis which sometimes exists between supervisory authorities and those they supervise blurs a distinction between genuine monetary policy and cartels."³⁸

This interaction between monetary policy and banking activity regulation is reflected in the second Banking directive which entrusts host member states with complete responsibility for measures resulting from the implementation of their monetary policies.

The Court finally received an opportunity to address the financial services sector directly in its judgement in the so called "insurance cases",³⁹ which were decided in December 1986. Here, the Court grappled with the interpretation of the right of establishment and the freedom to provide services in the Community, in the context of the provision of financial services.

37. J.Usher "Financial Services in EEC Law" (1988) 37 ICLQ p.144-154 at p.150 .

38. Agence Europe No. 4543, 6 May 1987 at p.9 .

39. Cases 220/83 Commission v France , 252/83 Commission v Denmark , 205/84 Commission v Germany and 206/84 Commission v Ireland . (1987) 2 CMLR 69 .

The approach adopted by the Court has been reflected in subsequent legislation proposed by the Commission. The significance of the judgement lies in the fact that it sets out the present state of Community law on the matter. Therefore, one will have to rely upon the terms of the judgement for guidance in the absence of specific Community harmonisation measures.⁴⁰ In addition, certain of the Community measures proposed or adopted, the Investment Services directive is one example, are content to refer the addressee solely to the relevant Treaty provisions, in certain circumstances. This will also indirectly lead to a review of the decision, which comprehensively interpreted the provisions in question. Thus, the relevance of the decision will be maintained even when Community measures are put in place. The judgement is also notable because, though dealing with insurance, it is largely applicable to the financial services field as a whole, and because it was the first substantial case on these Treaty freedoms to be decided after the landmark Cassis de Dijon decision.

The law as understood prior to the decision was briefly as follows. The Treaty, in this context, distinguishes between establishment and services as being two ways of supplying services into member states other than the state of residence. The right of establishment (Articles 52-59 of the Treaty) refers to the right of Community nationals, both individuals and legal persons, based in one member state to set up in another. In *Commission v France*,⁴¹ a case involving French taxation laws, this right of establishment was interpreted so as to entitle any person wanting to set up an establishment in another country, to make use of all

40. See J-W.Eberling "The proposed second banking coordination directive" (1990) Vol.15 No.1 ELR 60-68 .

41. Case 270/83 *Commission v France* (1987) 1 CMLR 401 .

forms of establishment mentioned in Article 52(1) ie. a branch, subsidiary or agency. This interpretation of the right barred discriminatory French tax regulations which made access to one form of establishment more expensive than to the other. This suggests that a state may not deny to foreigners the right to make use of all forms of establishment provided for in Article 52, even if it does so with regard to its own nationals.

In contrast, the freedom to provide services (Articles 59-67 of the Treaty) entitles the provider to offer services from base to someone in another member state, in the course of which he may, if necessary, temporarily pursue his activity in the state where the service is provided. In its declaratory judgement in the Van Binsbergen case,⁴² the Court interpreted the requirement of Article 59 that restrictions on the freedom of services be abolished, as entailing the abolition of discrimination against the person providing the service by reason of his nationality or of the fact that he is established in a member state other than that in which the service is provided. Thus the difference drawn between establishment and services could be seen to be one of location and degree, not of kind, indeed the services provided may well be identical. The existence of this indistinct, grey area traditionally led to an avoidance of drawing a clear dividing line between the two, but the Court attempted to do so in the insurance cases.

42. Case 33/74 Van Binsbergen v Bedrijfsvereniging voor de Metaalnijverheid (1974) ECR 1299 .

The Insurance Cases :

These were a series of cases brought by the Commission under Article 169 of the Treaty. They asked the Court to rule on the compatibility with Articles 59 and 60 of the Treaty, of national requirements that would-be providers of insurance services be established and authorised to do business in the destination state. In each of the cases, Ireland objected that the Commission was in effect asking the Court to do the Council's job : the subject matter of the draft second directive concerning non-life direct insurance, which was under discussion at the time, was precisely the scope of this freedom to provide insurance services. The Court observed that the Commission could take action under Article 169 if it considered that a member state was failing to fulfil a Treaty obligation, even if a proposed Community measure would, if adopted, put an end to the infringement.⁴³ It is therefore clear that the Commission will have a right of action under Article 169, even where negotiations on single market measures which may impact on the proceedings in question are taking place.

The German case was the most interesting of the cases, particularly in the light of the ruling given previously by the German court of last instance in the Schleicher case.⁴⁴ There, the accused was a German insurance broker who had placed business for a German resident with a London based insurer. He was prosecuted on foot of a law prohibiting German insurance brokers from arranging insurance for German residents with insurers established in another member state. The court of last instance upheld his

43. Paragraph 7 of the judgement, supra note 39 .

44. Judgement of the Kammergericht , Berlin 22 April 1983 .

conviction and refused to refer any questions of Community law to Luxembourg on the grounds that, in its view, the German provisions were fully compatible with Community law.

The Commission challenged the compatibility of this restriction with Articles 59 and 60 of the Treaty. It also argued that the restrictions on intermediaries could not be justified since the German law did not prevent German residents from dealing directly with foreign insurance companies. The Commission and Germany disagreed as to whether an intermediary was acting on behalf of the policyholder or the insurer respectively. This raises the significant question of the role of financial intermediaries in general, as more and more financial services business is conducted through intermediaries and by remote and electronic means rather than in the flesh. The Court held that Community legislation provided no basis on which it "could hold that an intermediary is acting on behalf of one or other of the parties to an insurance contract".⁴⁵ On any view, it felt, an insurance contract represented a service by the insurer to the policyholder. Regrettably, the Court did not deal separately with the restriction of brokers activities, preferring to treat it as a corollary of the establishment requirement imposed upon insurers.

The Court formulated a distinction between establishment and cross-border provision of services. It held that an insurance undertaking of another member state, which maintains a permanent presence in a host member state, comes within the Treaty provisions on establishment, "even if that presence does not take the form of a branch or agency, but consists merely of an office managed by the undertaking's own staff or by a person who is

45. Paragraph 16 of the judgement, supra note 39.

independent but authorised to act on a permanent basis for the undertaking as would be the case with an agency".⁴⁶ A narrow interpretation of this definition of establishment could reduce freedom of services to a dead letter. Is the Court suggesting that any permanent presence in a host member state is an establishment? Taken at face value, this could prevent an operator in the services sector from providing services into any member state in which it had an agent whose functions were extremely circumscribed. The establishment criterion could even extend to a representative office with no authority to do business on its own, but existing solely for the purpose of referring business to head office, to be provided by way of services.⁴⁷ The existence of a permanent presence might even preclude the writing of other classes or sizes of risk or even the same class of risk by way of services by the parent undertaking from another member state. Such an interpretation would reduce freedom of services to a very small role, not only in insurance, but also in banking and other areas, where it could seriously undermine existing commercial practices. This paragraph should, perhaps, therefore, be placed in its wider context and read in connection with the operative part of the judgement. It would then appear to mean no more than that the rules of establishment must be taken to apply fully to all operations carried out by or through such a 'permanent presence'. Thus, freedom of services could be relied upon where the 'permanent presence' was not actively involved in the provision of the service in question.

46. Paragraph 21 of the judgement, supra note 39.

47. See J.Flynn "Right of establishment & freedom to provide services - caselaw of the Court of Justice relevant to financial services" (1988) JISEL 71-85. See also U.Everling "Sur la jurisprudence récente de la Cour de Justice en matière de libre prestation des services" (1984) 20 CDE 3-15.

The Court then confirmed its judgement in Van Binsbergen,⁴⁸ where it held, inter alia, that a supplier cannot avail of the freedom of services, if its activity is entirely or principally directed towards the territory of one other member state and if it provides services under Article 59 from outside, for the purpose of avoiding the professional rules of conduct of that state. In this instance, it held, a member state is justified in taking measures to prevent such abuse. However, having thus quoted Van Binsbergen, the Court proceeded to omit the subjective test contained therein, in applying the case to insurance. In its concluding paragraph on this aspect, it referred to the provision of insurance services to a resident in a member state by an insurer who does not maintain any permanent presence in that state, or "direct his business activities entirely or principally towards the territory of that state".⁴⁹ The Court made no reference to the element of intention to avoid regulation prompting the decision to offer services from elsewhere in the Community, which was the key to the Van Binsbergen dictum. The test was solely whether the provider directs all or most of his business activities towards the destination state. An undertaking may have all sorts of commercial reasons for concentrating on a particular export market, and if this case lays down a presumption that such activity is carried out to avoid host state regulation, it is regrettable.⁵⁰ It may be proven that the Court simply declined to repeat the full Van Binsbergen formula in its summing up on this point. In this light, the dictum could be narrowly interpreted, limiting its effect to those instances where abuse may arise.

48. Supra note 42.

49. Paragraph 24 of the judgement, supra note 39.

50. See J.Flynn "Insurance : recent judgements of the European Court of Justice (1988) 37 ICLQ p.154-172 .

The Court noted that Community law, as it had accepted in its Van Wesemael decision,⁵¹ tolerated the regulation of services depending on their particular characteristics. However, it stressed that the freedom to provide services is a fundamental principle of the Treaty and restrictions on it must be justifiable by the general good and be embodied in rules applying to everyone operating within the state concerned. Such restrictions cannot be applied if the relevant interests are safeguarded by the rules applying to the provider of services in his home state. Such requirements also have to be objectively justified by the need to ensure compliance with professional rules of conduct, and the de facto protection of the interests which such rules are designed to safeguard. Lasok argued that this limitation on the scope of the Treaty provisions does not reflect an inherent limitation on the freedom to provide services. It is, essentially, an intrinsic limitation on the direct effect of the prohibitions in Articles 59 and 60, which will be progressively removed by the adaptation of secondary legislation by the Community institutions which will deprive the national rules of their justification.⁵² It is also arguable that the direct effect of Article 59 can be seen to depend on policy considerations in each individual case, and the question remains whether these policy arguments will still be able to be relied upon when the Community has enacted measures of approximation or coordination.

Not altogether surprisingly, the Court then found that the German requirements of establishment and authorisation constituted

51. Joined cases 110 and 111/78 *Ministère public and another v Van Wesemael* (1979) ECR 35 .

52. See K.Lasok "Freedom to provide insurance services in the light of the 'coinsurance' cases" (1988) 51 MLR 706-734 at p.726 .

restrictions on the freedom to provide services, inasmuch as they increased the cost of such services in the state in which they were provided, in particular where the insurer conducts business in that state only occasionally.⁵³ Steindorff argues that, by referring to the costs imposed on the foreign provider, the Court has opened the door for the inclusion of all state measures influencing the costs of the provider, into the restrictions to be abolished under Article 59.⁵⁴ He points out that the Van Binsbergen case had been decided before Cassis de Dijon and that, in its pleadings in the insurance cases, the Commission had invited the Court to adapt the criteria of Article 59 to those used for Article 30, which relates to the free movement of goods. The Commission, in this respect, cited *Rau v de Smedt*⁵⁵ where the Court had confirmed its previous jurisprudence in relation to Article 30. Community law, that case suggested, is violated if there is no discrimination against foreign goods and if interstate trade is not excluded or barred, but merely rendered more expensive or difficult. It thus seems that the Court would now be prepared to evaluate under Article 59, all state measures that create costs for the provider of services as well as those that discriminate against the said provider.

The Court next held that the insurance sector was, nonetheless, one area in which restrictions might well be justified by imperative reasons relating to the public interest. This was because the size and sensitivity of the sector had led all member states to lay down a web of regulations to protect the consumer, in particular, both as a policyholder and as an insured person.

53. Paragraph 28 of the judgement, supra note 39.

54. E.Steindorff "Freedom of services in the EEC" (1988) 11 Ford.Int. LJ 347-408 .

55. Case 261/81 *Rau v de Smedt* (1982) ECR 3961 .

The judgement might then be expected to have examined whether the restrictions complained of were justifiable, whether the public interest was already protected by the rules of the home state or whether the same result could have been obtained by less restrictive rules. That it did not quite follow that pattern was due mainly to the way in which the Commission pleaded its case, and to the content of the Community directives already in place which dealt with direct life and non-life insurance. These directives did not regulate the cross border provision of insurance services.

The Court found that the extent of this prior Community harmonisation was insufficient, in two respects, to obviate the need for host state supervision. Firstly, the host state should still be responsible for laying down rules concerning the sufficiency and valuation of technical reserves. Secondly, as no attempt had yet been made to harmonise the conditions of insurance contracts ie. their contractual terms, this should also remain the responsibility of the host state supervisor. These significant powers for the host state would continue in the absence of Community legislation (both of these matters were to be covered by the proposed second non life insurance directive), provided that it did not exceed what was necessary to ensure the protection of policyholders and insured persons.

The Court concluded that prior authorisation was an appropriate means of supervising compliance with these rules. The Commission had to some extent conceded this point, in recognising that a measure of supervision by the host state was justified. Although objecting to an authorisation requirement, it had not proposed how, short of authorisation, such a system might work. The Court held that such authorisation must be granted on request to an insurer complying with the rules, which must not duplicate

conditions already satisfied in the home state or repeat verification exercises carried out there. The German government asserted that its authorisation procedure satisfied that test and the Commission did not contradict it on that point. No reference was made to the length of time or the expense involved in obtaining a German authorisation.

The Court stressed that authorisation was only justified to the extent necessary to protect the consumer. It stated that the protection argument did not apply equally to every sector of insurance. "There may be cases", it said, "where, because of the nature of the risk insured and of the party seeking insurance, there is no need to protect the latter by the application of the mandatory rules of his national law."⁵⁶ The Court was not willing to effectively legislate by laying down criteria for deciding when a policyholder was big enough to look after himself. This distinction between different classes of consumer requiring different levels of protection has been incorporated in the Investment Services directive, which draws a distinction between professional and other investors.

The Court went on to hold that, in particular, in the field of co-insurance, there was no justification for the German requirement that the leading insurer should be authorised by the German authorities. Here the arguments for consumer protection did not have the same force as in connection with other forms of insurance, since co-insurance arises in the context of insurance taken out by "large undertakings or groups of undertakings which are in a position to assess and negotiate insurance policies

56. Paragraph 49 of the judgement, supra note 39.

presented to them".⁵⁷ In any event, Council directive 78/473 already provided for sufficient coordination and cooperation between supervisory authorities in the member states in this particular branch of the sector.

As regards the establishment requirement, the Court found that this was the very negation of the freedom to provide services. However, it did not completely prohibit the possibility of maintaining in force such a requirement, saying that it would have to be shown to be indispensable to the attainment of the objectives pursued by the authorities in question.

Comment :

It is a pity that the unfortunate Herr Schleicher's position was not clarified by the judgement. It was suggested after the decision that it would still be unsafe to advise German brokers that they could, with impunity, place business with foreign insurers having no permanent presence in Germany.⁵⁸ The issue of how Articles 59 and 60 apply to restrictions placed neither on the provider, nor on the recipient of the service but on the intermediary, is no clearer. Indeed the question can be asked whether this would be a restriction on the broker's freedom to provide services, either to his client or to the foreign insurer or is it a restriction on the freedom of the resident to receive services either from his broker or from the foreign insurer via the broker? Support for the claims of the recipient of services can be gleaned from the decision in *Luisi and Carbone*,⁵⁹ where the

57. Paragraph 64 of the judgement, supra note 39.

58. See Flynn supra note 50 at p.165 .

59. Cases 286/82 & 26/83 *Luisi and Carbone v Ministero del Tesoro* (1984) ECR 377 .

Court held that the freedom to provide services included, as a necessary corollary, the freedom for the recipients of services to go to another member state to receive a service there. The Court added that persons travelling for the purpose of business should, in this context, be regarded as recipients of services.

The Court was also able to avoid the difficult task of judging whether regulatory control in other countries is equivalent to that under German law, because the Commission produced no evidence on this point. Had it been raised, the Court may have been forced to assess not only the legal and administrative rules of different member states, but also the effectiveness of their enforcement. Thus it could have discovered that Danish authorisation and supervision requirements, for example, were sufficiently thorough and were merely duplicated by the German requirements. It has been pointed out that the Commission may have hesitated to raise that point for a particular reason.⁶⁰ If one follows the Court in not permitting additional control in the host state, when there is sufficient control in the home state, the result would be a situation where equivalent control exists in some member states and is lacking in others. Therefore, providers of services from some countries would have to suffer control in the host state, while others would not. This would only complicate matters for firms attempting to offer their services outside of their home state.

It follows, from the law as to the free movement of goods, that in principle this power of member states to protect general interests comes to an end when Community measures have 'occupied the field'. Once directives for the approximation or coordination of laws have

60. See Steindorff supra note 54 at p.384 .

been enacted, the states should not be able to deviate from these for the purpose of protecting the general interest. However, both the second Banking and the Investment Services directives contain exclusion clauses allowing member states to impose their own legislation for the protection of the public good on suppliers from other states. As the legislative programme for the completion of the internal market progresses, the focus will shift from existing national regulatory rules to the implementation of Community rules by member states, and this will raise different legal issues in due course. Regulation cannot just be suppressed if the Community does not wish to sacrifice consumer protection and other aims for the freedom to provide services. Indeed the thrust of the Single European Act is towards a high level of consumer protection, as was noted in Article 18 of the Act (Article 100a (3) of the amended Treaty). The difficulty is in the balancing of the legal protection of consumers and the furthering of interstate trade. The attempts made to strike this balance in the financial services sector will be analysed in the next chapter.

CHAPTER 3 : The Community approach to financial services legislation.

The challenge :

The White Paper declared that the liberalisation of financial services, linked to that of capital movements, would represent a major step towards Community financial integration and the widening of the internal market.¹ That the potential of the Community financial market is huge is evident from the Cecchini report, but it is arguable that the current barriers to such integration are no longer the product of national boundaries, restrictions and cartel arrangements. As already illustrated, the combination of technology and economic and political circumstances has globalised financial markets and the exploitation of financial technique has overcome barriers previously maintained by the multi-currency structure of the market. However, there are still two fundamental difficulties which will delay and possibly jeopardise the establishment of a single integrated market for financial services in Europe. Firstly, the problem of reconciling vastly different institutional structures and traditions in order to achieve a truly harmonised regulatory regime. Secondly, despite the sweeping away of restrictive practices in the main European financial centres, fragmentation of the market is likely to

1. Supra chapter 2 note 14. The gallop towards economic and monetary union, the subject of the inter-governmental conference scheduled for Rome in late 1990, is obviously of great import to Community financial integration. I have chosen, however, to concentrate on the specific measures tabled for the financial services industry itself.

persist due to deeply entrenched investor habits and customs.²

At the heart of this problem is a basic difference in traditions of capitalism within Europe. The first is the Anglo-Saxon preference for financial markets as sources of corporate finance and outlets for investment. This tradition relies on equity capital, strong shareholders, relatively open capital markets, a range of different sorts of institutions active in them and arm's length relations between banks and industry. Banks in London were only finally admitted to Stock Exchange membership as part of the Big Bang deregulation. The second tradition is exemplified by that of West Germany, which is dominated by its universal banks. West German finance, as already noted in Chapter one, relies on strong links between banks and industry which, itself, favours loan finance.³ German banks are members of the comparatively underdeveloped stock markets. Investors and savers prefer fixed income assets and generally invest and save through their banks. Financial products are more restricted and so are the methods by which they are sold.

Inevitably this conflict has created a difference in approach to financial regulation. In the former tradition, there is a functional approach to financial regulation which tends to

2. See S.Yassukovich "The Euro-Financial Services industry after 1992 : Regulation and the competitive challenge" (1989) Butterworths Journal of Int. Banking and Financial Law 201-203 .

3. See however S.Holberton "Envy of West German financing unfounded" Financial Times 22/6/1990 at p.10 , a comment on a report by C.Mayer & I.Alexander "Banks and Securities Markets : corporate finance in Germany and the UK" , which suggested that, in fact, the aggregate of sources of finance in both countries is remarkably similar (report published by the Centre for Economic Policy Research, London).

encourage the pursuit of securities activities through a separately capitalised entity. Distinct regulatory authorities supervise the performance of different functions. When an institution seeks to carry out securities activity within an entity operating under a banking licence, for example, the Bank of England (in its capacity as banking supervisor), acts as lead regulator and applies the principles of The Securities Association (the securities trading supervisor), in regulating the securities side of the business. In the latter tradition, a consolidated approach is adopted. Universal banks carry out commercial banking and investment banking activities within a single corporate structure which is subject to a single regime of financial regulation, applied by a central bank or another banking supervisory authority.

It would be foolish to attempt to make a choice between the two systems. Each has its drawbacks - grey areas and borderline problems are a consequence of the functional approach, and divergences in public policy objectives are likely when applied to different intermediary activities. A functional approach does not assist in developing ways in which self-regulatory and official bodies can be welded into an effective global system of supervision.⁴ In the universal banking system, it is generally understood that the central banks stand behind the deposit taking function of commercial banks in their capacity as lenders of last resort. Where securities activities are carried on by these same commercial banks under a single regulatory regime, applied by a single supervisor, the implication might be that the central bank

4. For an account of some of these difficulties in the English system, see "Changing boundaries in financial services" (1984) 24 Bank of England Quarterly Bulletin 40-45 .

will 'guarantee' commitments of the commercial banks in their securities activities as well. This is known as the "moral hazard" problem and can encourage greater risk taking by institutions in their investment activities. In this situation, investment services clients of these institutions are likely to feel secure regardless of the conduct of business standards applied by the institutions, and these standards are likely to suffer as a result.

The securing of a convergence of these different styles of capitalism, or, at least, a mutually beneficial co-habitation, was always going to be a difficult task for the Community and one it could not relish. It has been stressed that the Commission has no desire to do away with the rich traditions and characteristics of national markets in its attainment of the single financial market goal.⁵ The White Paper bears witness to a concerted attempt to integrate the financial markets which clearly had not been a priority objective up till then. Indeed, the Community initiatives with respect to securities and markets prior to 1985, have been described as at best timid and partial.⁶ The existence of exchange controls in most member states, together with the close association of financial markets with economic and monetary policy, had discouraged any attempts to open up these markets.

An example of the ineffectiveness of the Commission's efforts in this sector could be seen when, in 1977, it published in the form of a recommendation, its European code of conduct relating to

5. J-M.Fombellida , head of the division "Stock Exchanges and Securities" - DG 15 of the Commission, in an interview with the author on the 18/4/1990 .

6. See E.Wymeersch "Aspects de l'action communautaire dans le domaine des valeurs mobilières" (1989) No. 5-6 CDE 593-607 .

securities transactions.⁷ The Commission desired that the code be seen as separate from its other harmonisation work in the sector, because it gave an ethical approach priority over a legal approach. It declared that it was anxious to take full account of the dynamics of the financial market and of business life. It was seeking to improve the machinery of the market and the effectiveness of those operating on it. The Commission's specific aim in promulgating the recommendation was to create a unitary formulation of a number of principles already recognised by member states, which it hoped would lead to common professional business ethics on these issues. The code received a lukewarm reception and it is still relatively unknown to this day. In West Germany, the text was published by the Ministry of Finance without two of its recommendations on transferring or acquiring holdings conferring control of a company ie. strategic holdings. It seemed that these particular provisions were difficult to reconcile with German law and practice.⁸

Thereafter, Community measures tentatively sought to facilitate the access of securities to different Community stock exchanges, through harmonising the minimum conditions for their admission and coordinating the requirements regarding the contents of listing particulars. Wymeersch observed that the Community measures in this period were more concerned with the companies which used the

7. Commission Recommendation of 25/7/1977 : COMM 77/534 EEC , OJ L212/37 . Article 155 of the Treaty provides that the Commission shall formulate recommendations on matters dealt with in the Treaty, if it expressly so provides or if the Commission considers it is necessary. It is apparent from Article 189, however, that recommendations have no binding legal force.

8. See R.Buxbaum and K.Hopt "Legal harmonisation and the business enterprise" (Volume 4 in the Integration through Law series) (1988) Walter de Gruyter & Co at p.23.

stock markets, than with the markets themselves. He opined that these securities related measures were a specialised extension of the Community's better and longer established legislative efforts in the field of company law.⁹ The policy seemed to be to encourage and facilitate multiple quotations of company securities which would aid the growth and capacity to raise finance of their issuers.

The Commission in more recent times supported, both financially and vocally, the efforts of the Committee of Stock Exchanges in the EC to establish an inter-bourse data information system (IDIS). This was intended to electronically link different European exchanges and thus create an international share price information system. The aim of the scheme was to break down barriers between Community stock exchanges, and ultimately to create a Community wide trading system for securities of international interest. Such an interlinking, the Commission suggested in the White Paper, would substantially increase the depth and liquidity of Community stock exchange markets, and would permit them to compete more effectively not only with stock exchanges outside the Community, but also with unofficial and unsupervised markets within it.¹⁰ So much for the Community rhetoric : the idea never really caught on, in part because few stock markets at the time carried prices electronically and partly because it was cumbersome, effectively necessitating a web of bilateral agreements between national markets.¹¹ Thus the enthusiasm and impetus for the plan was not as great as the Commission might have hoped, and it subsequently focused its

9. Supra note 6 at p.600.

10. Supra chapter 2 note 14 at paragraph 107 .

11. See R.Waters "Pipe brings dream of Euro-Bourse closer to reality" Financial Times 19/4/1990 .

attentions on its legislative programme, entrusting such technical matters to the markets themselves.

The methodology :

The Commission was clearly still optimistic about the prospects of the IDIS project in 1985. That European stock markets are currently negotiating on forming a new collective price information system which could ultimately lead to a full blown trading system,¹² is in no small measure attributable to the approach adopted by the Commission in its White Paper. The Commission therein put the emphasis on the free circulation of financial products, which was being made ever easier by developments in technology. It drew a comparison between its approach after the Cassis de Dijon decision regarding industrial and agricultural products, and what had to be done for consumer credit, participation in collective investment schemes etc.¹³ Thus, the Commission considered it would be possible to facilitate the exchange of such financial products at a Community level, using a minimal coordination of rules on such matters as financial supervision, as the basis for mutual recognition by member states of what each did to safeguard the interests of the public. Such harmonisation, it felt, could be guided by the principle of "home country control". This entailed attributing the primary task of supervising the financial institution to the competent authority of its member state of origin, with the authorities of host member states having a complementary role. This would require a minimum

12. Ibid.

13. Supra chapter 2 note 14 at paragraph 102. See also the Communication from the Commission concerning the consequences of the Cassis de Dijon judgement OJ 80/C 256/2.

harmonisation of surveillance standards, which was subsequently clarified to mean essential or key prudential standards.¹⁴

Before considering the legislative measures themselves, it is important to note that the application of the Cassis de Dijon 'philosophy' to financial products as opposed to other products, though a strategic and devious move by the Commission, has inherent limitations. The nature of a financial product is fundamentally different to that of a manufactured good, in that the stability of the producer, the quality of the product and the long term character of the product imply that supervision of the financial sector is a necessary guarantee or element of the product itself. As Louis phrased it, there is a more evident and permanent tie between the provider of a service and its consumer, than between a vendor of a good and its purchaser.¹⁵ It can also be seen that in this sector, the pursuit of an activity very often does not give rise to a separately identifiable product - it is more usual for the product to be the pursuit of the activity itself.

Among the measures envisaged by the White Paper was a directive on investment advisers. It is not entirely clear what was intended to be covered by this directive. In early discussions at the Community level, there was some concern as to whether investment advisers should be included in the legislation at all. This was on the grounds that, in many member states, investment advice was not

14. See G.Fitchew, cited supra in the Introduction note 2 at p.2.

15. J-V.Louis "Conclusions générales" (to a colloquium entitled "Vers un marché unique des services financiers) (1989) No.5-6 CDE 608-614. See generally, J.Biancarelli "L'espace financier européen de 1993 et la protection de l'épargne, des investisseurs et des consommateurs de services" (1988) 14 Droit et Pratique du Commerce Int. 659-683 .

considered to be a 'stand-alone' activity, it tended to be provided in connection with other investment services.¹⁶ It has now been accepted however that it should be regarded as a separate category, and one that is increasing in importance. Subsequent events have shown that the legislative framework of the White Paper for the sector was a little too simplistic. For example, after five previous drafts, the Commission has produced a proposal for a capital adequacy directive. The need for such a measure was not foreseen by the White Paper. It spoke of the coordination of standards of financial stability for credit institutions, especially banks, but it did not envisage the need for separate coordination measures for non-credit institutions. At the time, the variety and diversity of the participants in Community securities markets was perhaps not fully appreciated by the Commission. Once the distinction between credit institutions and firms offering investment services was drawn however, the need for different approaches to capital adequacy, to ensure the existence of a level playing field between them, became apparent. Thus the directive is now regarded as an essential counterpart to what has become the Investment Services directive.

In this light, Padoa-Schioppa suggested that the White Paper had organised the raw materials but that it should not have been taken for granted that these were the right ones for achieving its aims. He contended that some of these directives were conceived in a period in which the feeling that they had little chance of being approved was widely shared in the Commission, and that they were

16. See The Securities Association "Investment Services Directive : a commentary and analysis" (1989) The Securities Association Ltd., London.

sometimes waved like flags to show that something was proposed.¹⁷ Nevertheless, the obvious merit in the Commission's approach was that it capitalised on the political mood in favour of economic integration, harnessed this goal to the 1992 deadline and revitalised, by the adoption of its new strategy, the legislative process of the Community.

The principal directives :

One directive underpins the entire financial services liberalisation process, and that is the directive of the 24th of June 1988,¹⁸ which removes all the remaining restrictions to capital movements within the Community. This directive progressively requires the abolition of all remaining exchange controls within the Community and liberalises all short term capital movements. It seeks to ensure that any member state resident will ultimately be free to carry out any capital transaction anywhere in the Community. This measure alone is not sufficient to achieve the integrated financial market however, because freedom of capital movement is in a sense a one way street.¹⁹ It allows the consumer or investor to take the initiative himself and approach suppliers of financial services in other member states, but it does not remove the barriers which prevent these suppliers from marketing their services and contacting potential clients in other member states.

17. T.Padoa-Schioppa "Questions about creating a European capital market" in "1992 : one European market ?" cited supra chapter 2 note 8, p.283-292 at p.287.

18. Council directive 88/361 for the implementation of Article 67 of the Treaty OJ L178/5 . See generally P.Oliver & J-P.Baché "Free movement of capital between the member states : recent developments" (1989) 26 CMLR 61-81.

19. See Fitchew supra in the Introduction note 2, at p.4 .

The Investment Services directive cannot be considered in isolation. It shares its underlying assumptions and rationale with the second directive on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institution.²⁰ This latter directive, which was adopted by the Council on the 15th of December 1989, has to be read together with the Solvency Ratio and Own Funds directives for credit institutions,²¹ which ensure a minimum degree of harmonisation of prudential solvency and liquidity standards. In fact, this assortment of directives, when fully adopted by the Council, will comprise a veritable "corpus legis" regulating the activities of financial intermediaries in the widest sense.²² That they should be viewed as a package is clear from the fact that they are all scheduled to come into effect from the 1st of January 1993, the member states having insisted on such contemporaneous implementation to avoid the possibility of an unfair competitive advantage being obtained by any one sector due to its earlier liberalisation.

At the core of the different directives is the idea of a single financial services passport, the principle that an individual or business licensed to pursue any economic activity in one member state must be automatically free to engage in the same activity in any other member state. Thus, an entity engaged in any financial service, from deposit banking to securities trading to various forms of financial advisory work, once having satisfied the authorisation requirements in its home country, will be

20. Council directive 89/646 EEC OJ L386/1 (heretofore and hereinafter called the second banking directive).

21. 89/647 EEC OJ L386/14 and 89/299 EEC OJ L124/16 respectively.

22. J-M.Fombellida "La proposition de directive sur les services d'investissement" (1989) No.5-6 CDE 583-592 .

automatically authorised to carry out the same business elsewhere in the Community. This authorisation has to be supported by harmonised standards of minimum capital adequacy for whatever business activity is carried on by the authorised institution. Herein lies the dilemma - the range of activities to be covered by the directives is vast, stretching from market making in securities to giving individual professional investment advice. Hence the number and diversity of persons covered, natural and legal, are equally large, encompassing high profile international banks, trading houses of all sizes and small localised investment advisers. The directives are also seeking to facilitate access to vastly different financial markets, in terms of tradition, size and participants : in 1985, the volume of business on the principal German stock exchanges amounted to some \$94 billion while the Spanish exchanges managed only \$4 billion, for instance.²³ It has been stated that there are now only two substantially British owned non bank institutions operating in the London markets,²⁴ after the Big Bang invasion which was led by American investment banks and large Japanese securities firms. Therefore, the challenge presented by the desire to create a level playing field in the financial services sector is an enormous one. One sceptic has been quoted as saying :

" Continental Europeans do not believe in level fields. They do not play cricket and have no intention of learning it. The foreign firms that do best here (in France) will be those that

23. Figures furnished by the International Federation of Stock Exchanges .

24. R.Lambert "Investment firms at mercy of single market talks" Financial Times 9/10/1989 p.6 .

learn to play their games their way."²⁵

The second banking directive is tailored along the lines of the universal banking model. It has been described as representing a consensus between two schools of thought, which reflect national philosophies on banking supervision and regulation.²⁶ There is the narrow British approach, which considers that the primary objective of prudential supervision is the protection of the savings of the public, and the broader German view, which advocates that nowadays, in addition to the protection of savings, the purpose of supervision should also be to safeguard the stability of the banking system and ensure equivalent regulatory treatment for the institutions operating therein.

The list of activities subject to mutual recognition contained in the directive includes all forms of transactions in securities. The home member state is responsible for the prudential supervision of its duly authorised banks, but the host state has residual powers of control relating to matters of liquidity and monetary policy. Credit institutions (the generic term used in the directive) are required to have a minimum initial capital, their ability to participate through investment in non-financial institutions is subject to a maximum level (except in relation to shareholdings in insurance companies) and significant shareholdings in credit institutions are also controlled. The objectives of the Own Funds and Solvency Ratio directives are to

25. M.Spiereburg, managing director of SG Warburg, a British based financial services conglomerate with an operation in France. Quoted in The Economist "A survey of Europe's capital markets" 16/12/1989 from p.58 .

26. G.Zavos "Towards a European banking act" (1988) 25 CMLR 263-289 .

harmonise the definitions of bank capital and solvency ratios for credit institutions. They reflect in this regard "a decade of brainstorming"²⁷ by the Cooke committee (meeting under the auspices of the Bank for International Settlements in Basle), a forum which is made up of banking supervisors of the group of ten leading financial services nations. Not all of the G10 countries are member states of the Community, but the adoption of the accord into the European banking system should indirectly move the European market towards something akin to a global finance market.

The Investment Services directive :

The passing of the banking directives would have given the universal banking model an unfair advantage over non-bank securities firms, if the latter did not have an equivalent freedom to operate within the Community. Therefore, in December 1988, the Commission finally approved and submitted to the Parliament for a first reading, its draft proposal for a directive on investment services in the securities field.²⁸ In accordance with the procedure set out in Article 149 of the Treaty, having received the opinion of the Economic and Social Committee²⁹ and the Parliament having completed its first reading of the draft on the basis of the report prepared by its Legal Affairs and Citizens Rights Committee,³⁰ the Commission took the opportunity to revise the original draft before presenting the amended proposal³¹ to the Council on the 23rd of January 1990.

27. See R.Lambert, *supra* note 24.

28. COM (88) 778 final OJ 89/C 43/7 22/2/1989.

29. CES 1019/89 SYN 176as 27/9/1989 .

30. Doc. A3 0055/89 of the European Parliament.

31. COM (89) 629 final, OJ 90/C 42/7 22/2/1990. The complete text of the proposed directive is annexed hereto at p.168.

It has been suggested that up to 70% of this proposal takes its content from the second banking directive.³² The Commission has admitted to aligning the text more closely on the content of this latter directive in its revised version, but the approach taken in the former is quite different. This directive takes a functional approach to regulation of investment businesses, which is more suited to a highly diversified financial centre such as the City of London, with its wide variety of types and sizes of financial institutions and a vast range of business activities. It is no coincidence that Britain, which has more non-bank financial institutions than any other European market, has been leading the fight to have the measure in place by 1993.

1. The preamble and the recitals :

The preamble gives Article 57 as the legal basis for the directive. The main relevant provision of that Article provides that "the Council shall issue directives for the coordination of the provisions laid down by law, regulation or administrative action in member states concerning the taking up and pursuit of activities as self-employed persons." The Article is in the Treaty provisions relating to the freedom of establishment, but its application is extended by Article 66 to matters covered by the chapter on services. The draft acknowledges in its recitals that it was necessary, for reasons of fair competition, to ensure that non-bank investment firms benefited from a similar freedom to create branches and provide services across frontiers as that provided for credit institutions by the second banking directive. Therefore, it seeks to liberalise access to stock markets throughout the Community, create a level playing field for

32. J-M.Fombellida, supra note 5.

financial services suppliers in these markets and provide broad common standards for the protection of investors.

The recitals to the draft directive include several interesting measures. The influence of the Community case law on the freedom to provide services and the right of establishment is apparent. Indeed the fourth recital adapts the proviso first raised in the Van Binsbergen judgement,³³ in relation to "regulatory arbitrage". It requires that the competent authorities of a member state should not grant an authorisation or should withdraw one, where it is clear that an investment firm has opted for the legal system of that state, for the purpose of evading the stricter standards in force in another member state in which it intends to carry on or carries on the greater part of its activities. Thus, the subjective element of the intention to avoid stricter rules which was seemingly omitted from the judgement in the insurance cases,³⁴ has been retained here. The fear was that an investment entity might seek to strategically exploit the provisions of the directive by registering in one member state, where authorisation would be easier or quicker to obtain, while locating its head office and principal activities in another member state. To ensure the prevention of such abuse, the recital then declares that the member states "must" require that the head office of an investment firm be situated in the same member state as the registered office. The original draft directive had contained such a requirement but it was removed from the body of the directive by the Commission in the face of criticism from the Economic and Social Committee. The Committee had said that this requirement suggested that the controls in each member state could never be

33. Supra chapter 2 note 42 .

34. Supra chapter 2 note 39.

expected to impose the same degree of restrictions or to be of the same quality throughout the Community.³⁵ The Committee felt that it was up to the Commission and the Council to bring in such a degree of harmonisation that there would be absolutely nothing to be gained from using such a 'letter box company'. Whether this requirement is in any case sufficient to solve the problem is an open question. A head office implies the central place of administration of a firm, and consequently a certain amount of activities would have to be carried on in that home member state. This could still leave considerable room to manoeuvre to a firm determined to avoid the professional rules of conduct in the state where it carries on the majority of its business.³⁶

The seventh recital provides that it shall be open to a member state to establish rules stricter than those laid down in the directive in the key areas, such as the requirements for authorisation and the prudential rules to be applied to investment firms authorised by its competent authority. However, the member state clearly could not impose such rules on 'foreign' member state institutions operating there, on the basis of the mutual recognition of national supervisory standards. This situation raises the possibility of a reverse discrimination against national institutions. It is difficult to envisage the situation where a member state would consciously opt for such discrimination, but it may occur if a member state's existing regulatory structure is not altered to take account of the contents of the directive, prior to the latter becoming fully effective.

35. See their report, *supra* note 29 .

36. See M.Dassesse "The single banking market of 1993" (1989) 4 European Trends 68-77, for comments on a similar clause in the second banking directive.

For example, the Financial Services Act in Britain is considered to be 'state of the art' in terms of investment services regulation, and it provides for a very detailed code of conduct of business rules which go beyond those envisaged by the directive. Many firms complain about the cost of compliance with this legislation and would undoubtedly complain even more loudly, if foreign member state institutions did not have to comply with it in full, thus reducing the costs they had to incur in operating in the UK market. However, it would be open to the British supervisory authorities to require compliance with these rules by all firms, on the basis that they were adopted in the interest of the general good, in accordance with the terms of the directive. The issue then would be whether these rules were excessive to achieve their purpose, whether they duplicated existing rules in other member states or whether they were objectively necessary to achieve their purpose. On the other hand, the forces of competition may oblige the British authorities to deregulate, in the sense of relaxing these rules so as to allow its authorised firms to compete on more equal terms.³⁷

Such reverse discrimination would not seem to be contrary to Community law, notwithstanding the potential distortions of competition that may be involved. This is apparent from the opinion given by Advocate General Rozes in the Waterkeyn case,³⁸

37. In this respect, Lord Rippon, in a debate in the House of Lords on amendments to the British regulatory system, pointed out that "the Single European Market in financial services would bring no benefit...unless the regulatory corset of the Financial Services Act could be made more compatible with the looser girdles employed in the rest of Europe". Reported in the New Law Journal 17/3/1989 p.369 .

38. Cases 314-316/81 and 83/82 Procureur de la République v Waterkeyn (1982) ECR 4337 .

which suggested that it would be a matter for the courts of the member state involved to address.

The eighth recital provides that the carrying on of activities not listed in the Annex to the directive should be governed by the provisions of the Treaty concerning the right of establishment and the freedom to provide services. In that context, the following recital states that host member states may require compliance with specific national regulations by firms not authorised as investment firms in their home member states and with regard to activities not listed in the Annex. This exceptional power is granted on condition that such provisions are compatible with Community law, are intended to protect the general good and that such firms or such activities are not subject to equivalent rules under the legislation of their home member state. This confirms the decision in the insurance cases as it relates to the justification of the application of national measures. However, the insurance judgement went somewhat further in holding that such rules must also take into account any supervision or verification carried out in the home state, and they must go no further than is necessary to achieve their purpose.

The extent of this recital's application is unclear. Presumably it applies to firms established in another member state, without any formal authorisation therein to provide services which are not listed in the Annex, and which it wishes to provide in the host state. Does it also apply to the provision of services by a firm, not authorised in its home state to carry out activities contained in the Annex, but authorised therein to carry out other activities, such as commodities broking, and wishing to establish itself in, or provide these services to, the host member state? Much of such confusion stems from the fact that the recital does not follow the distinction drawn in the annex to the directive

between investment activities and the instruments to which they relate. No assistance in this matter can be found in the text of the earlier draft of the directive because its wording was equally ambivalent in this regard, so it remains to be seen how the Council will interpret it. This provision is not without significance because, to take the example of dealing in commodities, this is subject in Britain to the financial services regulatory regime, but commodities are not one of the instruments specified in the directive. Therefore, this activity will not benefit from the Community passport and firms dealing in commodities will have to seek separate authorisations throughout the Community.

The eleventh recital provides that host member states must ensure that there are no obstacles therein to carrying on activities receiving mutual recognition in the same manner as in the home member state, as long as the latter do not conflict with legal provisions protecting the general good in the host member state. A comparable provision is included in the text of the directive : Article 16(5) recognises the power of host member states to punish irregularities committed by a 'foreign' firm contrary to legal rules adopted in the interests of the general good. However, the wording of the recital leaves it open to a wider interpretation. The recital refers to carrying on activities in the same manner as in the home member state : in the earlier draft of the directive, the equivalent recital referred to the activities being undertaken "using the financial techniques"³⁹ of the home member state. A similar recital is contained in the second banking directive, and in this regard, Davis cited the example of mortgage lending, which is one of the designated banking activities under the provisions

39. Supra note 28 .

of that directive.⁴⁰ He noted that under Belgian law, variable rate house lending is prohibited, whereas British building societies (who qualify as credit institutions), can and do lend such funds at variable rates. Does the mutual recognition of mortgage lending activity under the directive extend to the techniques used in Britain in this example? If so, can the Belgian authorities justify their restrictive legislation on the grounds of the general good in order to prevent the use of such techniques?

This raises the question whether a member state is still able to rely on its general good legislation in relation to the way the activities benefiting from mutual recognition are carried out, as distinct from its application to the activities per se. Alternatively, one can ask whether the inclusion, in this instance of mortgage lending, within the list of banking activities which benefit from mutual recognition, imports the requirement to recognise all the financial techniques applied thereto within the Community markets. Davis concluded that to make clear the intention of the second banking directive in this context, either the powers of the host authorities to legislate in the general good should be laid out far more precisely, or the rights of companies to enter different markets should be protected by a much more detailed list of designated activities.⁴¹ The same conclusion can be reached in relation to the equivalent provision in the Investment Services directive.

40. E.Davis "The single market in financial services" (1989) an essay in "Whose Europe..." supra chapter 2 note 4 p.69-88 .

41. Ibid at p.73 .

2. The text of the directive :

The draft directive applies to all investment firms. It defines an investment firm as any natural or legal person whose business it is to provide any investment service, which itself is defined as any of the services relating to any of the instruments listed in the annex to the directive. These include, inter alia, brokerage, market making, dealing as principal or the giving of professional investment advice in relation to transferable securities, money market instruments and financial futures and options among others. The home member state is defined as being where the the principal place of business is for a natural person, and where the registered office or head office, in the absence of a registered office, is situated for a legal person. The authorities responsible for authorisation and supervision of firms ("competent authorities"), are those designated as such by the member states. They must be public authorities, or bodies officially recognised by national law or by public authorities to be part of the supervisory system prevailing in the member state in question. This somewhat unwieldy definition was necessary to incorporate the self-regulatory systems in operation in some member states. Only certain of the provisions of the directive are applicable to credit institutions which are already authorised by their banking licences to engage in securities business.

As regards the authorisation of an investment firm, the competent authorities of a member state, without prejudice to other generally applicable conditions of national law, are required not to grant an authorisation unless the investment firm has sufficient initial capital, and unless the persons who effectively direct the business of the firm are of sufficiently good repute and experience. The capital adequacy directive, which has yet to be agreed by the Council, will lay down the rules for initial

capital for investment firms. In addition, the authorities are to refuse authorisation unless satisfied as to the suitability of the major shareholders or members of the firm, taking into account the need to ensure its sound and prudent management. This consideration must also be taken into account in relation to natural or legal persons who wish to increase or acquire a major holding in an investment firm. The competent authorities must be informed of such proposals and be given an opportunity to object to them.

Authorised investment firms must continue to be in compliance with these principal conditions and, in addition, must make sufficient provision against market risk in accordance with rules which are also to be prescribed by the capital adequacy directive. Member states are obliged by the proposal to draw up prudential rules to be observed on an ongoing basis by firms authorised by their competent authorities. Among such rules are the requirements that the investment firm has made arrangements in relation to compensation for investors who suffer due to the bankruptcy or default of the firm, and that the firm is organised in such a way that conflicts of interest between it and its clients, or between its clients, do not result in the interests of the clients being prejudiced. Supervision of these conditions and rules is within the exclusive competence of the home member state's competent authorities at all times. The draft proposal states, however, that member states may provide that certain of these prudential rules shall not apply where the service is provided to professional or business investors.

Under the terms of the proposal, host member states may not require an additional authorisation or establishment from providers of services who are authorised to offer those services by their home competent authorities. Where necessary for the

provision of certain services, host member states must ensure that authorised investment firms can have access to membership of their stock exchanges and organised securities markets (including financial futures and options exchanges), whether by direct or indirect means and also to membership of clearing and settlement systems which are available to domestic members of such exchanges and markets. A significant amendment to the directive at the revision stage provides that where the stock exchange or organised market of the host state operates without any requirement for a physical presence, such investment firms may become members without having any establishment in the host member state. Home member states are requested to allow host stock exchanges or markets to provide appropriate facilities within the home member state territory to facilitate such membership. This takes account of the growing number of screen based market systems in the Community and acknowledges the increasing drift away from the traditional dealing floor.

The directive allows for the retention by host member states of the power to take measures to prevent or punish irregularities committed within their territories, which are contrary to the legal rules they have adopted in the interests of the general good. In addition, the freedom of authorised firms to advertise their services in host member states is subject to any rules governing the form and content of such advertising adopted in the interest of the general good in the host member state. Thus, the permissible restrictions recognised by the Court in the insurance cases to the Treaty freedoms in question here, have been imported into the text of this proposal.

Comment :

At the risk of pre-empting the Council, it is worth reviewing some of the features of the Investment Services directive, with a critical eye towards its impact on the financial services industry.

The legal status of the recitals is unclear. In theory, their role is simply to relate the directive to other Community initiatives and legislation, while briefly summarising what the directive seeks to achieve. To this extent, they are not intended to add to the substance of the detailed text. However, each of the recitals discussed above deals with matters which have not, in fact, been explicitly provided for in the body of the proposal. For example, the fourth recital states that member states must require that the head office of an investment firm be situated in the same member state as the registered office. This obligation is not repeated in the text. This could prove confusing and problematical when the directive comes to be implemented by the member states. Are the recitals to be given legal force or are national legislators entitled to ignore them, referring to them only for guidance as to the legislative intent of the Community institutions ? What weight might a court give to the recitals when considering a case where a plaintiff has cited them in support of his claim ? It would be desirable for this issue to be clarified to avoid future uncertainty.

The requirement in the directive that the persons who effectively direct the business of an investment firm be of sufficiently good repute and experience, and that the ultimate owners of significant shareholdings in such firms be suitable persons, having regard to the need to ensure the sound and prudent management of such firms, essentially requires a value judgement from the competent

authorities. This is self evident and eminently reasonable on its face but even this can cause differences in a European context.

A simple example can illustrate the possible variations in interpretation of terms among the different member states. At a European conference on financial conglomerates, Geoffrey Fitchew the Director General of DG 15 (Financial Institutions and Company Law), was explaining how difficult it actually was to lay down detailed criteria for fitness and properness. He said that because it seemed so widely accepted that anyone who has been convicted of a criminal offence could not be regarded as fit and proper, a clause to that effect had been left out of the second banking directive. At this point, Christen Boye-Jacobsen, a Danish government official, interjected, saying that under their penal code, once a person has been punished and released he is a free man and he can be integrated once again into society. The implication was that a conviction should not disbar him from being a fit and proper person in this context, and he was sure that Denmark was not the only European country with such a principle.⁴² In this way, even seemingly straightforward principles can be interpreted quite differently amongst the European countries, and this shows the difficulty of the task of the Commission in trying to formulate an objective common standard. Critics have also argued that concepts such as suitability are ephemeral at best.⁴³ They can be employed not only to preclude patently undesirable raids on investment firms, but also to preserve local ownership and control and thus to protect domestic markets.

42. See the text of the Conference proceedings, cited supra in the Introduction note 7, at p.148 .

43. P.McBride Johnson and I.Finkle, "The 1992 European investment community : an exclusive club ?" (1989) Int. Financial Law Review (March) p.35-38 .

Among the prudential rules to be drawn up by member states under the proposal, is the requirement that an investment firm be a member of a general compensation scheme or that it make individual arrangements which would provide equivalent protection. The directive acknowledges the need for further harmonisation in this area, which threatens to be a major source of controversy in the discussion of the directive.⁴⁴ In the meantime, the directive provides that branches of investment firms shall be subject to the compensation scheme in force in the host member state, provided that their contributions to such scheme are calculated by reference to their income in respect of investment activity carried out in that state. One has to acknowledge that home country control of compensation provisions would be dependent on Community agreement on a minimum level of compensation to be paid out by the home member state to investors, anywhere in the Community, doing business with firms authorised by that state. No member state is going to countenance its investors doing business with foreign member state firms, if they cannot be guaranteed an acceptable level of compensation in the event of a failure, when investors doing business with domestic firms are assured just that. Nevertheless, it seems unfair to base a branch's contribution to the host compensation scheme on its income from investment activity in that state. It would seem more equitable to include a mechanism for assessing the risk level of a firm's operations in that state when fixing its contribution to the scheme.

44. See L.Kellaway "EEC Investment directive behind schedule" Financial Times 11/6/1990 p.18 and also, for an earlier expression of concern, B.Riley "City wants uniform EC market controls" Financial Times 28/6/1989 p.8 .

There is a glaring need for Community legislation in this field, but reaching agreement on Community compensation for investment business failures is likely to be extraordinarily difficult, because of the variety of investment businesses to be covered. Such agreement would also have to accommodate the differing legal attitudes of member states to such compensation. This would raise questions such as where should caveat emptor stop and compensation begin, or should compensation be available for claims of negligent advice or solely for loss of money or security due to bankruptcy or default ?

Another of the essential prudential rules requires the organisation of the firm in such a way that conflicts of interest between the firm and its clients, or between one of its clients and another, do not result in the interests of the clients being prejudiced. This exhortation leaves the control and management of such conflicts of interest to the complete discretion of the member states. Conflict problems are particularly prevalent in the universal banking model of financial institution and also in the rapidly emerging financial conglomerates, which offer virtually every kind of financial service to their customers. In fact, one study which examined this problem, identified no less than fourteen conflict situations which might arise in relation to a single transaction undertaken by such a conglomerate.⁴⁵

As far as investor protection is concerned, a client's interests may be prejudiced by a conflict because of the poor quality of the service he receives. A professional may unduly weigh his own interests against those of his client in these situations.

45. See R.Goode (ed) "Conflicts of interest in the changing financial world (1986) Institute of Bankers, London.

Different methods of control and management are available to member states, such as 'Chinese Wall' arrangements, disclosure requirements and formal rules of practice.⁴⁶ Unfortunately, in the absence of firmer Community guidelines, member states are likely to take very different attitudes towards the fulfilment of this prudential requirement and are thus likely to vary greatly in their legislative responses thereto.

The draft directive also permits member states to suspend application of certain of the prudential rules in relation to business or professional investors. The rules in question relate to the separation of investors' securities and investors' funds from those of the investment firm, by such firms, and to the compensation scheme requirement. This option is also available to the member states where the investment service concerned does not involve the investment firm in handling any money or securities on behalf of clients. Thus, the Commission can be seen to have taken the hint dropped by the Court in the insurance cases, to the effect that it felt certain investors were capable of looking after themselves. The Commission, however, has done little more than to acknowledge this distinction. It confines itself to the bald statement that member states "may provide that the rules set out...shall not apply where the service is provided to business or professional investors". It has refrained from fixing any monetary thresholds or suggesting other criteria for deciding whether an investor is a professional or not. The desire here is obviously to avoid a too detailed and extensive harmonisation measure. It was

46. For a detailed study of the conflicts problem, see "Conflicts of interest in banking and finance and their control and management" (1987) Financial Trends No.38 OECD, Paris .

suggested that to try and be more specific in this particular regard would be to open a Pandora's box of complications.⁴⁷

Nonetheless, in my opinion, this represents another tactic by the Commission to avoid taking the responsibility for developing regulatory policy at a Community level. Investor and consumer protection is one of the prime aims of any investment services regulation by member states, particularly in regard to the individual consumer who often lacks the ability, in terms of both knowledge and bargaining power, to protect himself. The lack of a definition of a professional investor could lead to divergences in the implementation of the directive, competitive distortions and confusion among investors as to the obligations of the firm with which they are dealing.

This merely serves to illustrate the complexity of the financial services market and highlights the differences between what can be called the retail and wholesale financial services sectors. In simplistic terms, at the former level, the consumers avail of the services offered by the institutions while at the latter level, the institutions operate amongst themselves. This does not prevent the institutions and the consumers from sharing concerns and having similar interests. For example, a consumer may be just as frustrated by regulations in his member state as an institution therein, because he may wish to take more risk than those rules allow or because the cost of purchasing financial products is excessively high, due to the extra overheads imposed by protective regulations. Indeed, it should be stressed that both consumers and institutions would be opposed to overregulation, because it

47. J-M.Fombellida, *supra* note 5 .

increases costs all round, restricts competition and may discourage the development and use of financial techniques.

Despite these common concerns, institutions and consumers clearly have different needs and member state legislation should recognise this. The London Stock Exchange has come under increasing criticism for disregarding the interests of the individual customer in its wooing of the powerful institutional investors.⁴⁸ The former's difficulties have been augmented by the dearth of brokers making markets in smaller stocks, which have traditionally been favoured by the smaller investor. Those brokers have had their fingers burned in the inevitable fallout due to the excess capacity in the market subsequent to Big Bang.⁴⁹ A comparable acknowledgement has taken place in America. The Securities and Exchange Commission has relaxed its notoriously demanding registration requirements in relation to private equity placements among large institutional investors.⁵⁰ Thus, although the need for a discerning system of investor protection has been signalled, the Commission has made no attempt to frame such a system in this directive. The ultimate development of a two speed system of investor protection will depend on the willingness of member states to interpret the provisions of the proposal imaginatively and constructively.

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48. See, for example, C.Dobie "Dissatisfaction fuels demand for rival exchange" The Independent 9/7/1990 .
49. For an account of the collapse of one such firm, see D.Green "Kitcat & Aitken to close after 90 years" Financial Times 30/5/1990 . See also B.Riley "A time of turmoil for the private stockbroker" Financial Times 28-29/7/1990 .
50. See J.Bush "New rule will clear a path" Financial Times supplement 2/7/1990 .

If it can be seen as any consolation, José-Maria Fombellida, having noted that the European Court had never had a case before it requiring a judgement relating to the rights of investors or intermediaries, suggested that it was probable that, in the near future, the Commission would commence work on a new directive which would seek to harmonise standards of conduct of all intermediaries active in securities markets.⁵¹ Such a measure is, unfortunately, most unlikely to see the harsh light of day before the end of 1992, when the current Commission's term of office will expire.

The exclusion clauses already noted, which allow member states to impose their own legislation for the protection of the general good, create a dilemma. There will always be a risk of restrictions being introduced under the guise of the public good which will interfere with the freedom to provide financial services. The opening up of financial markets, not just by the abolition of entry restrictions but also by allowing the free movement of modern sophisticated financial techniques, is one of the aims of the Commission. In this context, Fitchew admitted that there is no precise doctrine governing what is justified by the public interest.⁵² The view held by the Commission, he said, was that it did not want to get into excessively detailed harmonisation, because it would get sucked back into the highly comprehensive harmonisation programme of the 1970s if it tried to do that. The best strategy, in its view, was to leave the question to be sorted out in the first instance by market forces and in the

51. Supra note 5 .

52. See G.Fitchew "The progress to date - an EC perspective " a contribution to The Economist Conference Unit's "Restructuring Europe's financial services : 1992 and beyond" (1989) Rooster Books Ltd. p.23-31 at p.32 .

second instance by recourse to the European Court of Justice. This "wait and see" attitude may seem a little hapless, but it may be that the Commission is just biding its time until a suitable case comes along to raise the question directly before the Court.

It is necessary to mention one other aspect of the proposed directive. This is the provision contained therein relating to reciprocity. By virtue of Article 58 of the Treaty, subsidiaries established by third country financial institutions in any member state, are considered to be Community companies as of that moment, and can therefore enjoy the right of establishment and the free provision of services within its territory, together with all the benefits of the new financial services passport which Community firms will enjoy. However, in contrast, the branches of third country institutions do not benefit from these entitlements. The provisions of Article 7 of the draft directive will regulate the procedure where a third country undertaking seeks the authorisation of a subsidiary in a member state, or acquires a holding in a Community investment firm such that the latter becomes its subsidiary. The provisions exactly mirror those contained in the second banking directive, which were amended at each stage of the legislative process of that directive. Indeed, this clause was one of the most hotly debated issues raised by that directive and the eventual consensus reached produced a rather watered down set of provisions.

The measure provides for a two tier approach to reciprocity which differentiates with respect to the response of the Community between, on the one hand, a lack of comparable market access for Community institutions in third countries and, on the other hand, a failure to provide national treatment thereto by third country authorities. The Commission will be able to negotiate for such entitlements itself and will have power, in certain cases, to

limit or suspend future requests for authorisation or participation in Community financial institutions by third country firms. The Vice-President of the Commission has stated that the Community's banking market will be the most open, as well as the most unified major banking market in the world.⁵³ On this basis, the Commission believes that in a financially highly interdependent world, its banks and other financial intermediaries should enjoy fair access to and equivalent treatment in, other world markets. The Community has been negotiating, with this objective in mind, with its EFTA partners and general financial services negotiations are also underway in the GATT Uruguay round of discussions. In this regard, an express provision of both the banking and investment services directives requires any action taken by the Community to be in conformity with its international obligations.

The fear expressed amongst the international business community, both within and outside the Community, was that these measures could create a "Fortress Europe" or erect, to use Professor Gower's delightful phrase, a "cordon sanitaire"⁵⁴ around it, handicapping European investors and institutions in the use of the thriving global market and its advantages. The Deputy Governor of the Bank of England expressed similar reservations when saying that such unilateral reciprocity tests were symptomatic of introversion rather than a commitment to free trade. He was of the opinion that reciprocity rules needed to be discretionary and to

53. Leon Brittan at p.3 of a speech delivered to the Electra launch dinner on the 19/1/1990 .

54. Used in Gower's introductory speech to the Conference cited supra in the Introduction note 7, p.5-10 at p.7 .

be operated locally by experienced professional supervisors.⁵⁵ The reciprocity provisions finally adopted in the second banking directive differ considerably from earlier drafts of the measures. They show a significant shift in the institutional power balance with regard to their ultimate management, away from the Commission and towards the Council. Thus the member states seem intent on keeping a tight control over their application. But their fears seem unjustified - Leon Brittan has stated that "there will be no question of even considering closing our markets in any way to outside competition unless there is proven discrimination in their markets against European institutions."⁵⁶ The Commission has made it clear that these provisions will not have retroactive effect and will not, therefore, affect the subsidiaries of third country institutions authorised or participations acquired in firms in the Community, prior to the first of January 1993.⁵⁷ In any case, such provisions, in principle, are by no means new. Reciprocity requirements exist already in virtually all of the member states. It is the Community dimension to this politically useful bargaining tool which the member states, at the prompting of their powerful business lobbies, have found difficult to accept. This begs the question of whether the member states see the single market in financial services as a truly integrated market or as a network of integrated national markets.

The Capital Adequacy directive :

55. Sir G. Blunden "Target 1992" a contribution to Eurofi's "1992 - Planning for financial services and the insurance sector" (1989) Butterworths.

56. Supra note 53 at p.4 .

57. See the text of an information bulletin from the Commission "Europe 1992 : Europe world partner" Brussels 19/10/1988 .

The proposed Capital Adequacy directive for investment firms,⁵⁸ which is an essential counterpart to the Investment Services directive, has proven very difficult to negotiate. The fifth draft was finally approved by the Commission in April 1990. Its purpose is, firstly, to coordinate the levels of initial capital to be provided by investment firms other than credit institutions as a condition of their being authorised. Secondly, the proposal specifies, by means of ratios, the capital such firms must maintain in relation to the assortment of risks they run in operating their business. These are classified as follows :

(a) position risk - this reflects the risk of loss from adverse price movements in securities held for trading purposes, whatever their cause; (b) foreign exchange risk - this relates to a firm's vulnerability to losses arising purely from adverse exchange rate movements; (c) unsettled transactions risk - this concerns transactions where one or other party has not paid for the securities it has contracted to buy, or has not delivered the securities it has contracted to sell and (d) 'base' risk - this is intended to cover all other risks faced by investment firms, such as a collapse in market turnover. The latter requirement takes account of the wide variation in size of investment firms in the Community, by requiring the holding of funds equivalent to one quarter of the previous year's overheads. The scope of the directive extends to all credit institutions, including those which are not investment firms. However, in consideration of the requirements imposed on them by the solvency ratio and own funds directives, the directive offers a choice to national supervisory authorities as to which system to apply to the credit institutions authorised by them. The requirements will to some extent inevitably apply to credit institutions with securities activities

58. COM (90) 141 final, OJ 90/C 152/6 21/6/1990 .

anyway, because the ratios agreed by the G10 countries in Basle and adopted in the banking legislation, only cover credit risk and not position risk.

In drafting this proposal, the Commission has had to consider the very different interests and concerns of the whole range of investment businesses, and to try to create a level playing field between them and credit institutions relating to capital requirements. This balance is significant because the cost and deployment of capital will be a big element of firms' competitiveness after 1992. Unfortunately for the Commission, the overlap in business interests between banks and securities houses and the integration of financial market activities has not been matched by developments in the international coordination of the regulation of securities houses.⁵⁹ While the Commission has been formulating its own views on capital adequacy, the Barnes committee, a sub-committee of the Bank for International Settlements, has been investigating equity position risks in banks, although non-bank investment firms fall outside its ambit. It has the advantage of having a worldwide perspective and the capital adequacy debate is now likely to bounce between the two forums like a tennis ball.

The drafting of this directive has been another battle in the ongoing conflict between (for the sake of polarisation) the British and German attitudes in this field. The British view is that initial capital requirements should be held to a minimum, but under a close scrutiny which would allow sophisticated adjustments

59. See R.Waters "Drexel's fall may spur the talking-shop" Financial Times supplement 2/7/1990, for a discussion of the proliferation of talking-shops among European and worldwide securities regulators.

to be made to cater for different types of risk.⁶⁰ The British lobbyists also wanted the rules to recognise that portfolio risk could be reduced by diversification and hedging. The West German practice, applicable only to universal banks, requires substantial initial capital, thus creating an entry barrier, but thereafter the firms are able to do business relatively freely.⁶¹ No separate capital is required for position risk in securities dealing, but there are limits on foreign exchange risks and in relation to other instruments, including futures.

In addition to reconciling these divergent approaches, the Commission's objective has been to establish a regime which gives neither type of investment institution a comparative advantage.⁶² It is anxious that its requirements do not lead to changes in the organisational structure of investment firms, such as giving universal banks an irresistible incentive to subsidiarise their securities operations.⁶³ The danger here is that the Investment Services directive cannot be adopted without the Capital Adequacy directive and thus delay in one will necessarily delay the other. As the countdown to 1992 gathers increasing momentum, a lot of discussion still has to take place in this respect. The danger of negotiating against a time limit where national interests are so divergent is that content is compromised for the sake of

60. R.Lambert supra note 24, see also "Adequacies inadequate" The Economist 30/9/1989 p.80 .

61. See The Economist supra note 25 and also T.Dickson "Anglo-German boost for single insurance market" Financial Times 31/3/1990, which noted a significant softening of Bonn's earlier insistence on the toughest possible capital requirements during negotiations on the directive.

62. R.Lambert "World leadership in financial services within the grasp of the EC" Financial Times 17/10/1989 at p.2 .

63. See the text of a speech given by Leon Brittan to the Overseas Bankers Club on the 5/2/1990 .

agreement. The price for agreeing these directives should not be the bringing forward of technically flawed measures.⁶⁴

This highlights one of my principal concerns about the legislative progress towards 1992. There is no doubt that deadlines concentrate the mind but there are dangers in this radical investment services programme being driven by a timetable rather than the need to get things right. The harmonisation or coordination of the laws relating to the authorisation, supervision and capital adequacy of investment firms is at the core of this programme. The overriding need is to get the foundations right, because of the pivotal role of financial markets and of the financial services industry generally, in the economy - in Lord Cockfield's words : "Financial services oil the wheels of the competitive market economy"⁶⁵ - and because of the potential for transmission of shocks between national economies if the supervisory framework is not effective. As Bradley puts it: "Though it has proved a useful lubricant for the legislative process, the technique of mutual recognition, a 'second best' compared to coordination of national provisions, gives rise to the danger that the interests of the consumer and/or investor protection may be subordinated to the policy of speedy completion of the internal market and encourages the member states to accept the lowest common denominator in fixing the Community

64. See R.Nowinski & R.Brooks "Financial services must take account of new European rules" Financial Times 12/4/1990 at p.9 .

65. See the proceedings of the symposium cited supra chapter one note 1, at p.5 .

standard."⁶⁶

These measures of financial services legislation have been forced to distinguish between banking and investment firm activities, in order to accommodate the divergent traditions in these fields among the member states. However, it is arguable that this creates a false institutional distinction between the two, mirrored in the different, although hopefully complementary, supervisory structures. It is clear that securities and banking markets are becoming increasingly integrated. It was reported in December 1989, that British banks now act as agents in just under half (by value) of individuals' domestic equity trading, compared with one third just a year previously.⁶⁷ The fragmentation of regulatory responsibilities, both geographically between national authorities and functionally between bank and securities regulators, is becoming outdated in the global financial marketplace, and failure to recognise this could have serious implications for the Community financial sector.⁶⁸ Similarly, a legislative process where one measure is continually seeking to catch up with another in timetable terms, and where specific provisions fiercely negotiated in one context are imported wholesale into another context without distinction, cannot be desirable. Legislation in this field will not stop after 1992. Indeed, the Community policy and approach will be further refined by Commission proposals, the impact of market forces and European Court decisions, but it would be preferable for a suitable framework to be in place beforehand.

66. K. Bradley "The Common Market in financial services" JUS letter bulletin 7/89 JUSB22 :see also R. Kinsella "The Second Banking directive and the Investment Services directive" (1988) JISEL p.37-43 .

67. The Economist supra note 25.

68. See Dale supra chapter one note 36 .

Implementation by the Member States :

The approach of the member states to implementation of the directives will have an important role to play in this context. The willingness of ministers to agree directives at the Community level has not always been matched by their readiness to translate them into national law. The Commission is becoming increasingly aware of the seriousness of this problem.⁶⁹ Although 60% of the proposals for the internal market contained in the White Paper have made it through the Community legislative process, in February 1990 the rate of implementation by member states stood at 70% of this total. The rate had increased by three percentage points since December 1989,⁷⁰ as the Commission stepped up its policing role. The Commission, however, remains optimistic about the issue of transposition of financial services measures into national law. In this regard, it was pointed out to me, that the wave of deregulatory measures (discussed in chapter 1) which commenced in Britain with Big Bang and has seen similar developments in, for instance, French, Spanish and Dutch securities markets,⁷¹ was at least to some extent prompted by the knowledge that discussions were underway and proposals inevitable

69. See the Sixth Annual Report by the Commission to the European Parliament on monitoring of the application of Community law COM (89) 411 21/12/1989 .

70. L.Kellaway "Progress on European single market gathers pace" Financial Times 2/4/1990 .

71. See L.Raun "Moves to recoup business" Financial Times 12/6/1990, a special supplement on The Netherlands which highlighted the climaxing 'explosion of reforms' on the Amsterdam stock exchange.

at the European level in the financial sector.⁷² The outcome of such legislative foresight would be a Community financial system which would be quite prepared for the impact of the 1992 legislation. Somehow, I fear this will not be the case.

The 1992 approach will also bring into play the principle of competing jurisdictions. Curzon-Price believes that free trade on the basis of different regulatory systems puts the regulatory systems into direct competition with each other.⁷³ This process of competition will soon establish a ranking from the most preferred to the least preferred of the regulatory norms. A member state faced with the presence of the latter in its regulatory system can either do nothing, thus burdening its industry with an unpopular norm or it can adopt its legislation spontaneously. In a properly informed market, she felt, the consumer would be allowed to determine the appropriate balance between cost and quality, and once the market has selected the optimal norm, countries could be expected to converge on that norm. However, in the securities field, the market is not properly informed (see chapter 4), and therefore member states will be obliged to retain disclosure requirements and conduct of business rules to protect the inadequately informed consumer. This illustrates the danger of assimilating financial products with other products in an attempt to facilitate their freedom of supply. Nevertheless, though the principle of competing jurisdictions will not be a panacea for the problem of effective implementation of Community financial

72. J-M.Fombellida supra note 5 : see also D.Lascelles "Bank of England drops plans to equalise banks' liquid assets" Financial Times 19/4/1990 at p.1 - an account of unilateral action by banking authorities in Britain being shelved due to, inter alia, the likelihood of EC measures on the same issues.

73. V.Curzon-Price cited supra chapter 2 note 4 at p.33 .

services legislation by member states, it is likely to be a consideration in the minds of member state legislators, who might fear an exodus of business and firms from their excessively regulated markets in the aftermath of 1992.

In recent times, financial market regulation in member states has tended to be used as a means of correcting a perceived market failure or as a response to scandals which threatened to undermine the public confidence in the markets. When the Financial Services Act was enacted in 1986 in Britain, its legislative genesis came firstly from the need to re-regulate the rapidly changing organised securities markets which were revelling at the time in their post Big Bang freedom. Secondly, and more immediately, it came as a result of a comprehensive review of the system of investor protection in Britain,⁷⁴ commissioned by the Department of Trade and Industry in the wake of a number of financial scandals in the City of London markets, which had left numerous investors stranded and caused considerable disquiet amongst critics of the financial system. Thus the Act, whatever its merits, was a reasoned response to a recognised need for legislation. Until the 1980s, French financial markets were fragmented, heavily regulated and dominated by government debt. Their liberalisation was a Socialist initiative encouraged by volatile and high interest rates, the decline in household savings and the wide interest rate margins of the corseted and uncompetitive banks.⁷⁵ As one participant put it : "When logic suggested that free markets work best, the French liberalised

74. L.Gower "Review of Investor Protection" (1984) HMSO CMND 9125 .

75. See The Economist supra note 25.

theirs very rationally."⁷⁶ Exchange controls were relaxed, a new banking act in 1984 removed some restrictions on what different banks could do, tax breaks spurred the growth of collective investment and privatisations helped double stock exchange turnover. As for the market itself, computerised trading was introduced, existing markets reorganised and a new market in derivatives (MATIF) was started.⁷⁷ Several of these measures can be linked to developments at the Community level, but it is clear that they were progressively adopted in pursuit of explicit government policies.

Implementing measures taken on foot of the Community directives heretofore mentioned will have a somewhat different impetus, namely the completion of the single financial market envisaged by the 1992 programme. This different impetus may indeed affect the approach of member state governments to their adoption. The problem of delay in implementation has already been noted. Whether the opportunity will be exploited to introduce protectionist measures in the guise of general good requirements remains to be seen. What is certain is that the willingness to embrace the ideal of an internal market in financial services will depend largely on the perceived strength of the domestic markets, their indigenous participants and their ability to compete in such an enlarged market. Member states will be faced with an option of taking advantage of the opportunity to critically examine the workings and operation of their financial markets, or, of implementing the directives in a piecemeal fashion in order merely to fulfil their obligations of Community membership. Unfortunately, the timetable

76. G.Lejoindre, an associate director of Banque Indosuez, reported in *The Economist* *ibid.*

77. See Banque Indosuez, *supra* chapter one note 26.

aspect suggests that the latter approach may be more frequently adopted.

Financial Markets :

Almost sixteen years after starting to work together informally, the Community stock exchanges are belatedly trying to present a more unified front towards the Commission, in the light of the stream of 1992 legislation which could seriously affect the way many conduct their business. European bourses have hitherto taken comfort from the Brussels view that market supervision is a matter for the markets themselves, and the Commission has made it clear throughout that it has no intention of developing into a European Securities and Exchange Commission. In 1984, the bourses revived the European Capital Market Group (ECMG), a sub-group of the EC Stock Exchange Committee, with the aim of developing it as the single interlocutor with the Commission for the bourses.⁷⁸ Such a unified approach is untypical of the exchanges and it is clear that, in spite of the efforts of Community legislation in related fields, their diversity will remain a stumbling block in relation to the integration of the markets.

The Community currently has forty different stock exchanges, many of them already linked by common members, companies listed and active investors. They operate in different ways, some by open outcry, some on screens, with competing market makers, specialists or order matching. There are numerous different types of shares and debentures : bearer, registered and non-voting, for example. Settlement takes from two days to one month on the various

78. See H.Simonian "European stock exchanges close ranks" Financial Times 13/4/1989 .

exchanges. There is also the matter of twelve different national currencies. All of these reduce the attractiveness of European markets both for third country investors, and for member state issuers who find their domestic stock markets too small to raise money there. "The costs of a fragmented European equities market are bankrupting the industry", according to one participant therein.⁷⁹

Scale is especially necessary for efficient financial markets and liquidity is essential. In theory, a central market would be more liquid, transparent and easily regulated than a host of competing ones. Liquidity is the main concern of large institutions who want to do big deals. Transparency is important to the retail customer who does not want to be cheated and wants to get the best price available. Price accuracy is one of the main tests of the efficiency of a stock market and the greater the volume of business through a market, the less erratic its prices will be as a fair indicator of value. These principles have supported much regulatory legislation in the past and will continue to do so. Applied to the mass of European markets, the potential for improvement is obvious.

This reasoning prompted the chairman of London's International Stock Exchange (ISE) to propose a single equity market for Europe's leading companies, open to securities houses in all the financial centres of Europe.⁸⁰ He even suggested that if Community exchanges could not cooperate on such a scheme, the ISE would seek to carry it out on its own. In this context, it already has at its

79. H-J. Rudloff, deputy chairman of Credit Suisse First Boston, quoted in *The Economist* supra note 25 .

80. See R. Waters "Towards Europe's super league" *Financial Times* 11/9/1989 at p. 22 .

disposal a powerful prototype in SEAQ International, which is a market in the shares of most of Europe's largest companies and already handles more business than London's domestic market.⁸¹ Other markets oppose the plan however on nationalistic grounds, which is not surprising, given the competition to be Europe's principal financial centre,⁸² and also because they believe SEAQ International is too lightly regulated and that it uses an alien trading mechanism.

Wymeersch suggested that such a centralisation of operations on a single exchange would favour the major stock exchanges of Northern Europe, and would result in the depopulation, in a financial sense, of peripheral and Southern areas. This, he felt, would ultimately reflect an uneven redistribution of the fruits of European integration, whereas a more deliberate policy of decentralisation of operations would be more in the interests of European integration.⁸³ A French proposal in response to the ISE's initiative, was for the establishment of a 'Eurolist' involving the trading of shares in Europe's largest companies through each national exchange, trading to be governed by the rules and regulations of the market where it was carried out. The predictable response of the ISE was that European markets would remain as fragmented as ever, and that such a list would not offer sufficient depth and liquidity to attract global investors, issuers and institutions alike.⁸⁴ The different approaches reflect different objectives for the market. The French system would be

81. R.Waters "Bourses battle for pride of place in Europe"
Financial Times 17/5/1990 at p.19 .

82. See D.Lascelles "A potential financial capital for the EC"
Financial Times 25/9/1989 at p.5 (supplement).

83. Supra note 6 at p.602 .

84. See R.Waters "Stock exchanges fail to bury the hatchet"
Financial Times 22/5/1990 at p.30 .

better suited to retail investors who need the protection of a tightly regulated market, whereas the British one would be suitable only as a market for professional investors. Another opinion on this debate, that of Rudiger von Rosen, the vice chairman of the Federation of German Stock Exchanges, was that the Community would end up without any one central exchange but with different centres. He contended that private investors who are used to a home market, need facilities at home and he pointed out that they were the ones who made the business profitable.⁸⁵

Whatever the outcome, a European equity market along the lines of the one proposed could not exist without an appropriate infrastructure. As mentioned previously, the Federation of Stock Exchanges in the European Community (FSEEC) has taken the first steps in such a direction and has agreed to create an electronic network to disseminate price and other information fed from all the national exchanges.⁸⁶ In May 1990, a joint venture agreement to build the first phase of this information network, to be known as the Pipe, was signed at a meeting of European stock exchanges in Copenhagen. However, the agreement was only signed after serious reservations had been expressed, and commentators have suggested that the chances of Pipe collapsing, even at this early stage, seem to be high.⁸⁷ Rather than a visionary proposal, such action was precipitated by the threat posed to the stock exchanges by informal screen based networks, such as that operated by Reuters, and also by the plans of NASDAQ⁸⁸ to establish a presence in Europe. It had been reported that the London ISE and NASDAQ

85. Ibid.

86. Waters supra note 11 .

87. For example, see Waters supra note 84 .

88. An American over the counter screen based system - National Association of Securities Dealers Automated Quotation .

were at one stage secretly negotiating a possible joint venture until the former pulled out and "turned instead towards Europe".⁸⁹ Thus it was the spur of competition rather than an urge to develop a European system which prompted the Pipe plans. There is also the inevitable conflict as to what model any such trading system should follow, whether the market should be order driven, as in Paris, or operated by market makers, as in London. Both have their advantages, the former being better for the retail customer, the latter offering advantages to the institutions.⁹⁰

A market cannot function properly unless the participants have confidence in their deals being settled promptly and efficiently. The hodgepodge of paper-based and electronic systems in operation around Europe makes this ideal somewhat illusory. It also illustrates the likelihood of settlement arbitrage ie.the migration of trading to the exchange that settles most quickly. It is suspected that the market in Frankfurt suffered so badly in the "mini-crash" of October 1989, because foreign traders sold heavily there in preference to other exchanges in the knowledge that they could get their cash within two days!⁹¹ It has also been argued that the cheaper it is to settle trades, the more incentive investors have to turn over their portfolios and this is likely to stimulate the volume of trade. This has prompted the London exchange to develop its Taurus project, a programme which eliminates paper share certificates and introduces electronic book

89. Supra note 80 .

90. See J.Krier "L'intégration des marchés des valeurs mobilières en Europe" in M-J.Castello-Branco & J.Pelkmans (eds) "The Internal Market for Financial Services" (1987) European Institute of Public Administration p.163-173.

91. See The Economist supra note 25 .

entry and a delivery versus payment system.⁹² This would reduce settlement costs considerably and suggests that the days of the humble share certificate may be numbered.

The Commission's approach to these issues is that they should be left to the national markets to decide. Fombellida remarked that it is not the Commission's role to decide whether a quote driven or a market making system should prevail, this should be a decision for the marketplace.⁹³ In his view, the Commission's role was to ensure that the same facilities and freedoms were open to everyone, thereafter market forces and competition could take over. In the absence of greater European integration embracing a formal Community economic policy, these matters will be left to member state stock exchanges and competent authorities to resolve.⁹⁴ It is difficult to see the Investment Services directive having as great an impact as the Commission might hope, without the concurrent manifestation of a greater European spirit among national bourses. Any agreement they might reach on a real single European equities market is a long way off and the markets are likely to remain fragmented. The strength and depth of these markets will be important to European industry, if it is to be able to take full advantage of the opportunities presented to it by the dynamics of the 1992 programme. In this climate, the blind faith of the Commission in the wisdom of the marketplace may be somewhat misplaced.

92. See A.Freeman "Many will struggle to meet the improvement timetable" Financial Times supplement 2/7/1990 .

93. Supra note 5 .

94. It is interesting in this context to note the attitude towards change on the principal Italian stock exchange in Milan - see H.Simonian "Reform stalks the Milan panther" Financial Times 16/5/1990 at p.31 .

CHAPTER 4 : The regulation of financial markets.

The share of economic life under the control of government has undergone an enormous expansion in the past century. The share of a country's income that has been spent by government has risen perhaps three to five fold in the Western world during this period. No simple satisfactory measure can be assigned to government regulation of economic life at any time, but the inundation of the economy by present day regulations must in comparison to the past, be as Noah's flood was to a normal spring.¹ Economic regulation in this context is merely one of several forms of government intervention in day to day life. Political power is used to regulate private conduct whenever any law is made establishing civil or criminal liability, or when taxes are levied with inevitable side effects even when revenue raising is the sole goal. Thus, there is a tendency to identify regulation with the whole realm of legislation, governance and social control. But such interventions are not considered as 'regulation' in the sense to be discussed. Regulation here, in broad terms, may be used to describe activity of the State which determines, controls or alters the operation of markets. In addition, it may connote the legal rules and other measures adopted by the State to control private behaviour in furtherance

1. See Professor G. Stigler "The regularities of regulation" an essay in "Financial deregulation.." cited supra chapter 1 note 19 p.1-11 .

of specific policy objectives.² Within the framework of American public policy and administration, regulation has acquired a more specific meaning. It refers to sustained and focused control exercised by a public agency over activities that are generally regarded as desirable to society.³

The current popularity of studies in and about regulation, with their particular vocabulary and conceptual apparatus, has been identified as spreading from America where it has spawned a huge literature.⁴ Its expansion in Europe has been fuelled by the increasing interest shown by public lawyers in the activity, as distinct from the control, of government itself : the functions it is performing, the nature and source of the powers it is exercising and the characteristics of the populations in relation to which such powers are being exercised. The long tradition of regulation in the United States stems from the American ideology in relation to the political control of market processes. This declares that the market works well under normal circumstances,

2. See T.Daintith "A regulatory space agency ?" (1989) Vol.9 No.4 Oxford Journal of legal studies 534-546 .

I have chosen not to consider the various theories which seek to explain why regulation comes into existence. For an elaboration, see R.Posner "Theories of economic regulation" (1974) Bell Journal of Economics 335-358 . I have also refrained from entering the regulation by government, by public agency or by self-regulation, debate. A good starting point here, is R.Baldwin & C.McCruden's "Regulation and public law" (1987) Weidenfeld & Nicolson.

3. See G.Majone in the Introduction to G.Majone (ed) "Deregulation or re-regulation ? (1990) Pinter Publishers Ltd. p.1-6 at p.1.

4. The constitutionality of economic regulation in America has been established since the decision in *Munn v Illinois* 94 U.S 113, 126 (1887), where the Court stated : "When...one devotes his property to a use in which the public has an interest,...he must submit to be controlled by the public for the common good...".

and should be interfered with only in specific cases of 'market failure', such as monopoly power. In contrast, popular acceptance of market ideology is a more recent phenomenon in Europe, where the market economy and its ability to withstand pressures has traditionally been mistrusted by political opinion. This helps explain why the study of public regulation is still a relatively new area of scholarship in Europe.

My particular concern is with economic regulation as it is applied to financial markets which, in its own right, is a sprawling subject which can only be selectively discussed. In the previous chapter, I analysed some of the initiatives being taken at the Community level to regulate these markets. It is worthwhile to examine the theoretical underpinnings of these and other regulatory efforts. Financial markets are different from other markets but not so different that the analysis of markets is still not central to determining the optimal scope and form of regulation.

Market economies exist in a state of perpetual tension between the freedoms conferred by the private ownership of productive property and the need to impose communal limits on the exercise of those freedoms. The study of economic regulation is largely concerned with exploring and understanding that tension.⁵ That tension is heightened in financial markets, in particular in those in Britain and America, which are among the most highly developed institutions of market capitalism. Their capacity for innovation; their experience of revolutionary structural change; the ferocity

5. L.Hancher & M.Moran in the Introduction to L.Hancher & M.Moran (eds) "Culture, capitalism and economic regulation" (1989) Clarendon Press p.1-7 .

with which they practice competition; their increasingly global organisation; the extent to which they apply rational calculation and high technology; all these show them to be in the social vanguard of the market order.⁶ In theory, this sector has the potential to be an outstanding example of the efficiency which can result from classical competitive capitalism. This presents its own dilemma : how to reconcile the competitive urge and desire for gain with preservation of an effectively regulated moral order. The sector, therefore, presents regulators, who must continually assess, reassess and reformulate governing rules, with a task of enormous complexity. The consequences of their actions reverberate throughout the economy and across national boundaries.

Despite the internationalisation of the industry, it is apparent that the economic setting and the legal and political culture of a country will have a profound effect on its style and quality of economic regulation. There will always be the need to appreciate the difference between the universal features of the culture of capitalism and the particular features of individual national capitalism. For this reason, I shall concentrate on the Anglo-American experiences of economic regulation. Differences exist between them, but they tend to result in variations on common themes. The systems of regulation in these countries have already been exposed to critical analysis and they may provide a constructive guide to the evolution of regulation in less developed markets.

6. See M.Moran "Investor protection and the culture of capitalism" an essay in "Capitalism, culture and economic regulation" ibid p.49-75 at p.51 .

Why regulate financial markets ? :

"Financial markets worldwide are regulated for two reasons. First, because the stability of the financial system is a public good, which market forces on their own are not guaranteed to produce ; second, in order to protect the investor, depositor and policy holder against the wide and imaginative variety of scams, frauds and scandal, to which financial markets have been exposed ever since the tulip bulb speculations of the seventeenth century, if not before."⁷

The overall aim of most financial market regulation therefore, is to ensure the safety, stability and integrity of the system. The working of the system depends completely on public confidence in the ability and willingness of institutions to carry out the contracts into which they have entered. So most economic systems adopt a policy designed to prevent the occurrence, and lessen the macroeconomic consequences, of severe financial shocks caused by the failure of a financial institution to meet its payment obligations or by a sudden collapse in that public confidence.⁸ Regulation concerned with the stability of the system is known as prudential regulation.

The other side of the regulation coin is investor protection. A degree of protection is essential if members of the public are to have the justified confidence to participate in financial markets. Professor Gower suggested that one has to make a value judgement on the relative weight to be attached to market freedom and to investor protection. His view was that regulation in the interests

7. G.Fitchew, cited supra chapter three note 52 at p.24 .

8. See Padoa-Schioppa, cited supra in the Introduction note 7 at p.25.

of the latter should be no greater than is necessary to protect reasonable people from being made fools of.⁹ This view is more appropriate to participants in the retail financial services market, and regulation here can be justified to protect them from their own greed and from exploitation of their ignorance. The corresponding arguments for protection in the wholesale market are weaker but by no means non-existent. Confidence is a public good in wholesale markets just as it is in retail markets and that is why the markets themselves will seek a degree of regulation. An account of the collapse, in 1981, of the Norton Warburg group, a London firm of investment advisers and fund managers, indicates that even the large institutions are not immune from investing unwisely or making serious misjudgements.¹⁰ Regulation here is thus concerned with the transparency of the market, and often takes the form of 'rules of conduct' regarding the behaviour of the market participants and preventing excessive speculation ie. conduct regulation. Nevertheless, regulation cannot eliminate the inherent element of riskiness in securities investment. It can, though, reduce some risks by making more information efficiently available to investors and by increasing public confidence in the integrity of the markets and of the participants therein.¹¹

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9. L.Gower "Review of investor protection" HMSO CMND 9125 at para. 1.16. In the 1930s, an English court declared that "the main object...is to secure that persons who carry on the business of dealing in securities shall be honest and of good repute, and in this way to protect the public from being defrauded" - *Lymburn v Mayland* (1932) AC 318 .
 10. See M.Clarke "Regulating the City : competition, scandal and reform" (1986) Open University Press at p.102 .
 11. See R.Schotland "An overview : new myths and old realities" an essay in L.Goldberg & L.White (eds) "The deregulation of the banking and securities industries" (1979) Lexington Books p.9-30 .

Scandal ! :

Despite the accepted logic behind regulation, when enacted it is often a defensive response to a perceived public outcry rather than a planned form of social engineering. Scandal or the exposure of fraud often performs a catalytic function, providing the political impulse for new measures of investor protection or market regulation, in order to restore the confidence of the public in the market system.¹² Thus regulation only becomes newsworthy when something goes wrong in the system. It is intrinsic to financial markets and to a financial centre, like the City of London, that they are prone to scandals. Their business is money, very large sums of it, much of it other people's, and some of it the State's money. Although some of its institutions perform financial functions that are simple and stable, the work of most is to perform complex and ever-evolving manipulations with money, so as to make it available to others on attractive terms, with a view to a profit or a fee. Such business inevitably gives rise both to fraudsters, whose object is to manipulate money for private ends, and to innovators who invent new manipulations, which may constitute a more efficient or otherwise desirable service, or no more than a sleight of hand and a quick profit. People do not really know what goes on in a financial centre like the City. There is a suspicion that there is less correlation between value added and profits and salaries there than there is in most other sectors of the economy. Thus, people doubt if activity there is very valuable, but so long as it does not

12. R.Ferguson & A.Page "The development of investor protection in Britain" (1984) 12 Int. Journal of the Sociology of law 287-305 at p.293 .

interfere too much with what is going on in the rest of the economy, they are content to let it go on happening.¹³

That is, until something goes wrong in the City. Then the basic mistrust of the financial community emerges and there are calls for reform, vociferous public debates, committees of inquiry and, frequently, scapegoats. The apparent victims of 'crime and immorality' in financial services are identifiable and usually vocal. Ministers are obliged to appear concerned about them, if not, the politicians who oppose them will make political capital from their indifference.¹⁴ The incentive, then, for regulators is to impose such comprehensive regulations that they will not personally be likely to be held responsible for future failures and failings during their own term of office. Since the eventual costs of regulation are borne by unidentifiable consumers, taxpayers or voters in general, regulation will tend to be inflated into overregulation. This leads to the dilemma that too much law (ie.regulation) impairs the development and the innovativeness of the markets, whereas too little law leads to further abuses and ultimately the perversion of the markets themselves.¹⁵ The problem is that public and political attention soon moves on elsewhere, and the responsible authorities and the regulated businesses are left to operate as efficiently as they can with the system presented to them.

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13. See J.Kay "The forms of regulation" in C.Veljanovski (ed) "Financial regulation - or over-regulation ?" (1988) Institute of Economic Affairs, London p.33-42 .
 14. See A.Seldon, in the Preface to "Financial regulation - or over-regulation ?" *ibid* p.vii-viii .
 15. See Buxbaum & Hopt, *supra* chapter 3 note 8 at p.263.

A series of scandals in the City of London in the late 1970s and early 1980s was one of the reasons for the great changes in regulation which have taken place there. They also led to the passage of the first comprehensive law governing financial regulation in Britain, the Financial Services Act. The current structure of regulation in Britain derives very largely from the contents of the Gower report. The terms of reference of the report asked Professor Gower to consider what statutory protection might be necessary for investors, without any suggestion that he review the costs as well as the benefits of the exercise. In his assessment, Professor Gower was conscious that it would be self-defeating to impose regulations so severe that the costs grossly outweighed any perceived benefits, or that were so strict that they forced business to go overseas. But he rejected any cost-benefit analysis of regulation on the grounds that "I am not competent to undertake it and partly because I am sceptical about its practicability".¹⁶ Commentators point out that the complete dismissal of any wider principled approach to regulation which incorporated fundamental economic understanding is unacceptable.¹⁷ Regulation always has an opportunity cost and excessive or heavy-handed regulation by whomsoever administered, can be distorting and destructive in its effects. It is accepted that costing the law is often an imperfect and controversial exercise but this does not justify ignoring it.¹⁸

16. For this and the immediately following references, see Gower supra note 9 at paras. 1.15 & 1.16 .

17. See C.Veljanovski in the Introduction to "Financial regulation - or over-regulation ?" supra note 13 p.1-15 .

18. For a detailed discussion of this process, including its limitations, see G.Baldwin & C.Veljanovski "Regulation by cost-benefit analysis" (1984) 62 Public Admin. 51-69 .

In addition, the Gower report contains several misconceptions about the economics of financial markets. It claims that "there is a tension between market efficiency and investor protection which often pull in different directions" and that an efficient market which is free from regulation "would not afford protection to investors which anyone today would regard as adequate". It also states that American studies of regulation generally reach the conclusion that increased regulation has made no discernible difference, one way or the other, to market efficiency.¹⁹ Veljanovski contends that efficient markets by definition afford investors adequate protection, given the costs of protection.²⁰ Indeed, Stigler claimed that "...efficient capital markets are the major protection of investors".²¹ The evidence from American studies of regulation, though still disputed, is generally quite the opposite to that stated by Gower. In his classic 1964 study, Stigler asked whether the Securities and Exchange Commission's (SEC) disclosure rules governing new issues of shares had led to any benefits to investors. Using statistical analysis, he was forced to conclude that the rules had no important effect on the quality of new securities sold to the public. In the light of the costs of these rules, the investor was worse off with investor protection legislation than without!²² The details of the study are still controversial, some have even called it "a triumph of

19. Supra note 9, at p.7 note 14 .

20. Supra note 17 at p.10 .

21. G.Stigler "Public regulation of the securities markets" (1964) Vol.37 no.2 The Journal of Business 117-142 at p.124 .

22. Ibid.

ideology over scholarship",²³ but it is not an isolated assessment. The balance of the American evidence, based on assessments of several industries and not just financial services, tends to show that regulation does not achieve its desired effects in protecting consumers and investors, but does impose significant costs on industry.

Gower was not entirely at fault for the approach he took, given his terms of reference, limited resources and professional company lawyer background. Moreover, while he presented his report as a blueprint for the reorganisation and improvement of investor protection, it has been contended that it was, in fact, used simply as a political exercise by the Thatcher government, its design being to manoeuvre City institutions into recognising the need for formal public accountability.²⁴ Nevertheless, it is clear that the framework set down in the report provided the conceptual foundations for the Financial Services Act.

A role for economic analysis ? :

It is a pity then that those foundations show a total disregard for the economic realities of financial markets. Surely this is one area where economics has a direct and immediately relevant role ? It would seem logical that, in order to devise an efficient system of regulation, one should first obtain a thorough knowledge

23. I.Friend & E.Herman "The SEC through a glass darkly" (1964) 37 The Journal of Business 382-405. For an overview of several of the studies in this area, see I.Friend "Economic and equity aspects of securities regulation", an essay in R.Lanzillotti & Y.Peles (eds) "Management under government intervention : a view from Mount Scopus" (1984) JAI Press Inc. p.31-58 .

24. See Clarke supra note 10 at p.118 .

of these markets and their economic purpose and effects. There is a perennial conflict between the legal and economic approaches to investor protection and to regulation in general. The lawyer's acceptance or rejection of a practice will reflect his or her notion of the mutual fairness of a transaction between parties. The approach has overtones of fairness and morality and its substantial concern for justice may make him or her attend too little to what may be the costs of correcting perceived injustice.²⁵ On the other hand, an economist's approach is characterised by its concern with social planning for the whole. Economists regard individuals as "a fungible commodity, each substitutable for another" and fairness concerns "the propriety of allocation of resources or income among large distinguishable bodies or groups of individuals".²⁶ The economist's great ability in measurement may tend also to cause him or her to attend too little to the immeasurable. While lawyers may have too little scepticism about the efficacy of law, economists may have too little about the efficiency of markets.

It is my belief that an understanding of the functions of financial markets is a prerequisite to analysis of the regulation thereof. I shall concentrate on the theory relating to capital or securities markets and must acknowledge that the approach taken has been somewhat simplistic ! In addition, despite the theoretical progress that has been made in recent years, much of the details hereunder are still disputed.

25. H.Manne "Insider trading and the stock market" (1966) Free Press at p.3 . Manne, here, sets out his argument in favour of the legalisation of insider trading, which he contends has beneficial effects for the securities markets and their participants.

26. Ibid.

Generally, the primary function of a capital market is to transform the savings of private individuals into the investment capital required by business enterprise. This process requires mediation between the interests of the investor and those of the company seeking long term capital. This capital market is known as the primary market and is where new issues of securities are traded. It should be distinguished from the secondary market, where existing securities are traded. Buxbaum & Hopt have identified three ideal preconditions which are necessary for an optimally structured and efficient capital market.²⁷ These are :

1. Institutional efficiency : the institutional efficiency of the capital market requires that unhindered access to the market be guaranteed for capital providers and demanders, and that flexibility in the various forms of capital investment is ensured. The market should also have the ability to absorb different investments and participants, flexibility of supply and demand and, of course, stability.

2. Operational efficiency : this addresses the costs of investment mediation and capital acquisition. It requires the minimisation of obstacles to transactions on secondary markets, where it is essential that turnover be rapid, cheap, free of fluctuations and transparent. The liquidity of the secondary market is important to primary market investors, because it enables them to dispose of their investments readily.

3. Allocational efficiency : a market is allocationally efficient when scarce resources are channelled to their most productive uses. Hence the market should efficiently transfer funds between

27. See Buxbaum & Hopt, supra chapter 3 note 8 at p.219 .

lenders and producers, by generating prices that continuously equate marginal rates of return for all lenders and borrowers.

These are the theoretical economic conditions for an efficient capital market system which should provide the framework for any evaluation of regulatory measures.

For economists, the primary rationale for regulation, along with other elements of public policy towards industry, is to remedy various kinds of market failure.²⁸ A market failure is a situation in which the characteristics of transactions in a market differ from like characteristics that are judged to be desirable from the point of view of achieving certain objectives. As regards financial markets, traditional analysis identifies two types of market failure : externalities and information problems, notably asymmetric information. A classical definition of externalities predicts that they arise where one person, in the course of rendering some service, for which payment is made, to a second person, incidentally also renders services or disservices to other persons, of such a sort that payment cannot be extracted from the benefited parties or compensation enforced on behalf of the injured parties.²⁹ Externalities are therefore concerned with the social and private costs or benefits of the actions of economic agents (consumers or companies). Capital adequacy requirements are a response to one kind of externality in financial services. To elaborate, if a large number of depositors simultaneously attempted to withdraw their funds from a bank, there would be a risk that there would be insufficient funds to honour their

28. See J.Kay & J.Vickers "Regulatory reform in Britain" (1988) 7 Economic Policy - a European forum 285-353 at p.301 .

29. See A.Pigou "The economics of welfare" (1932) Macmillan at p.183.

claims. The resulting negative externality between depositors is clear, as each would end up scrambling for a slice of the available assets. Similarly, when an institution deals in contracts for future delivery, such as options, the market will suffer if doubts arise as to the institution's ability to honour the contracts if prices or circumstances move against it. Thus, capital adequacy requirements seek to ensure that there will be liquid funds available to cover every reasonable eventuality - for example, the different risk-related reserve requirements proposed by the draft Capital Adequacy directive (see chapter 3). Such measures, themselves, give confidence to depositors and options traders, which minimise the chance of a bank run or failure to honour a contract in the first place.

The second market failure is in the market for information. Mandatory disclosure of specified information is the usual regulatory response to this failure. Investment information is a public good - once published, its use does not diminish the total supply and individual users cannot exclude others from using it. The incentive to find out information is the ability to trade profitably on that information. Once acquired, a piece of information can be resold at very little cost, but incentives for discovery require that the originator of the information be rewarded at a higher level than the marginal cost of dissemination. As monopolistic exploitation of material information provides better returns than a free market sale, there is insufficient incentive for dissemination and so the well-informed participants may prefer to trade for their own account. The argument against disclosure regulation is that an unregulated market would provide an optimal amount of investment information. Potential buyers, such as private placees, would use their bargaining power to negotiate the disclosure of material information. Similarly, on the trading market, companies would

supply sufficient information to attract investor interest and satisfy the needs of recommending brokers and analysts. However, this argument overlooks the inefficiencies in the market for information, which interfere with the dissemination of information and thus justify a minimum disclosure requirement.

Asymmetric information problems are particularly prevalent in financial services. It is very hard for many consumers to tell directly whether their broker is offering honest, impartial advice or favouring his own interests. It is equally difficult for them to know whether their transactions have been executed on the best available terms, or whether an institution with which they are contemplating doing business maintains adequate margins of solvency. For large institutions regularly engaging in substantial transactions, the costs of establishing the quality of services provided are probably of relatively little significance. However, for smaller investors and companies, obtaining reliable assessments will frequently be impractical or costly.³⁰ This explains why one of the economic rationales offered for investment institutions, such as unit trusts and pension funds, is the economies of scale in gathering and handling information offered by their large diversified portfolios.

Reputation is the market's own device for establishing quality of services. It is a reliable guarantor of good behaviour where conditions are such that the seller intends and wishes to be involved in many repeated contracts with each individual purchaser.³¹ This will be the case in wholesale markets where all

30. See Mayer, cited supra Introduction note 6 at p.xiv .

31. See C.Goodhart "The costs of regulation" in "Financial regulation - or over-regulation ?" supra note 13 at p.17-31 .

involved are professionals and usually relatively well-informed. This contrasts with the small investor who often deals with the smaller intermediaries and is likely to be more inexperienced and less knowledgeable. The intermediary will not have so much to risk from losing its reputation, and, in cases of fraudulent behaviour, may be consciously aiming to take the client's money and disappear with it. The sums invested by the smaller client, though small in value, may be a sizeable proportion of his total wealth, so a single case of bad behaviour by an intermediary could spell disaster for the client. Thus, a greater need for effective adequate disclosure may be identified at the retail market level, as opposed to the wholesale markets, where reputation has its own controlling effect.

The obvious response to these information problems has been to improve information flows by requiring more extensive disclosure and the maximum transparency of market dealings. Disclosure is most appropriate where the customer and others involved are capable of assessing what is disclosed and of relating their decisions to it, and where those responsible for the business in question conduct their affairs in the knowledge that information relating thereto will be disclosed.³² The capacity of the customer to absorb information differs greatly according to his background and previous knowledge and this constitutes a decisive limit on disclosure's effectiveness. Not surprisingly, given the nature of the industry, disclosure is often only a formal procedure. Full disclosure disappears very rapidly when there actually is

32. See D.Walker "Regulation in financial markets" (1983) 23 Bank of England Quarterly Bulletin 499-501 . On disclosure generally, see B.Mercadal "Some thoughts on the disclosure approach to securities regulation" (1978) Journal of Comparative Corporate law & Securities Regulation 139-144 .

something interesting to be disclosed. It is only bodies which have nothing adverse to disclose that actually comply quickly and efficiently with the requirement. Disclosure documents are also often written in a forbidding legal and accounting jargon and in the form of legally impeccable insurance policies.³³ These are only comprehensible to experts and emphasise positive rather than negative information about the company. Mandatory disclosure may, however, create substantial savings for informed traders by collectivising some of the costs of acquiring, processing and verifying information that those traders would otherwise have expended.

Economists argue that the mere fact that market failure exists in a particular area, does not imply that the costs of remedying it by means of intervention are necessarily less than the costs of intervention. The fact that markets often fail in adequately supplying collective goods does not justify the presumption that government action can remedy the market failures, according to one observer.³⁴ Thus, it is argued that a balance should be struck between the gains from intervention and regulation, and the costs of intervention.³⁵ This is especially so in financial services, where increasing competition has squeezed margins and placed a premium on low cost methods of trading. The evidence suggests that

33. See R.Posner "Economic analysis of law" (1972) Little Brown & Co. at p.199 .

34. R.Bryant "International financial intermediation" (1987) The Brookings Institution at p.126 .

35. See Kay supra note 13 at p.40 .

the price elasticity of demand for financial services is high.³⁶ Therefore, any increase in the financial burden created by regulatory costs is likely to have a greater influence on the volume of financial transactions than if such elasticities were low. A reduction in volume entails reduced liquidity in the marketplace and lessens its attractiveness to customers. In this light, one can appreciate the concern of economists in relation to the current regulatory system in Britain, namely that there was little economic analysis of the economic benefits to be obtained from the regulation, and even less of the costs of achieving its objectives.

The Efficient Capital Market Hypothesis (ECMH) :

This is in marked contrast to American analysis of securities law and financial regulation, to which I shall now turn. There, the economic consequences of laws are a prominent concern in the executive and judicial branches of government, and among those analysing the law. However, of all the recent developments in financial economics, one particular theory has captured the attention of the securities culture and achieved the widest acceptance by the legal culture. This is the ECMH. It now commonly informs the academic literature on a variety of topics. It structures debate over the future of securities regulation, both within and outside the SEC and has served as the intellectual premise for a major revision of the disclosure system administered

36. For example, see P.Jackson & G.O'Donnell "The effects of stamp duty on equity transactions and prices in the UK Stock Exchange" (1985) Bank of England Discussion Paper No.25 . See also H.Stoll "Regulation of securities markets : an examination of the effects of increased competition" (1979) New York University, Monograph 2 .

by the SEC. It has even begun to influence judicial decisions and the actual practice of law. As Gilson & Kraakman put it, the ECMH is now "the context in which serious discussion of the regulation of financial markets takes place".³⁷ The ECMH merits investigation because the challenges posed to regulators, lawyers and economists by the regulation of European financial markets are no different from those encountered by their American contemporaries in relation to their markets.

The ECMH is the offspring of a series of studies made during the 1950s and the 1960s, by economists and statisticians who examined the pattern of stock prices, hoping to predict future movements in price. They concluded that prices were random, in the sense that their correlations with past histories were too weak to be exploited profitably. This was contrary to the prevailing view that prices tended to follow certain waves or patterns, and that the investor who accurately identified these could profit from the certain knowledge that a price would rise or fall at a particular time.³⁸ The ECMH answers the riddle of random price changes. It asserts that a securities market is efficient when prices fully reflect all available information relevant to their value. This implies that prices will adjust virtually instantaneously, and in an unbiased manner, to any new information released to an efficient market. Because no-one can predict new information, no-one can successfully forecast the direction or magnitude of future changes in prices. Thus the body of empirical evidence had found its causative theory.

37. R.Gilson & R.Kraakman "The mechanisms of market efficiency" (1984) 70 No.4 Virginia Law Review 549-644 at p.550 .

38. See L.Stout "The unimportance of being efficient" (1988) 87 Michigan Law Review 613-709 - an excellent and informative appraisal of the topic, which I have relied on considerably.

Markets are therefore described as efficiently reflecting a particular class of information, if it is so quickly incorporated into price that no-one can expect to make consistent profits trading on the basis of that piece of information. Efficiency can be expressed in three forms, which relate to different classes of information and facilitate the classification of empirical tests of price behaviour.³⁹ Random walk price movement findings support the view that a market is efficient in the weak form, in the sense that prices fully reflect all information concerning past price movements and therefore the latter do not present trading opportunities. Semi-strong efficiency requires that prices incorporate other publicly available information as well, such as newspaper reports, required disclosures and dividend announcements. Studies here indicate that market prices react so quickly to this type of information that no investor can regularly profit by trading on it. Strong form efficiency exists if prices incorporate all relevant information, including non-public information. Tests here are restricted to identifying investors who are likely to possess such information and determining whether these traders consistently outperform the market. Results have been mixed, but corporate insiders, such as company directors, systematically do earn net returns higher than the market average. Mutual funds, however, appear to outperform the market only well

39. E.Fama is credited with first proposing this division of the ECMH in his review article "Efficient capital markets : a review of theory and empirical work" (1970) 25 Journal of Finance 383 .

enough to cover their administration and trading costs.⁴⁰

Of course, if the market was perfectly efficient, no stock would ever be mispriced and there would be no incentive for analysts to seek out new information. However, 100% efficiency is not to be expected. It would only be possible if there were no transaction costs in trading securities, costless access by all market participants to all available information and agreement by them as to the implications of such information for the current price and distributions of future prices of each security ie. homogenous expectations.⁴¹ The significance of the ECMH lies in its prediction that, even though information is not immediately and costlessly available to all participants, the market will act as if it were. This produces the paradox that the market will only remain efficient if most participants believe it is not, and accordingly engage in the securities research necessary to create efficiency ! Markets that are substantially efficient afford investors the opportunity to earn competitive positive returns from such securities research.

Evidence of the judicial acceptance of the fundamentals of the ECMH can be found in the American Supreme Court's decision in Basic Inc. v Levinson.⁴² Here the Court held that a plaintiff in a

40. Gilson & Kraakman, supra note 37 at p.556 footnote 27 . The ECMH has indirectly led to a series of cases in America, where members of pension funds and similar institutions have sued the management for engaging in wasteful and unnecessary investment research. The reasoning behind the claims was that any information which the research might uncover would already have been incorporated in the market price.

41. See J.Gordon & L.Kornhauser "Efficient markets, costly information and securities research" (1985) Vol.60 No.5 New York Univ.Law Review 761-849 .

42. Basic Inc. v Levinson 108 S.Ct 978 (1988).

private securities fraud action need not have read the prospectus in which a misstatement or omission occurred. For the plaintiff to establish a presumption of reliance, all that is required is that he establish that the misleading statement or omission affected the market price of the security. This is known as the 'fraud on the market' theory and it relies on the ECMH's assertion that the price of a security will reflect all the information available to the market. Thus, the fraud theory was considered by the Court to be a desirable doctrine, because it expanded liability in a fashion that promoted pricing efficiency and served the congressional policy that markets operate "as indices of real value".⁴³ In this climate, American policymakers are no longer content to debate whether securities markets are informationally efficient to any particular degree, they now debate how they might be made more so. Improving efficiency has become a goal of American securities policy, "on a par with more traditional goals such as investor protection or fair and honest markets".⁴⁴

A critique of the ECMH :

A critical evaluation of the ECMH suggests that its importance may be overestimated. Indeed, more recent economic research and controversy about the hypothesis casts doubts on its empirical claims and theoretical underpinnings.⁴⁵ Nevertheless, it still continues to influence legal decision making. Two key assumptions are necessary to the view that improving market efficiency should be an important goal of securities regulation. The first is that share prices in an efficient market accurately reflect the best

43. Ibid at p.989-991 .

44. Stout, supra note 38 at p.621 .

45. See Gordon & Kornhauser, supra note 41 at p.764-765 .

estimates of the financial prospects of the issuing company. The fundamental basis for valuation of a share is its expected future earnings. An efficient market price is therefore thought to measure rationally the worth of the share in terms of the present value of those earnings, discounted for nondiversifiable risk. In theory, this should facilitate investors in making optimal savings decisions. To make a good savings decision, an investor must know how much consumption he will get tomorrow for the consumption he gives up today. That is, he must know the financial returns of any security he purchases, namely the payout of dividends or interest and any capital gain or loss.⁴⁶ The pricing mechanism should give the best indication of those future financial returns for an investor.

However, casual observation suggests that the stock market moves up and down much more than can be justified by changes in rationally formed expectations, or in the rates at which they are discounted. This is supported by empirical research which has shown that the valuation of companies has often drifted away from estimated valuations based on the replacement costs of the firm's actual capital assets and the present values of the future returns those assets could be expected to earn.⁴⁷ This implies that market speculation multiplies the underlying variability of dividends and earnings. In effect, the price investors are willing to pay is

46. It is questionable whether individuals who put money into shares are, in fact, making a savings decision at all. The vast majority of household savings is concentrated not in the stock market, but in assets of reasonably reliable value, such as property, pension plans and interest bearing accounts.

47. See, for example, W. Brainard, J. Shoven & L. Weiss "The financial valuation of the return to capital" (1980) 2 Brookings Papers on Economic Activity 453-502 .

determined not by financial fundamentals but by their perception of how other investors value the stock ie. expected price changes in the near future. The point was perhaps best illustrated by Keynes in his 'beauty contest' analogy :

"Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole ; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view."⁴⁸

Evidence for the claim that stock markets are irrational is found in speculative 'bubbles', among the most notable of which were the 1929 American, and 1987 global, market crashes. In such a bubble, prices rise to levels unsupported by potential earnings and then drop in a short time to a fraction of their former value. Keynes was thus forced to despair of investment based on genuine long term expectation, and he concluded that there was no evidence that the investment policy which is socially advantageous coincides with that which is most profitable.⁴⁹ It seems that it is possible to have a market that is substantially informationally efficient, yet reflects share prices that are unrelated to their value as financial instruments. Therefore, measures aimed at increasing the market's speed in adjusting to information would appear to be

48. J.Keynes "The general theory of employment, interest and money" (1936) Harcourt Brace, New York. See pp.156-160 .

49. Ibid.

unlikely to produce optimal savings decisions by individuals. Firstly, because the rational investor will not rely completely on the vagaries of the stock market to defer income to his later years. Secondly, because it appears that investors do not make investment decisions solely on the basis of the expected future earnings of shares. Thirdly, financial theory predicts that rational investors will diversify anyhow, and mispricing of securities will only distort savings decisions of the portfolio holding investor if all other securities are similarly mispriced.⁵⁰ Inefficient markets would be more likely to pose problems to investors if they increased the volatility of share prices or reduced their average returns. Inefficiency, if anything, is likely to reduce volatility because it implies that share prices will take longer to reflect new information. Market prices do not affect the returns on shares either. It is more likely to be fraud or mismanagement, for example, which reduce share returns.

The second assumption underlying the significance of efficiency to securities regulation relates to the allocative function of capital markets, and is known as the 'capital allocation theory'. It is argued that efficient stock prices serve allocational efficiency - the proper allocation of scarce resources among competing alternate uses. A market economy relies on its pricing mechanism to channel goods and services to their most highly valued use. Thus, mispriced securities would misallocate resources, because stock prices influence the production, distribution and consumption of goods and services. This is, perhaps, the most compelling justification raised in support of the pursuit of informationally efficient markets. However, unlike

50. See Stout, *supra* note 38 at pp.669-671 and p.684 .

most goods and services distributed by the economy, stocks have no intrinsic value. They are only instruments representing other, possibly valuable, rights. The connection between stock prices and the allocation of real resources is therefore inherently uncertain. The capital allocation theory was developed in response to this uncertainty, to explain the economic effects of stock prices.⁵¹

The first flaw in the capital allocation theory, is that an appraisal of the realities of corporate financing behaviour illustrates that equity issues play a negligible role in corporate financing. Companies relatively rarely rely on equity issues for funding. In the 1970s, for instance, new equity accounted for only 6% of corporate funding in America, and less than 4% in Britain.⁵² These figures may have increased somewhat in the 1980s, but a recent study of the financing patterns of British and German companies between 1982 and 1988 indicated a continuance in this trend.⁵³ The vast majority of funding, in both countries, came from internal resources and bank borrowing. The insignificant role of funding in stock markets is most likely due to tax measures favouring debt borrowing and to the high costs of raising equity capital. Stock prices also have little influence in relation to the availability and cost of the other, more commonly used sources of capital for companies. A company which is highly valued by the stock market may find it easier to borrow money than if its share price was depressed. This will be because the same optimistic information that led the market to view the firm's prospects favourably will also make the firm an attractive lending

51. See Stout, *supra* note 38 at p.642 .

52. See Mayer, cited *supra* in the Introduction note 6 at p.xi .

53. C.Mayer & I.Alexander, *supra* chapter 3 note 3 .

proposition. In assessing a company's creditworthiness, a banker will prefer to measure the risk by comparing the outstanding debt of the company to the value of its underlying assets, rather than to the 'value' represented by the stock market price of its shares.

A further flaw in the capital allocation theory is that the funds that companies receive when they do sell equity are not determined by prices in the trading market. They are set in negotiations between the issuers and institutions with whom the equity is being placed, or between the issuers and the underwriters of the issue. There are two forms of new public equity issue. The more frequent is a flotation, when a privately held company 'goes public' for the first time. The other method is used when a company, which has already issued shares to the public which are traded on the market, decides to raise additional capital by making a further issue. Commonly, when either such issue is made, the new equity is first sold on a private market, the underwriting market, where underwriters purchase the entire issue at a negotiated price and then sell it directly to the public. In a flotation, there is obviously no existing stockmarket price to assist in deciding the issue price. Underwriters may consider the prices of shares of comparable companies trading in the same sector, but they can only be of minimal guidance, because the factors relevant to share pricing are numerous and vary from company to company. When a public company seeks additional capital, the underwriters may refer to the current trading price. This is likely to function purely as a ceiling above which the offer price to the public should not rise. This is because issuing large amounts of stock usually increases the supply available on the market and, in the absence of a corresponding increase in demand, will depress the price below prior trading levels. To this extent, efficient trading prices help underwriters accurately price this type of

issue. To the extent that such issues affect the allocation of capital among the firms that use them, an informationally efficient market will therefore help to properly allocate capital.⁵⁴ However, if the logic concerning the contribution of informationally efficient markets to capital allocation was to prevail, then regulatory measures would be aimed at making prices in the underwriting market for new issues more efficient, rather than those in the trading market.

The goal of efficient trading markets has also been supported (or defended) on the grounds that market prices can determine who owns a company. The so called 'market for corporate control theory' asserts that in an efficient market, hostile takeover offers can direct control of the company from unprofitable management to more effective owners.⁵⁵ The theory focuses on the impact of management's competence on stock price which 'should' reflect the expected earnings of the company. Good management should be able to extract optimum profits from a company and this will support the share price. When a bidder offers to buy a company at a price higher than the market price, the bidder must believe that under its control the company will have higher earnings than at present. Inefficient share prices would distort the functioning of this market for control. A bidder might offer to pay a premium over market price for an inefficiently priced firm, even if it did not think it could run the business better itself - the undervaluation by the market would be sufficient to make the target a bargain. Thus, a takeover bid will often mobilise enough investment to raise the price of the target's shares to levels much closer to

54. See Stout, *supra* note 38 pp.650-656 .

55. See generally, F.Easterbrook & D.Fischel "The proper role of a target's management in responding to a takeover offer" (1981) 94 Harvard Law Review 1161-1204 .

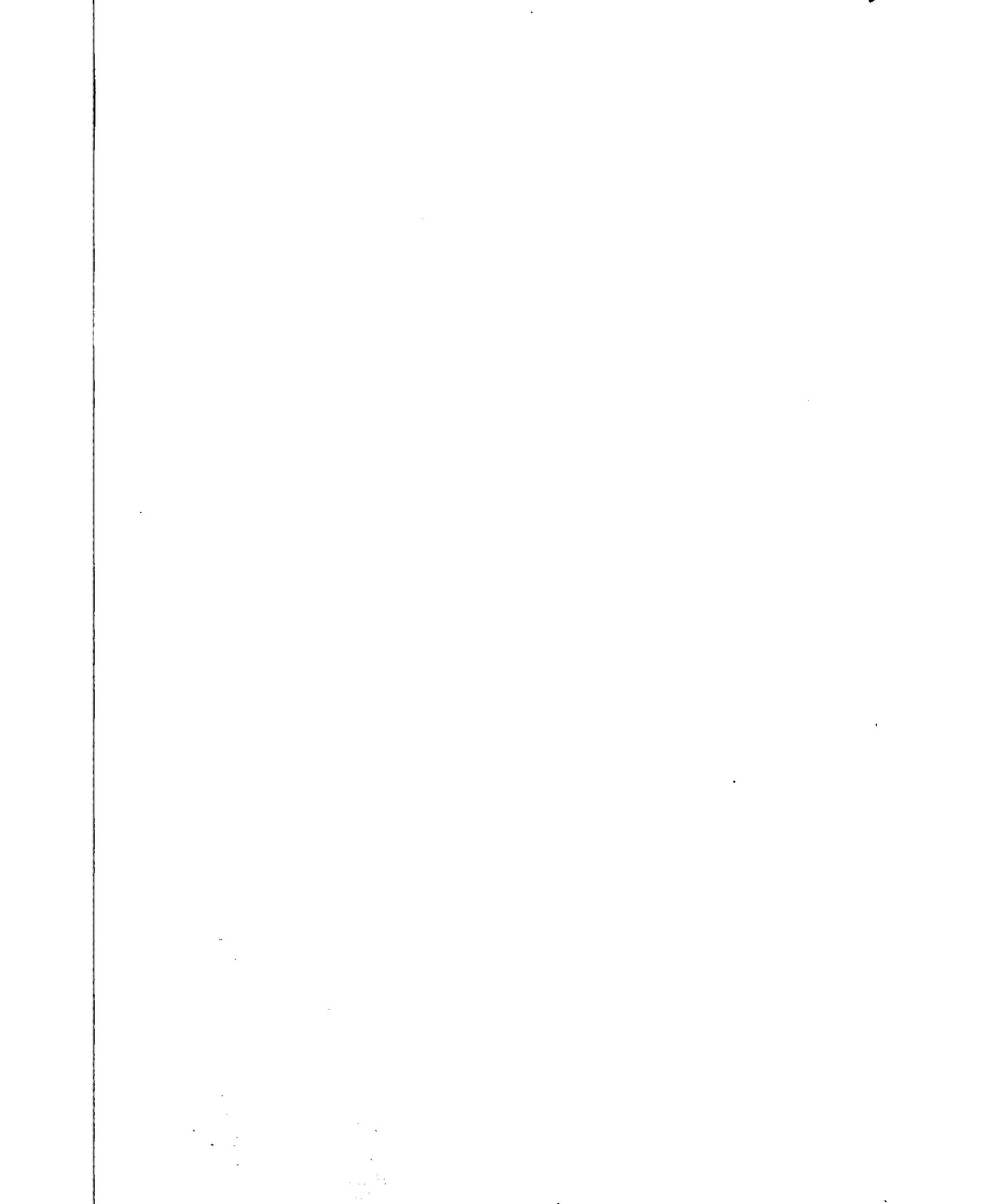
the fundamental valuation of the underlying assets. This is itself an indictment of the efficiency of markets in accurately pricing shares.

A bidder may act for reasons unrelated to efficiency, but stemming instead from internal power or prestige reasons, or from the easy availability of credit.⁵⁶ The theory also overlooks the fact that the marginal price of shares in the trading market rarely determines whether a takeover will occur. In practice, the successful bidder must pay a substantial premium over the prevailing market price, this being the average price necessary to induce all, or the majority, of the shareholders to part with their shares. At most, the market price will perform a signalling function by suggesting a 'floor' for the final offer price, but it cannot dictate what the successful offer price will be. That will be set in the market for corporate control and, in this instance, it is the price mechanism in this market which has the important allocative role.⁵⁷ It is difficult to imagine a more significant allocative decision than who owns and controls a company. If efficiency of pricing is to be pursued, it would be better to consider it in the context of this particular market.

Therefore, it can be argued that stock markets have far less allocative importance than has been assumed. If efficient share pricing contributes only marginally to allocation of resources, and share prices cannot be considered to be good indicators of the intrinsic value of the shares themselves, then the value of

56. R.Buxbaum "Federal aspects of corporate law and economic theory" an essay in T.Daintith & G.Teubner (eds) "Contract and organisation : legal analysis in the light of economic and social theory" (1986) Walter de Gruyter p.274-292 .

57. See Stout, supra note 38 at p.692 .



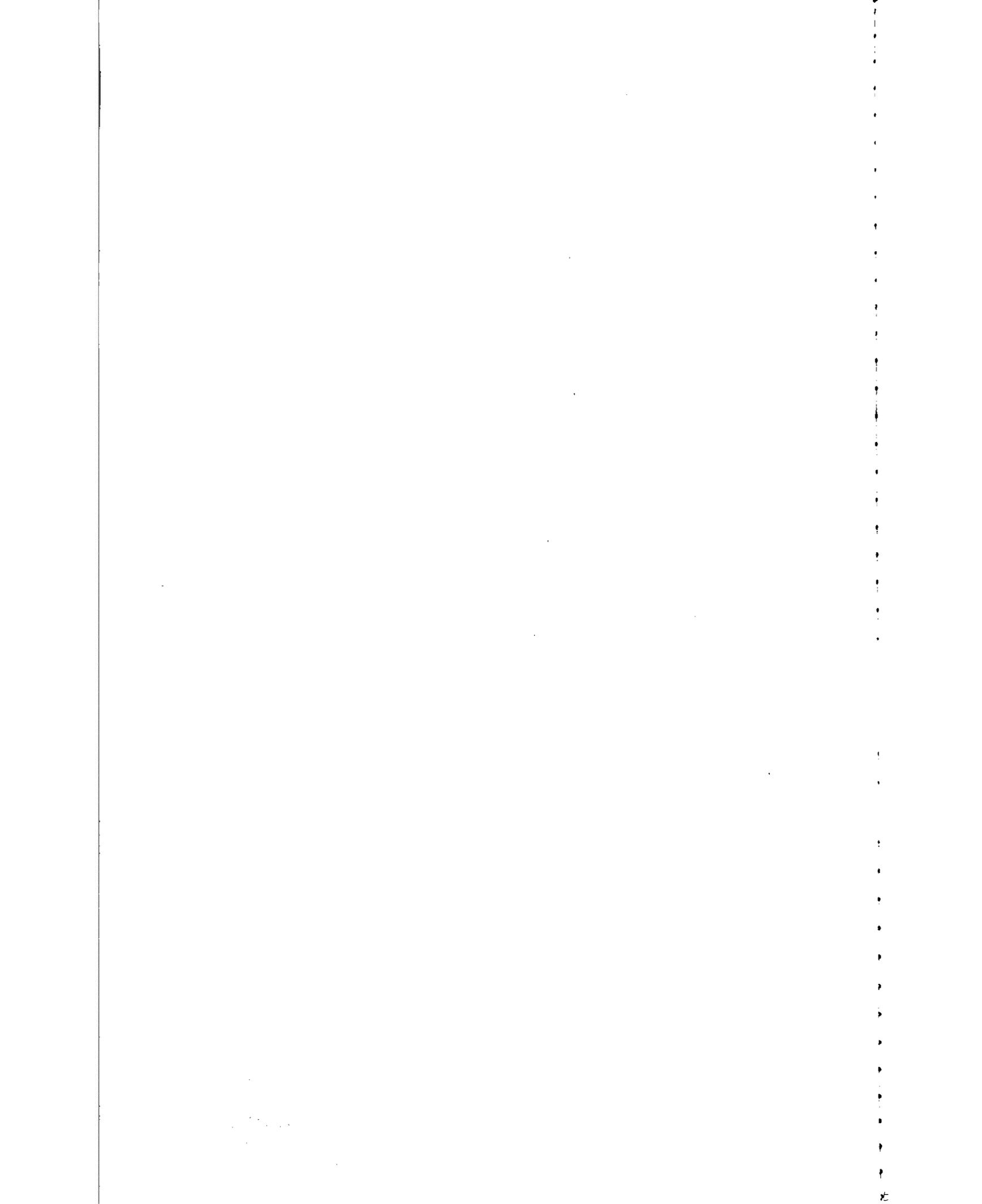
pursuing informational efficiency as a goal of securities markets is questionable. Efficient stock markets require effective distribution of large amounts of information and a trading system which can incorporate that information into stock prices. Neither comes cheaply. Arguably, the costs of improved efficiency have not been balanced by proportionate benefits, and thus the "legal rush to embrace and apply" the ECMH, may have been overly precipitous and unwise.⁵⁸ This is not intended to belittle the role of economics in questions of securities policy. The theory emphasises the significance of information to securities markets and presents a forum for critical analysis of disclosure policies and other information related measures.⁵⁹ This American experience is useful as an example of the interplay between economic analysis and legal policy making. It illustrates the need for regulators to thoroughly analyse the objectives of their regulatory measures and the means of carrying them out, both from a legal and an economic perspective.

Are the stock markets for gamblers or for investors ? :

In the light of the questionable importance of their evaluative and allocative roles, the social value of secondary trading in

58. Gordon & Kornhauser supra note 41 at p.764 .

59. Information matters have been the source of recent heated discussions at the London Stock Exchange, in relation to the rule that delayed for 24 hours the compulsory disclosure of the prices at which large share transactions were completed. The Office of Fair Trading claimed that this rule deprived the market of information and that the resulting loss of transparency diminished pricing efficiency. In addition, it felt that the rule increased uncertainty and led to higher dealing costs for investors and the loss of liquidity in the stock market. See R.Waters "LSE rule criticised as anti-competitive" Financial Times 1/5/1990 p.20 .



financial markets may be doubted. Since the earnings prospects of the company whose assets are being traded, and indeed the fundamental value of the assets themselves, are unaffected by such secondary trading, such trading cannot create wealth, it can only redistribute it.⁶⁰ The resources used in this exercise are therefore largely wasted, which is a net loss to society. The argument has been extended to the financial system as a whole. Fears have been expressed that it is absorbing scarce resources, specifically in the form of intelligent, managerial-quality labour, and that the apparent rewards available in the system have diverted energy and resources from other sectors. These resources, it is contended, are being thrown into financial activities that are remote from the production of goods and services and generate high private rewards, disproportionate to their social productivity. They favour short term position taking in contrast to long term wealth creation. This is why it seems plausible to say that the majority of transactions on the trading markets involve simply a reshuffling of existing assets between the portfolios of professional dealers. In addition, Tobin argues that computer technology is being harnessed not to carry out transactions more economically, but to balloon the quantity and variety of financial exchanges.⁶¹

In its defence, it is wrong to denigrate stock market trading as pure gambling. The financial system, as a whole, allows individuals and households considerable facilities to shift the time pattern of their spending and consumption. It facilitates them in achieving their needs and preferences, rather than having

60. See C.Goodhart, *supra* chapter 1 note 15 at p.11-13 .

61. See J.Tobin "On the efficiency of the financial system" (1984) 153 *Lloyds Bank Review* 1-15 .



to slavishly conform to the time profile of their earnings. It enables individuals to trade earnings in their productive years for consumption in retirement. Futures markets allow businesses to hedge against events that might alter the prices of commodities they will be buying or selling. Capital markets enable fundamental risks of business enterprise to be taken by the adventurous, while risk averters content with lower average returns, are protected from many possible sources of loss. The negotiability of securities traded in financial markets provides liquidity to the individual investor, who can therefore alter and structure his investment portfolio as he sees fit. The secondary markets are an integral part of the system itself, of which each component part is essential to and compliments the other. A market system which enables people to satisfy their revealed wants, which clearly include trading in financial assets (even if it is only mere speculation), as efficiently and cheaply as possible, should add to general welfare. Even if secondary trading was no more than pure gambling, there would still be a case for having it provided competitively and efficiently rather than by a high cost oligopoly.⁶²

Summary :

Regulation of financial markets is clearly a melting pot in which different disciplines, varying versions of capitalism and alternate legislative strategies constantly simmer. I have attempted to analyse the subject with an economic perspective in mind. Economists have always maintained that it is possible to study the effects of public policies and not merely to assume that they exist and are beneficial. Under this scrutiny, regulation has

62. See Goodhart, *supra* chapter 1 note 15 at p.12.

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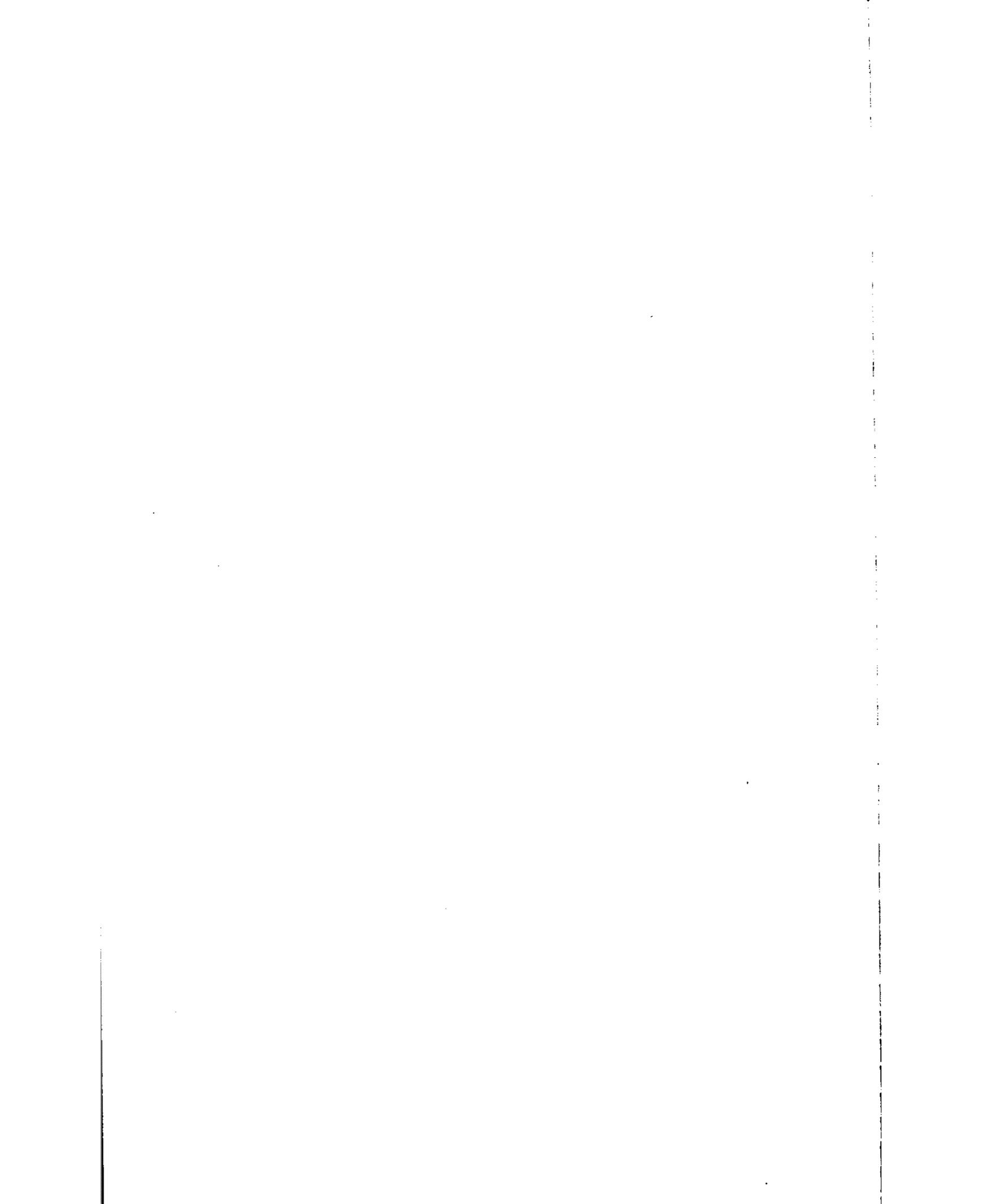
often been seen to be sorely lacking. The normal pattern is that market failure provides the rationale for the introduction of regulation, but the scope of the regulation is then extended to a wide range of matters which are the subject of general interest, regardless of whether there is any element of market failure or not.⁶³ The economists' concern is that the process of regulatory legislation all too often fails to be informed by much economic analysis or input. The legislation has often seemed to flow from a public revulsion from some kind of practice, with little assessment of its actual social costs, which is then enacted against in a quite general way. Even if a regulatory measure is an appropriate response when first implemented, a solution to today's problem is an admission ticket to new problems, particularly on the ever changing stage of financial services. Therefore, a balanced analysis of any regulation must evaluate its costs and side effects, not merely its intended benefits, and must subject it to periodic re-evaluation. As Stigler said : "Public policy should serve proper goals, and do so efficiently - this is a statement of the problem. To solve the problem by definition is impossible. The only defensible solution is to use our general economic theory, which, for all its deficiencies is our most tested and reliable instrument for relating policy to effects...".⁶⁴

A new wave of regulation, modifying existing measures or introducing new ones, will be required as a result of the efforts at the European Community level to regulate activities on stock markets and the provision of financial services in general, throughout Europe. Hopefully, some of the foregoing thoughts will

63. See J.Kay & J.Vickers "Regulatory reform : an appraisal" a contribution to "Deregulation or re-regulation ?", supra note 3 at p.223-251.

64. G.Stigler supra note 21 .

be reflected in the approach taken to the regulatory legislation to be adopted by the member states. If not, the danger exists that excessive regulation and intervention will distort competition and raise costs in the markets, thus reducing their attractiveness and discouraging participation therein.

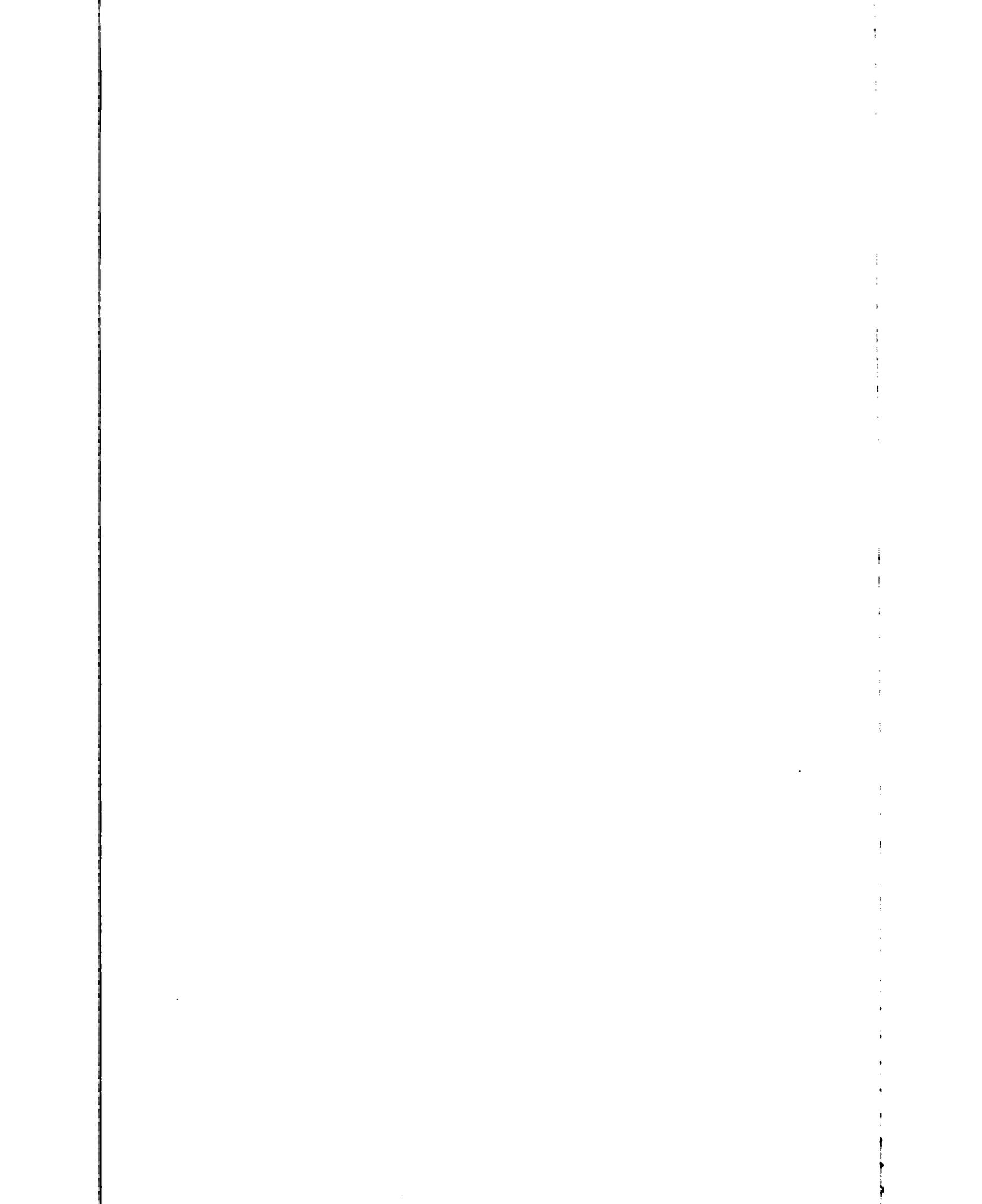


CONCLUSION :

The European financial services industry is in a state of flux. It can no longer afford to remain protected and fragmented, shackled by internal bickering and obsessed with nationalistic concerns. It has the opportunity to emerge from behind the shadows of America and Japan, and assert itself as an independent financial power, speaking with one authoritative voice. To do this, it will be necessary to build on the strengths of the industry while acknowledging its weaknesses, to respect the diversity of its markets and to exploit the expertise of its participants.

While healthy competition between and within the financial markets can only be a positive development for all concerned, the attractiveness of those markets to non-European businesses must not be ignored. It is possible that competition in the future will lead to a concentration of trading on one or a few markets, gradually turning the rest into peripheral regional exchanges, specialised in small-sized domestic companies. Alternatively, intensive competition could continue between the principal markets, to the detriment of smaller exchanges and outside businesses. As yet, individual stock exchanges have not resorted to specialisation, but their future might well lie in the exploitation, by each market, of its comparative advantages, and the concentration of its efforts on particular segments of its clientele.¹ Such an approach would be completely reliant on the

1. See M.Pagano & A.Roell "Trading systems in European stock exchanges : current performance and policy options (1990) 10 Economic Policy - a European forum 63-115.

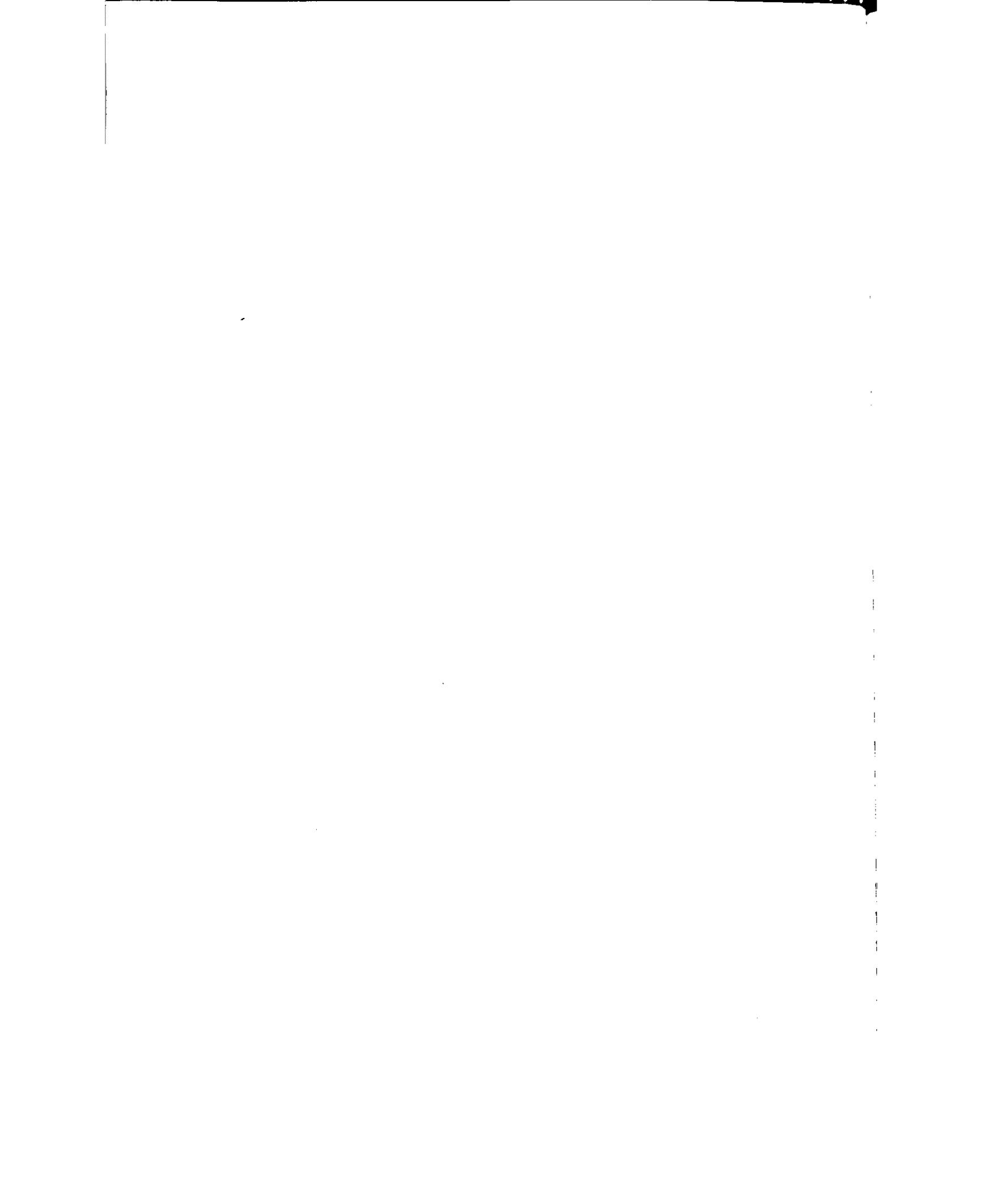


ability of both service providers and consumers to move themselves and their money freely within the Community.

The securing of such mobility is the goal of the institutions of the European Community, who, in preparing legislation for this sector, have sought to establish the necessary conditions of a free market in financial services, while relying on the financial industry to create the sufficient conditions.² To legislate for the industry is, indeed, a difficult task, and one which has been complicated by the blurring of the traditional demarcation lines between the once separate and distinct businesses and institutions involved therein. National authorities no longer preside over basically segregated financial markets, with supervision carried out along institutional lines. The changes in the pattern of financial intermediation require that regulation, not to mention the regulators, be more sophisticated and sensitive to the competing interests within the market. For example, the second Banking directive, by implication, imposed the 'universal' banking model on the Community, but the Investment Services directive is perceived as its essential counterpart, being necessary to redress the balance and ensure that the mythical level playing field is accessible by all enterprises competing in the provision of investment services.

The Commission and the Council have been seen to be in favour of deregulation, in the sense of the liberalisation of financial markets, but they simultaneously advocate their immediate re-regulation, to ensure that investors are protected and to preserve the stability of the financial system in general. This is entirely

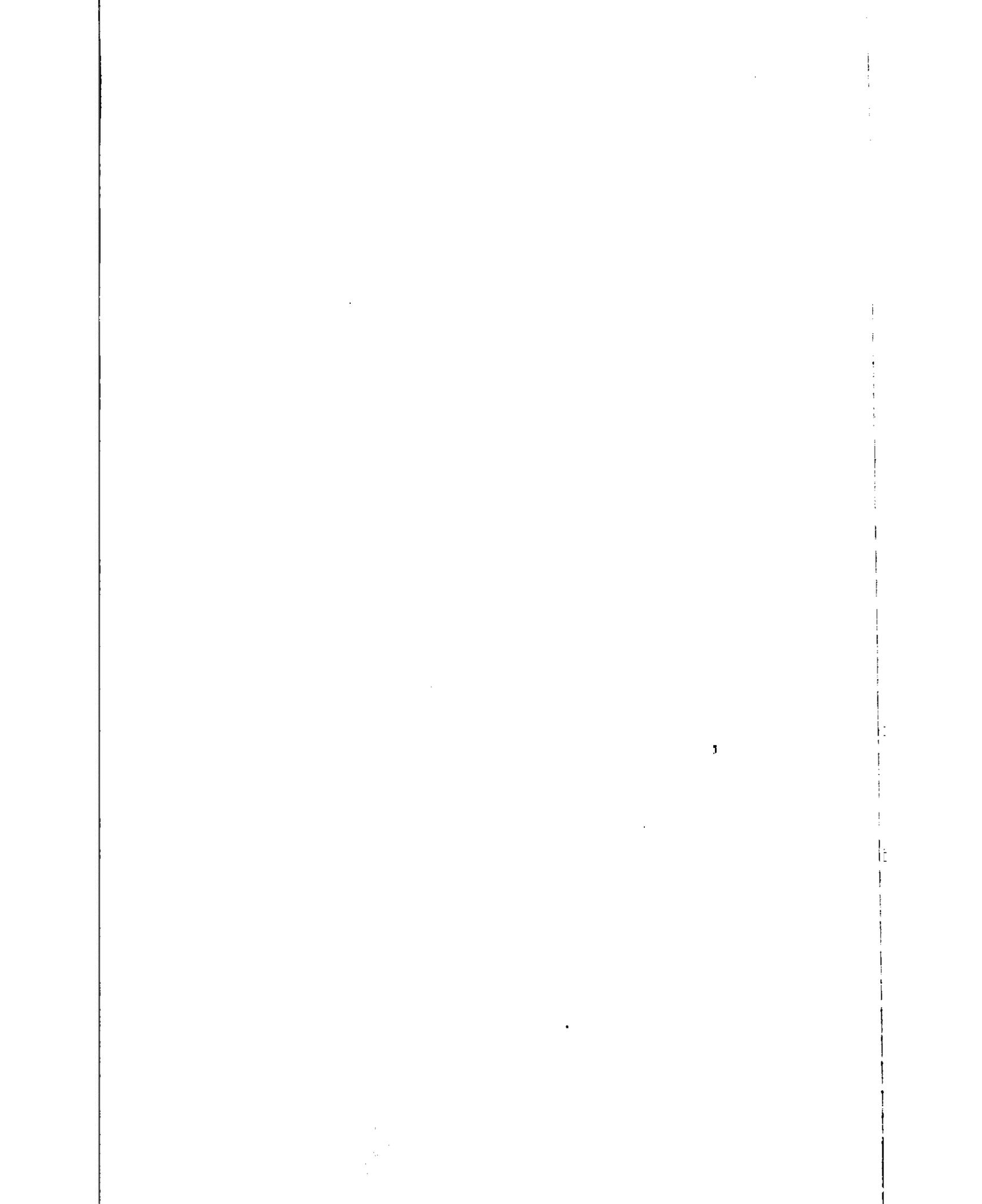
2. See F.Maude in the Foreword to "1992 - The Single European Market (1988) IFR Publishing Ltd. p.9-10.



praiseworthy in the current climate, which features among its characteristics, fierce competition, share price volatility and the ever present threat of another big, fraud, insider trading or share support scandal. My concern is that the Community institutions, in concentrating on the minimum harmonisation of essential prudential standards, and favouring the mutual recognition of national regulatory controls and supervision, may not have gone far enough. To ensure that mutual recognition works, a greater degree of harmonisation which can ensure a more stable, competitive and equitable market, may be necessary. The demands of the 1992 timetable, while accelerating the Community efforts in this field, may ultimately jeopardise their prospects of success.

Much will depend on the approach of the member states to the implementation of the Community directives. The onus will be on them to implement and apply the directives in a manner which opens up their national markets, without enacting disguised protectionist measures in the guise of compliance legislation. In an ideal world, a reasoned approach to the legislation, which opts for the most economically effective means of implementation, would be selected. The simple axiom, suggested by Breyer for creating and implementing any regulatory programme, would be utilised. This states that first the objectives of the regulation are determined, then the alternative methods of achieving them are examined and finally, the best method for doing so is chosen.³ If only it were so straightforward ! Nonetheless, in framing implementing measures, account should be taken of the costs of such legislation to ensure that they are at least proportionate to the benefits which it seeks to achieve. Although the impetus for this

3. See S.Breyer "Regulation and its reform" (1982) Harvard University Press at p.5.



legislation will have come from the Community 1992 programme, it should not prevent the adoption of a transparent, costed approach by the member states.

After 1992, the Commission will need to be ruthless in its detection of instances of non-compliance or disregard of the Community legislation, and should not hesitate to resort to the Court of Justice to seek redress in the form of legal remedies against the offending member state or organisation. The deterrent effect of such surveillance, if well-publicised and sufficiently absorbed by the financial community, could help develop a greater degree of Euro-consciousness therein. When acting in this capacity, the Commission will often encounter national regulatory authorities, who traditionally have resented such interference. Of late however, the Community stock exchanges for instance, have attempted to present a more unified front to the Commission, but their tendency to pursue their own expansionist plans while disregarding the benefits of increased integration and cooperation will not disappear overnight. This emphasises the need for greater international coordination between regulatory and supervisory authorities, in particular in the securities sector, where international venues for communication and the exchange of information are in no way as established and productive as they are in the field of banking. So much financial services business is now done internationally, in different currencies and across national and regulatory frontiers, that cooperation among national authorities is almost a pre-condition to effective supervision at a domestic level.

What will be the implications of all these developments for customers for financial services? It is generally accepted that most change will be seen in the retail services market. The wholesale markets, due to the international and mobile nature of

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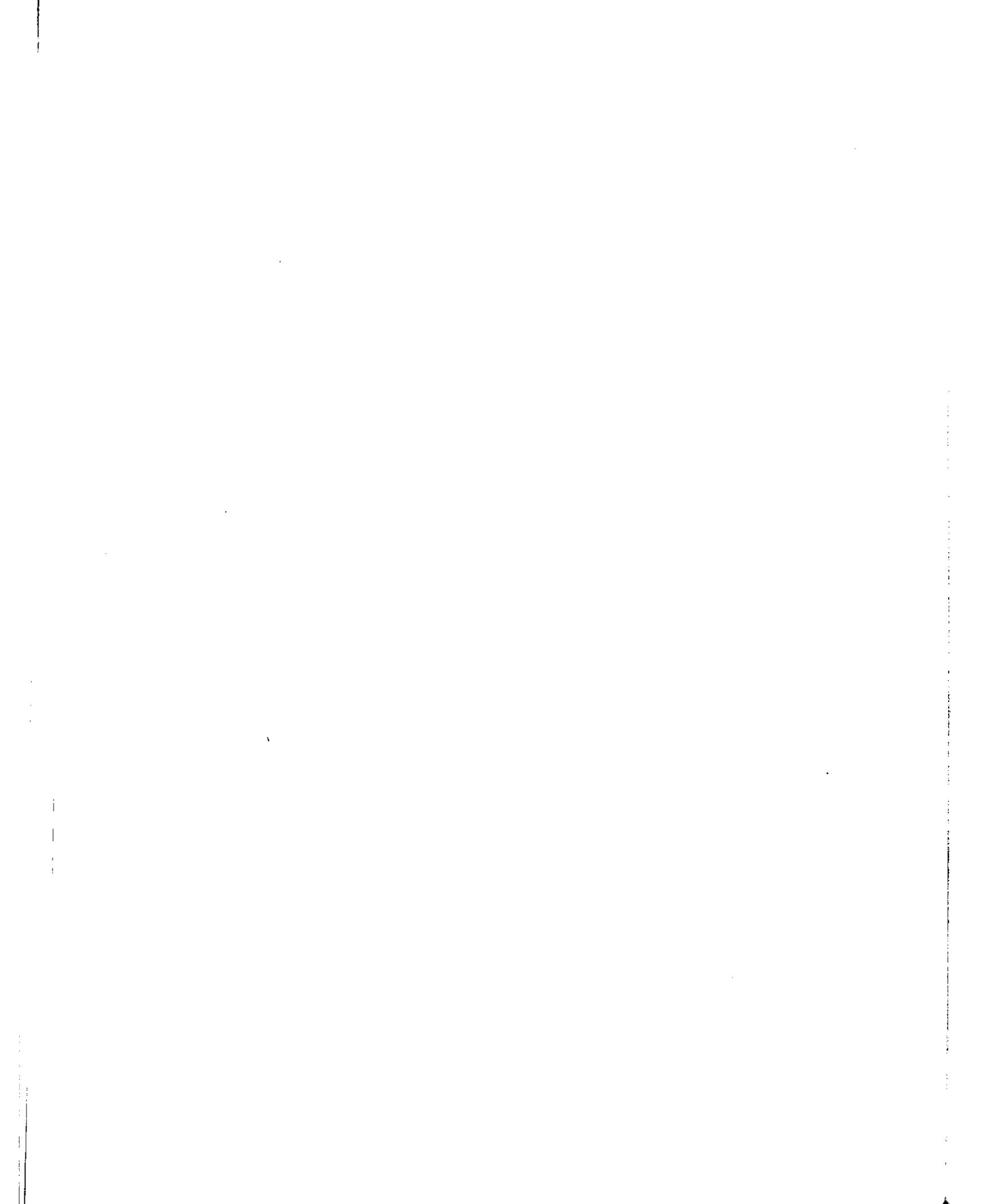
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their participants, have developed their own momentum towards integration, and most of the economies of scope and scale offered by an integrated European market have already been exploited therein. Retail markets present a different scenario. Much has been said and many figures quoted, about the opportunities that will be presented to the retail customer by the opening up of the markets, and about the important role to be played throughout by consumer protection. These benefits should not be exaggerated however, because local tastes and customs are likely to remain for a long time to come. The reason why demand for many financial products varies across the Community is mainly because of differences in preferences, habits, language, culture and incomes which will be wholly unaffected by 1992. It is possible that there are as many customary barriers to pull down as there are legal or structural ones. In this context, Kay argues that economic integration is about the creation of greater product diversity within national markets, not about the elimination of product diversity in international markets.⁴

For these reasons, firms would be unwise to dismiss the benefits of geographical specialisation and local knowledge. An Italian insurer will know Italy and its insurance market better than a Danish one - he can make better estimates of local risks. Similarly a Greek banker might be a better judge of a Greek citizen's creditworthiness than a French banker. Established firms have the benefit of consumer recognition and familiarity, a form of goodwill which has to be developed over time. In addition, there will always be the problem of tradition to be overcome. Will Germans, for instance, want to entrust their hard earned savings

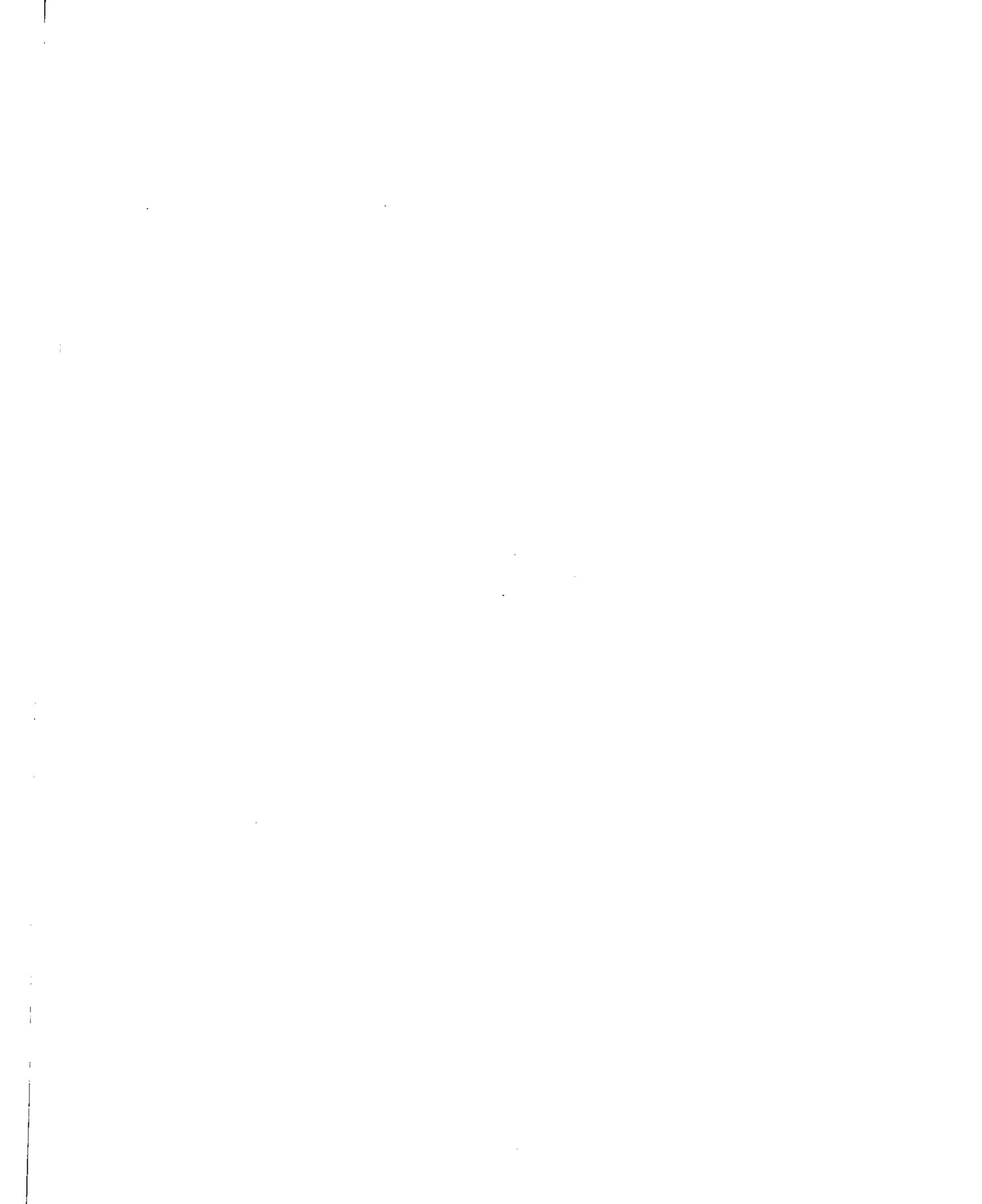
4. See J.Kay "Myths and realities" in "1992 Myths and Realities" (1989) London Business School pp.1-28 .



to "foreign" businesses, or will they be prepared to shop around for the best value or the best terms available, irrespective of the product origin ? Arguably, there would be greater scope for national loyalty when an Italian buys a car than when a Spaniard takes out a bank loan, but that Spaniard might feel more secure knowing his money is in the hands of a local, familiar bank than with a strange sounding, newly arrived foreign bank. It is difficult to predict just how the 'European' retail consumer will react to the possibilities that may be opened up to him by the single market.

If financial products were assimilable to goods or merchandise, then their retailers could justifiably hope to change consumer behaviour through a combination of market research and extensive advertising campaigns in target host countries, in the belief that tastes and habits would be amenable to alteration by successful marketing. In theory this may be possible for the retailing of financial services : the Investment Services directive facilitates the advertising of services by authorised firms in host member states through all available means of communication, but makes this freedom subject to any rules governing the form and content of such advertising adopted in the general good therein. In practice, barriers erected by traditional habits and experience will continue to obstruct efforts by potential new participants to enter markets. As an example, British firms usually sell unit trusts through competitive newspaper advertisements, whereas West German law does not permit advertising that compares the performance of various unit trusts, and banks are the most frequent sales points.⁵ To what extent will the advent of the internal market in financial services change this ? Rather than

5. See The Economist, cited supra in the Introduction note 3.



attempting to change established practices in Germany, a British firm, determined to secure a foothold in the market, is more likely to seek to form a link with a German bank, thus securing an outlet through which it can offer its services and its products can be distributed.

Davis provides a very good example of how financial services firms can and have circumvented such customary and practical barriers.⁶ He refers to the relationship between Gouda, a Dutch insurance company, and Endsleigh, a British insurance retailer, whose principal market lies in insuring student possessions and travel. Endsleigh sells insurance to students in Britain, but covers them with policies that are taken out in The Netherlands. It is obvious that Gouda would face a much harder marketing task, if it attempted to sell direct to the British market from the Netherlands. The value which Endsleigh creates is in vouching or warranting the quality of a Dutch company to British individuals who have probably never heard of it, and are most unlikely to bother to try to find out about it.

This experience suggests that direct exporting of services is unlikely to be attractive to market participants in retail services. It is more likely that small scale acquisition of, or close cooperation with, existing enterprises in host member states, may be the way forward for those firms with a stake in the retail market. A concrete example of such a manoeuvre was the link up between the Royal Bank of Scotland and the Spanish bank Banco Santander.⁷ Under this arrangement, Santander took a 10%

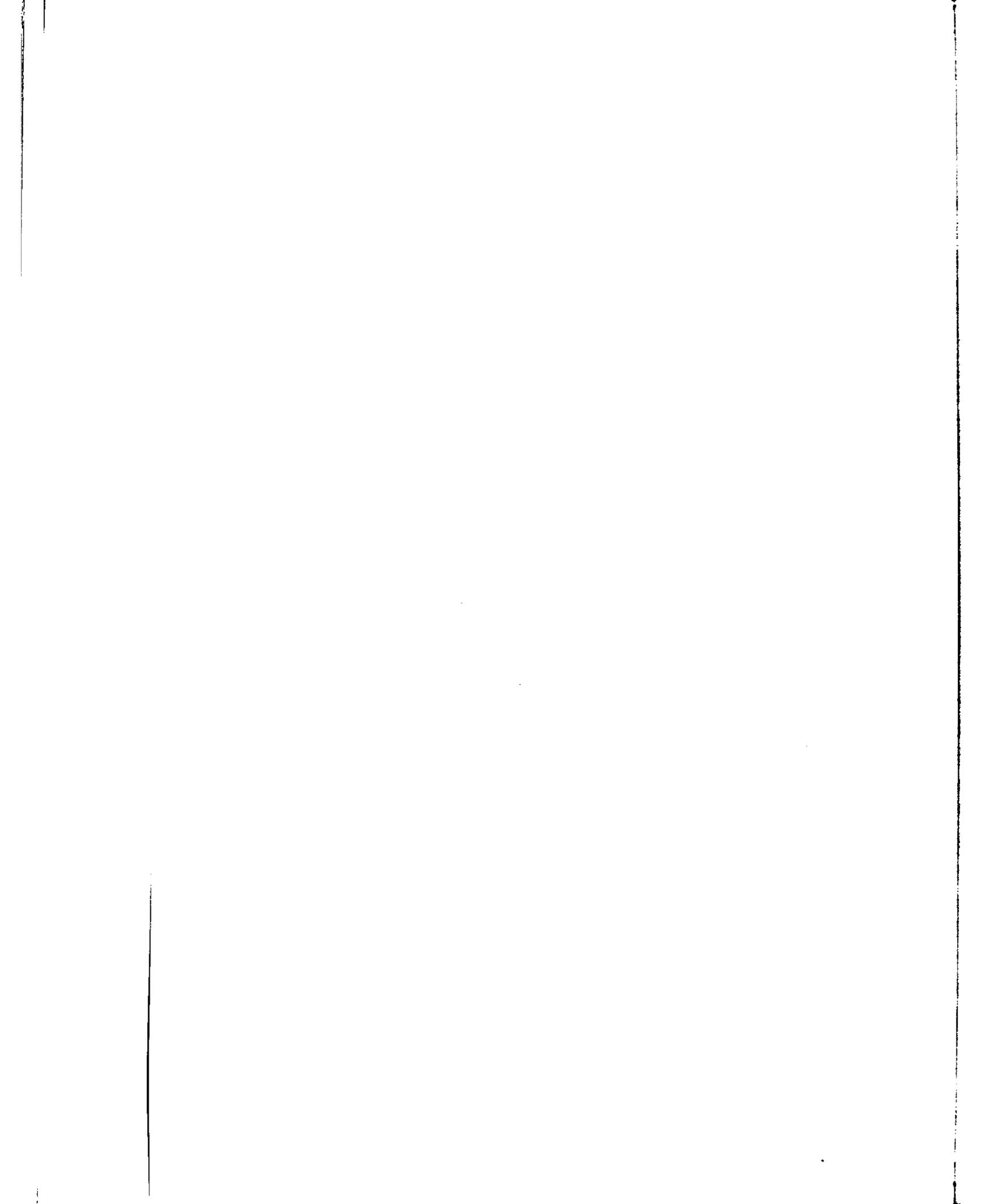
6. Supra chapter three note 40 at p.80 .

7. See D.Lascelles "Resources pooled to tackle Europe" Financial Times 25/9/1989 .



shareholding in the Royal Bank and the latter took a 2.5% interest in Santander. Santander also intended to make a long term loan to its new partner of \$200m. Since the deal was finalised, the two partners have set up branch sharing arrangements, exchanged personnel and launched a number of joint ventures in areas like franchising and venture capital. Their aim is to pool the resources of two medium sized European banks, to tackle the EC single market more forcefully than they could on their own. It will be interesting to see if this was just the first in a long line of similar collaborations, aimed at seducing the post 1992 European consumer of financial services.

These are clearly exciting times for the European financial services industry and all involved therein. It is difficult to predict with any conviction the shape the marketplace will take in the near future. Indeed, it is misleading to speak of a marketplace, which until recently meant exactly the physical entity that the name suggests. A modern securities market is defined by aspects such as the set of agents to whom information is disseminated, the trading and settlement mechanisms, the regulatory structure and the range of instruments traded. This difficulty is exacerbated by the capacity which the markets have shown for adopting to changing trading conditions and to innovative developments. The former are generally the product of a combination of external circumstances, and the latter will only be limited by the extent of man's own guile and ingenuity.



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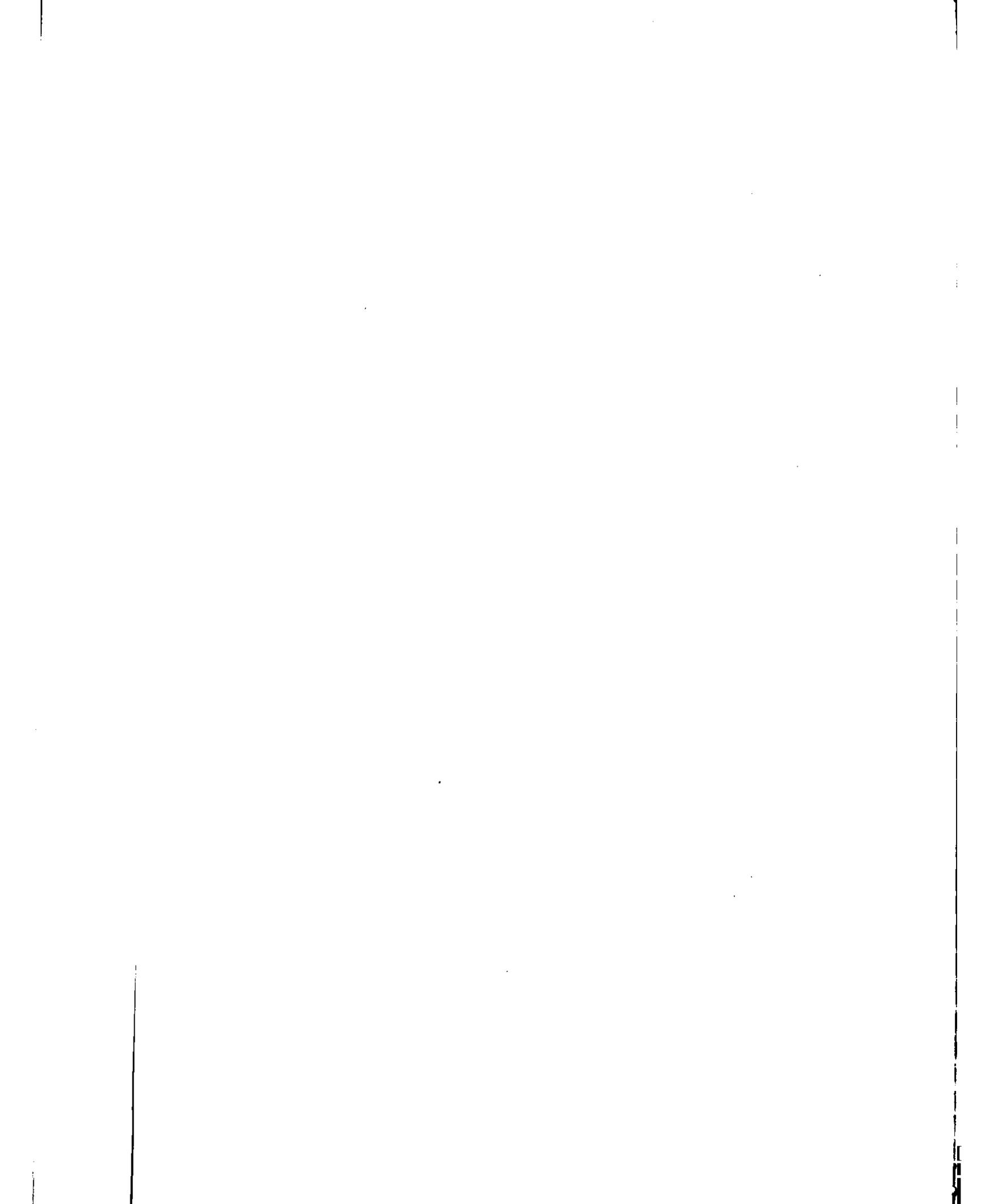
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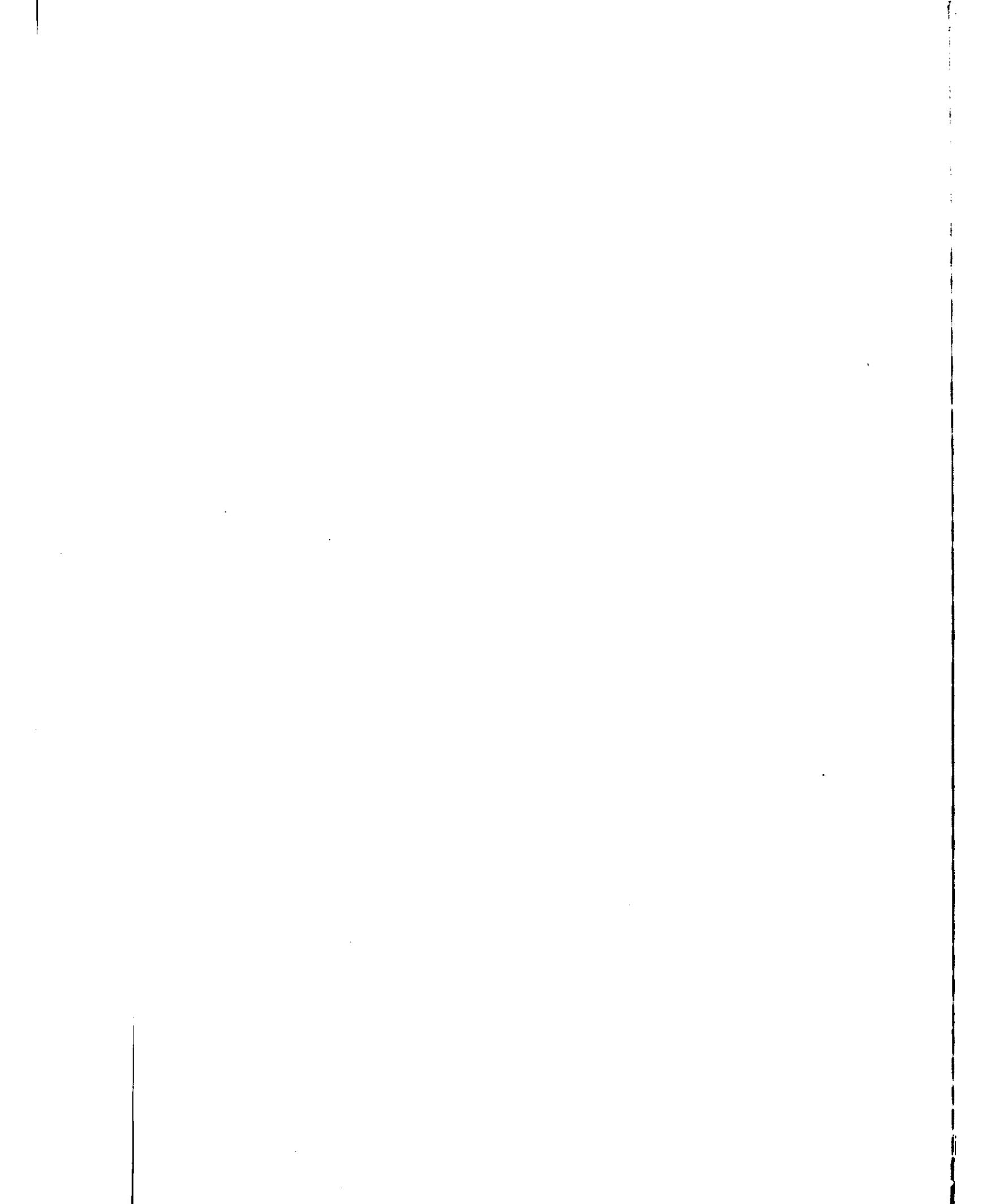
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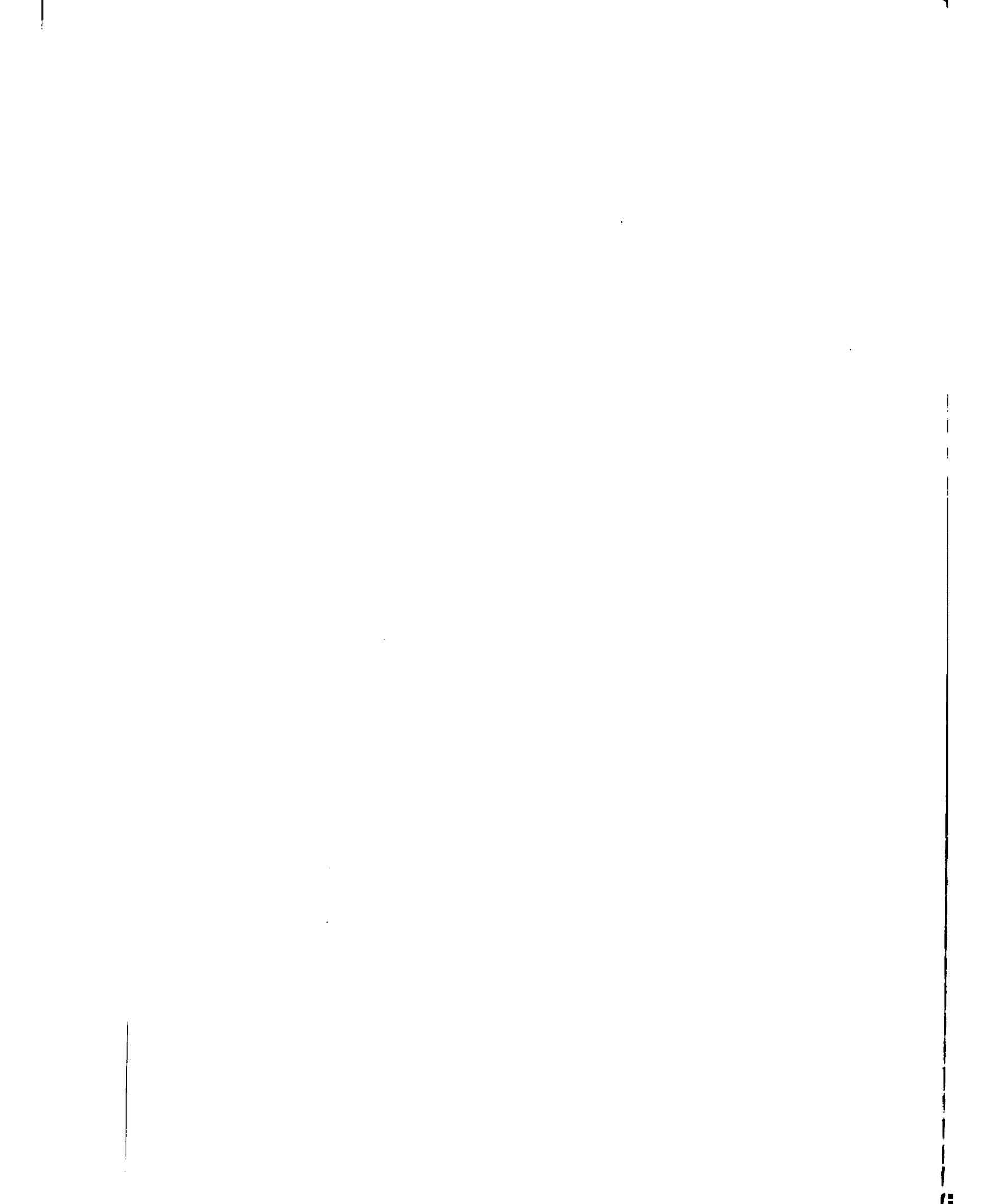
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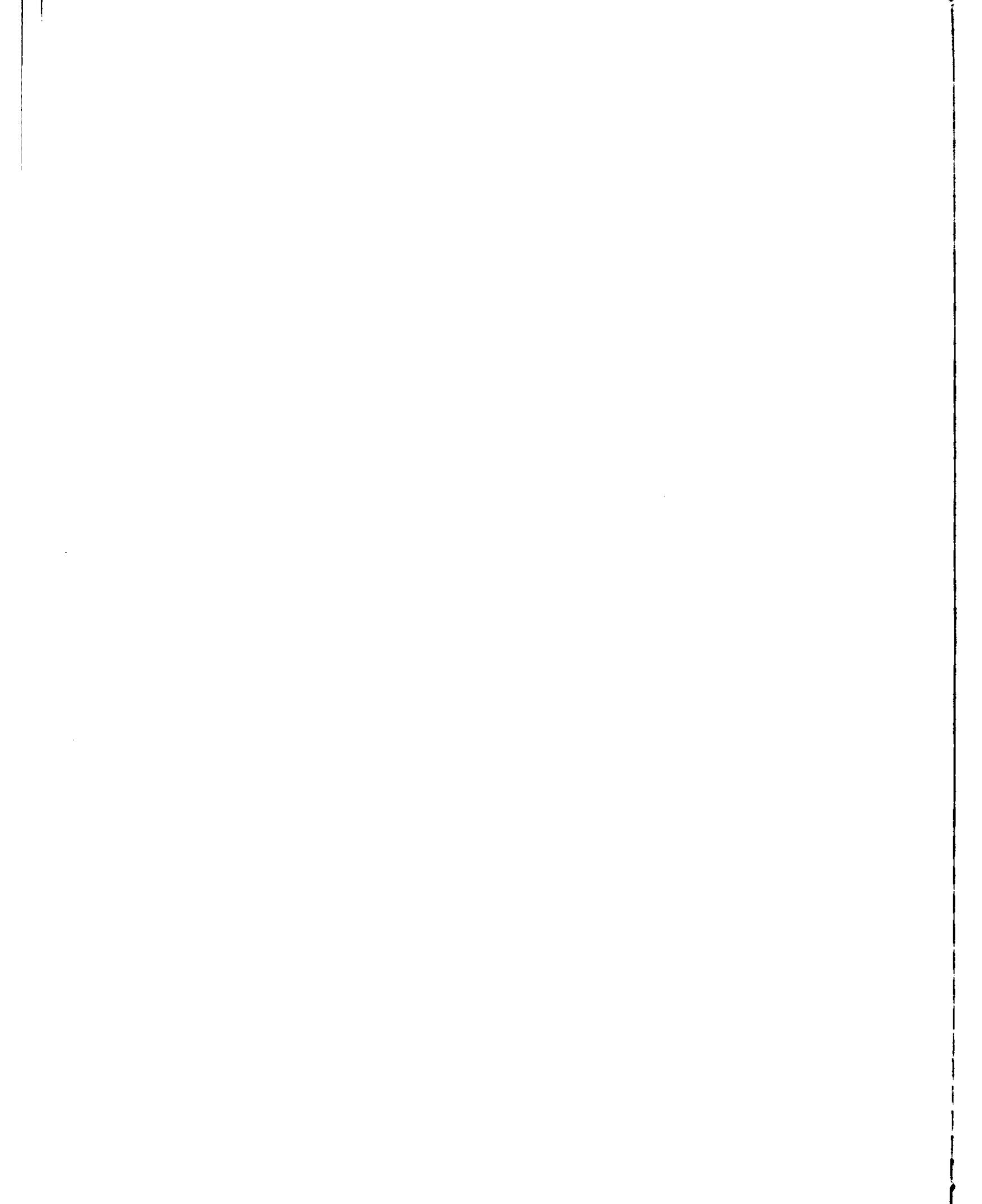
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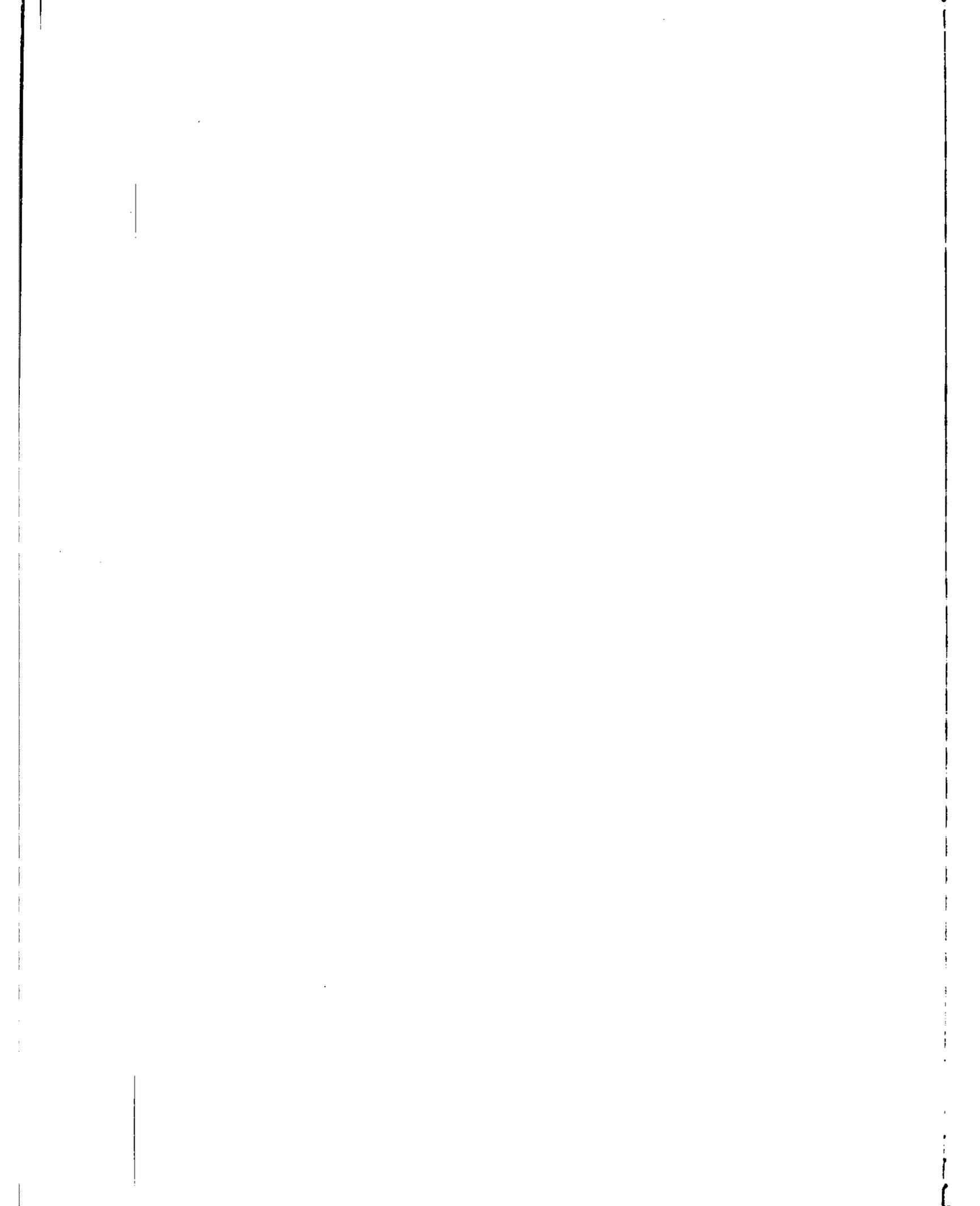
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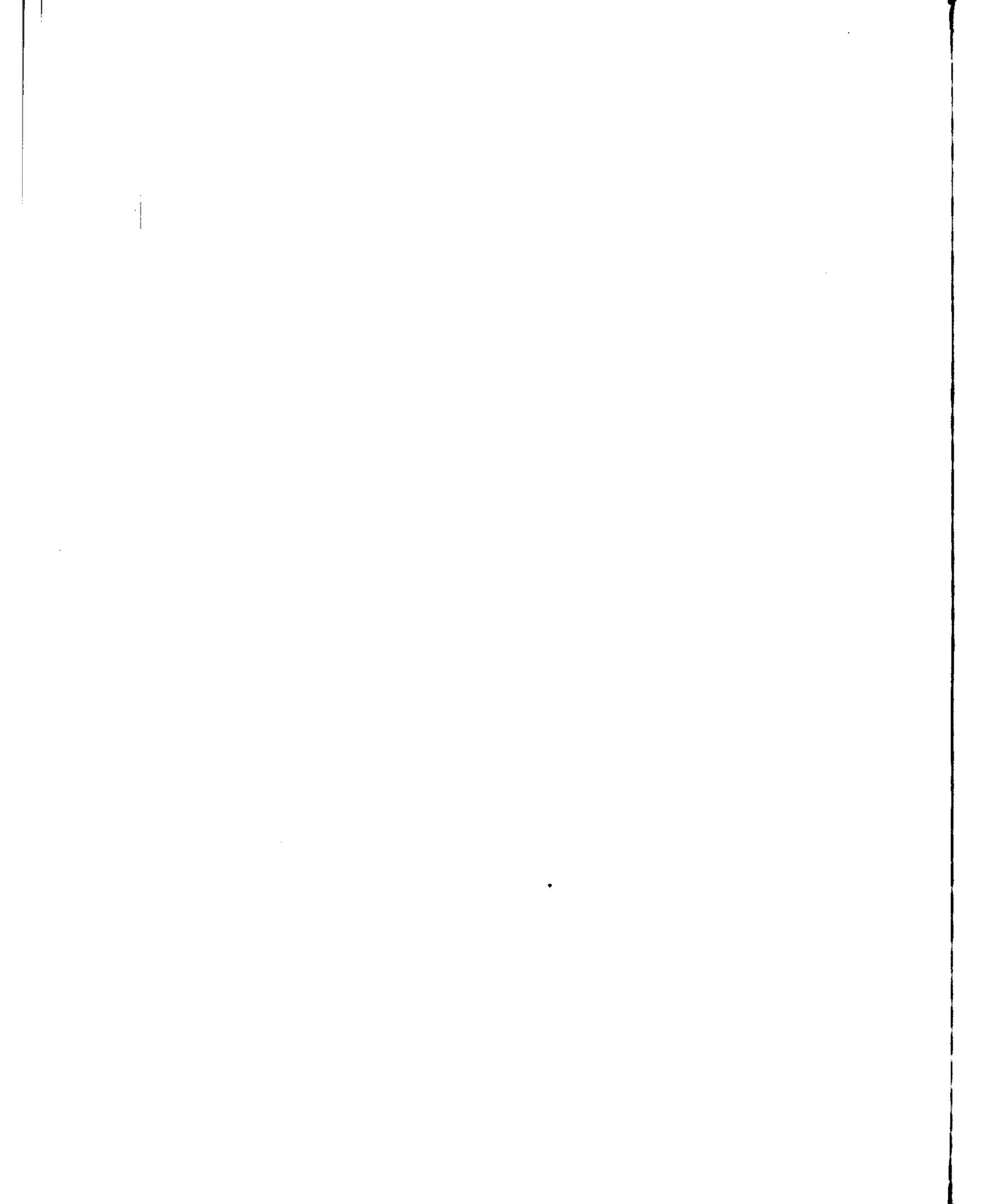
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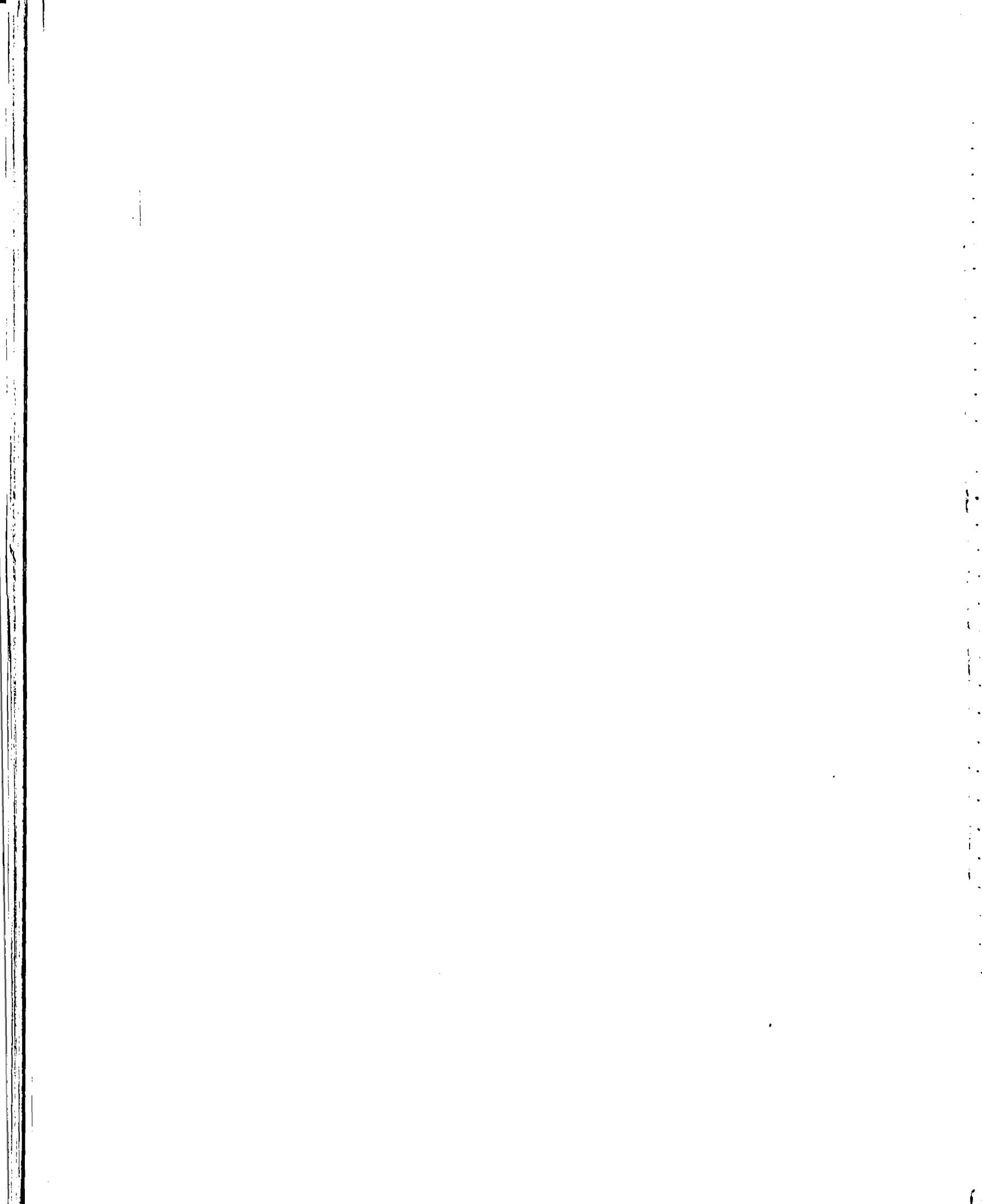
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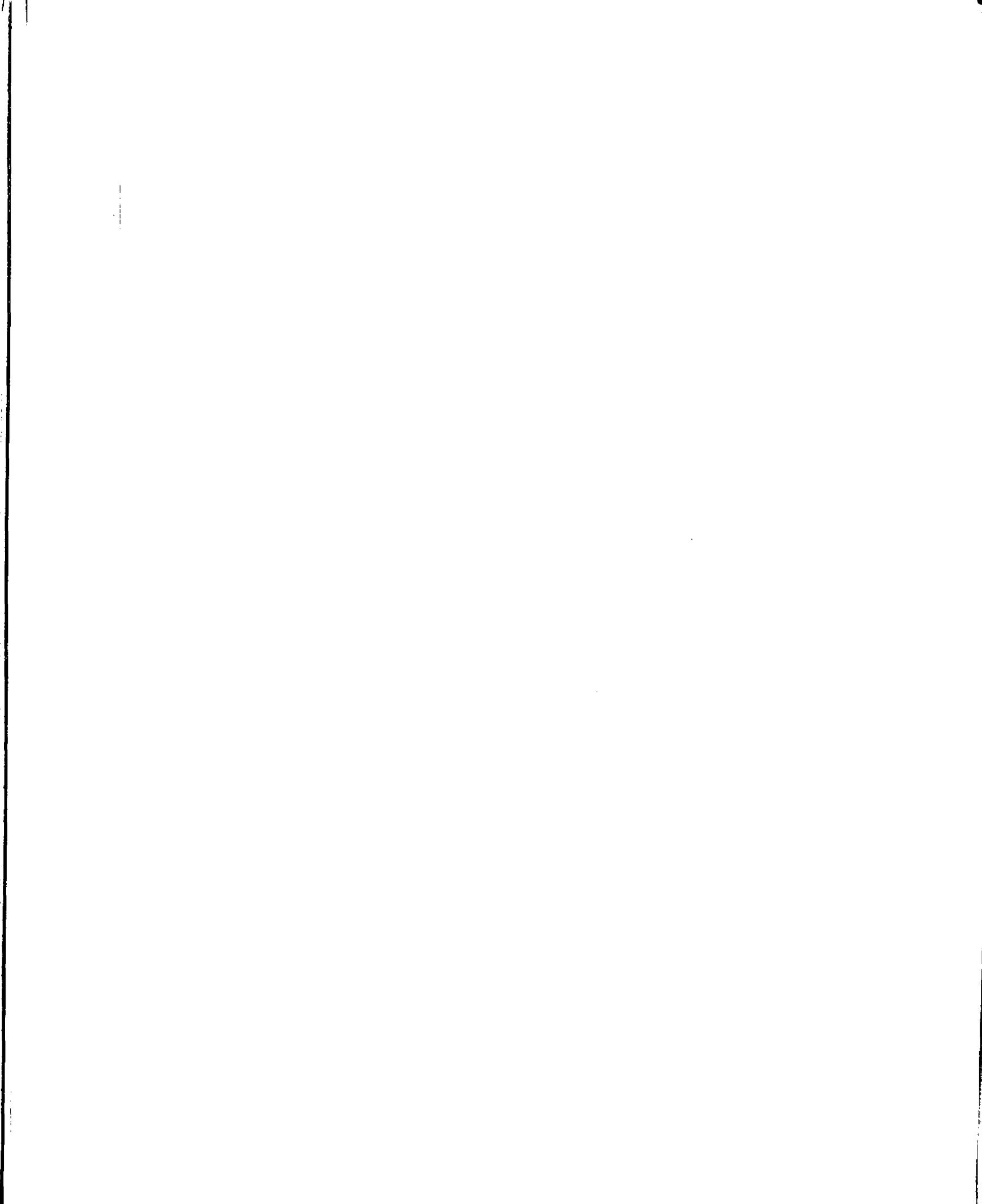
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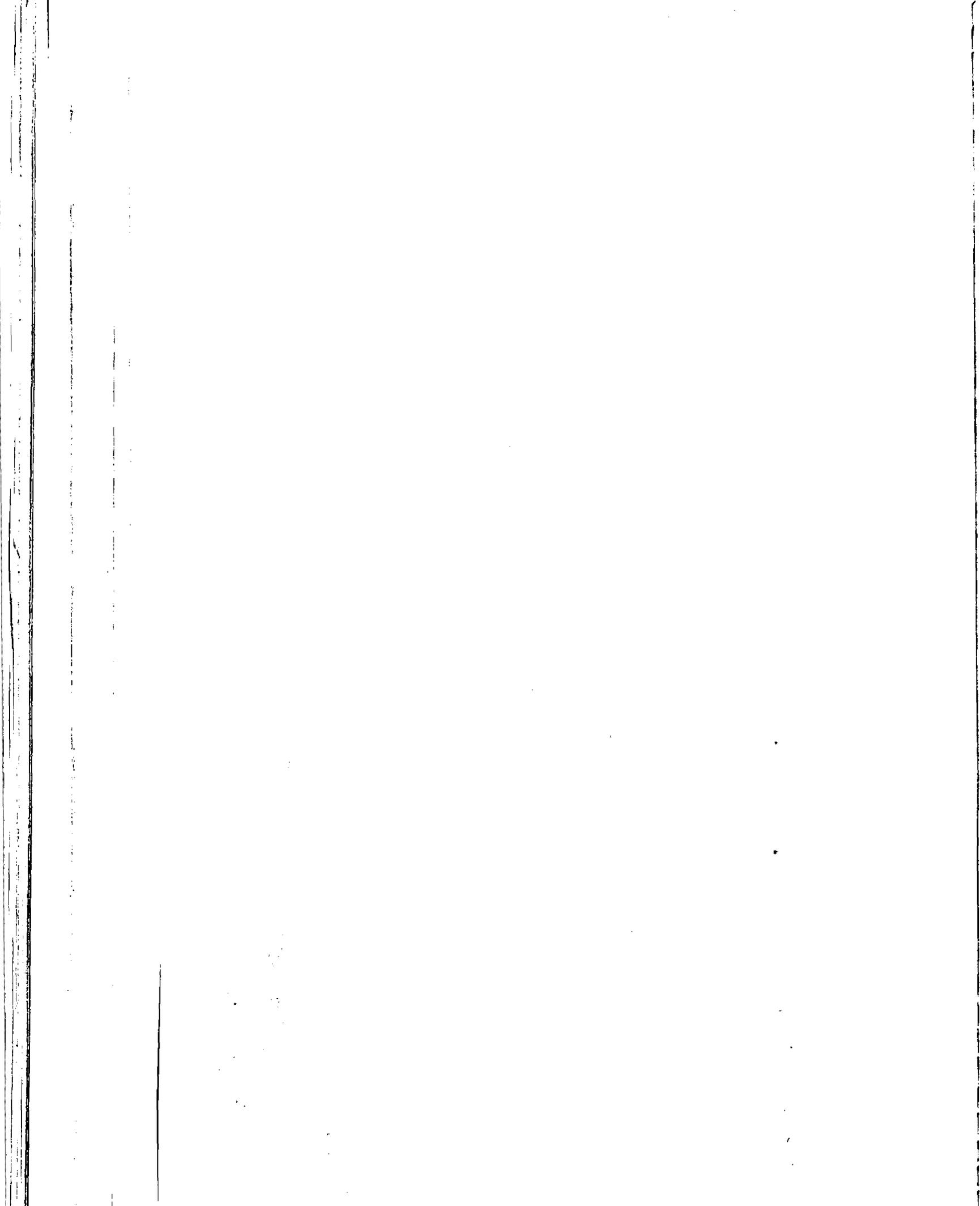
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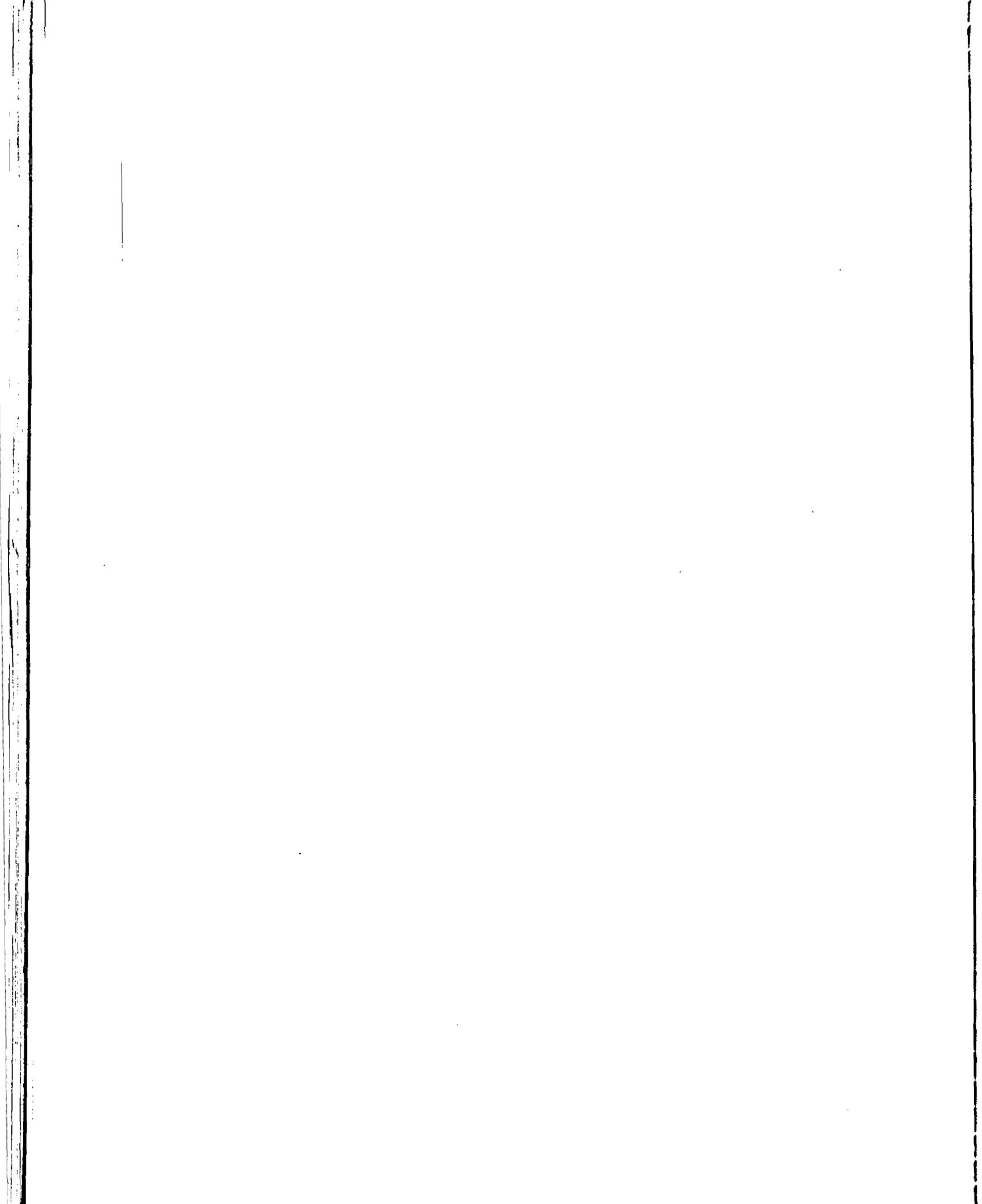
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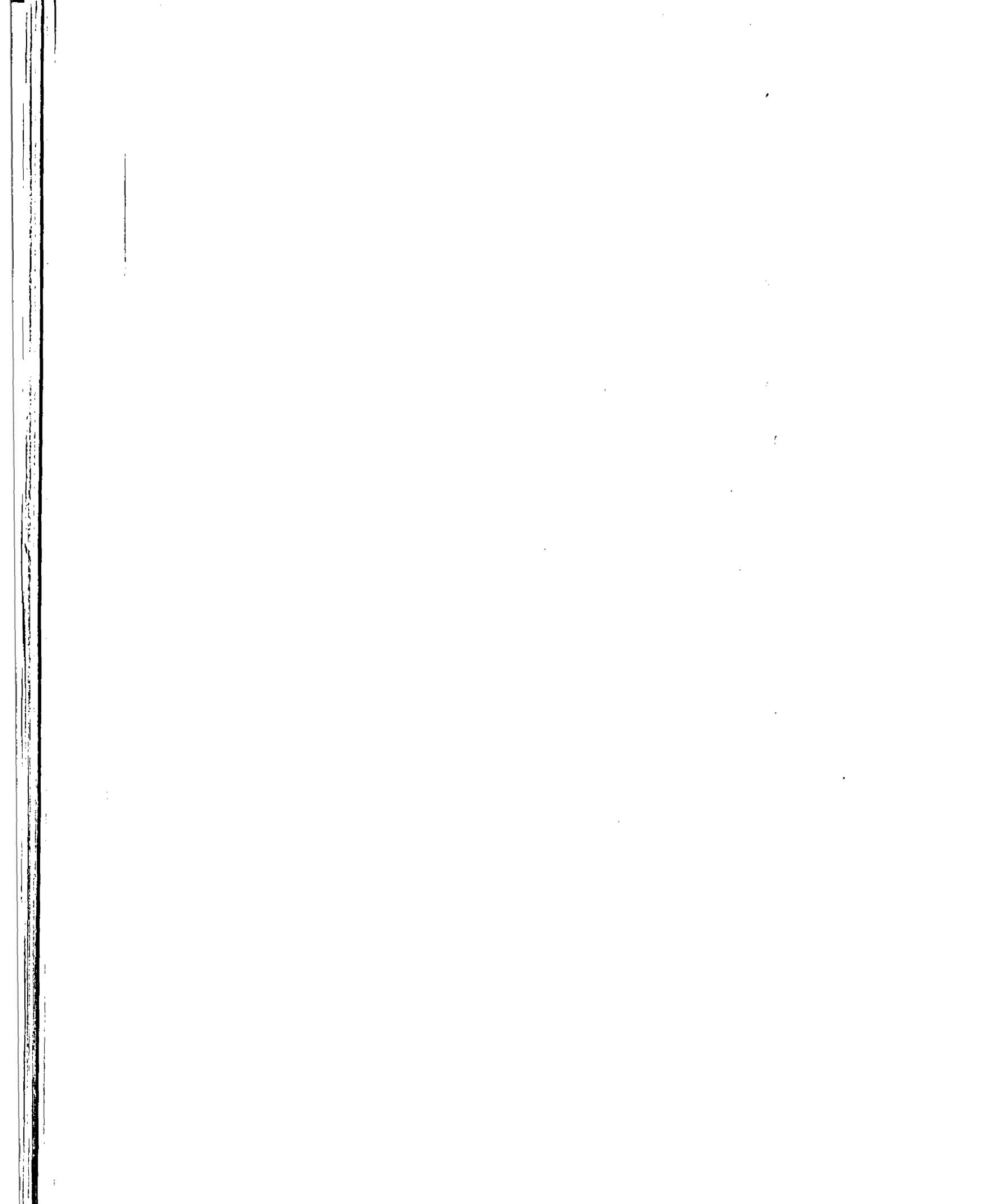
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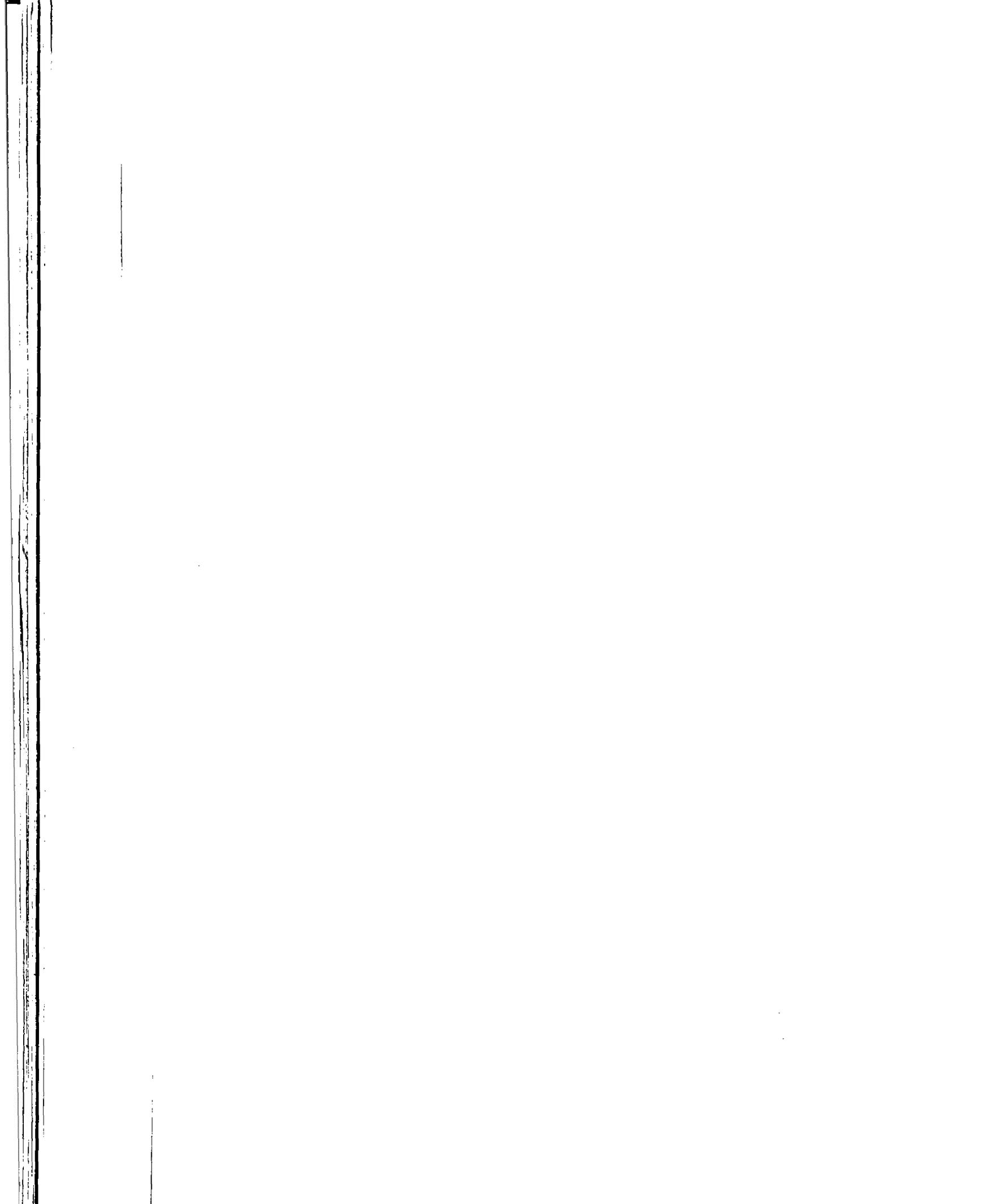
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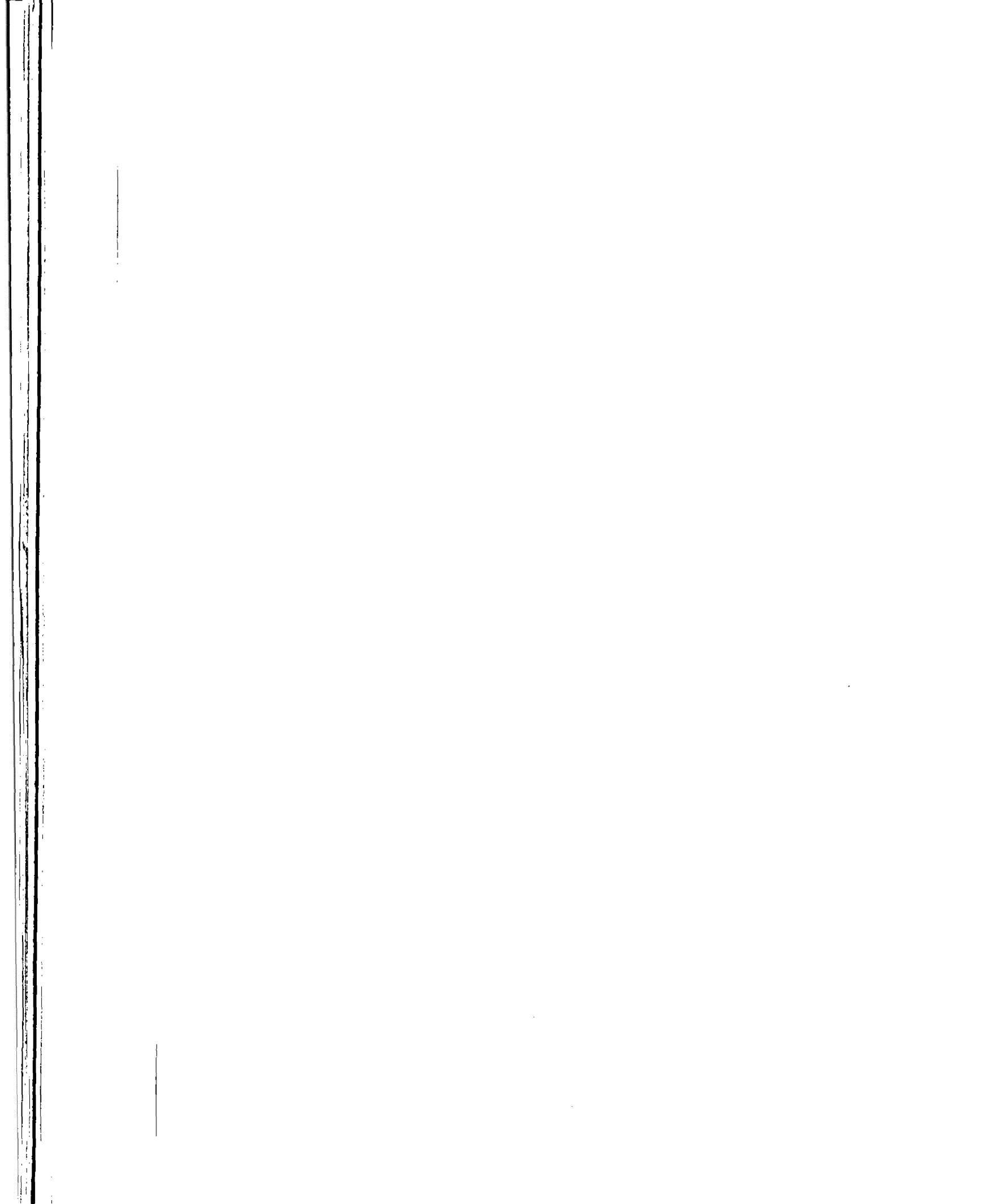
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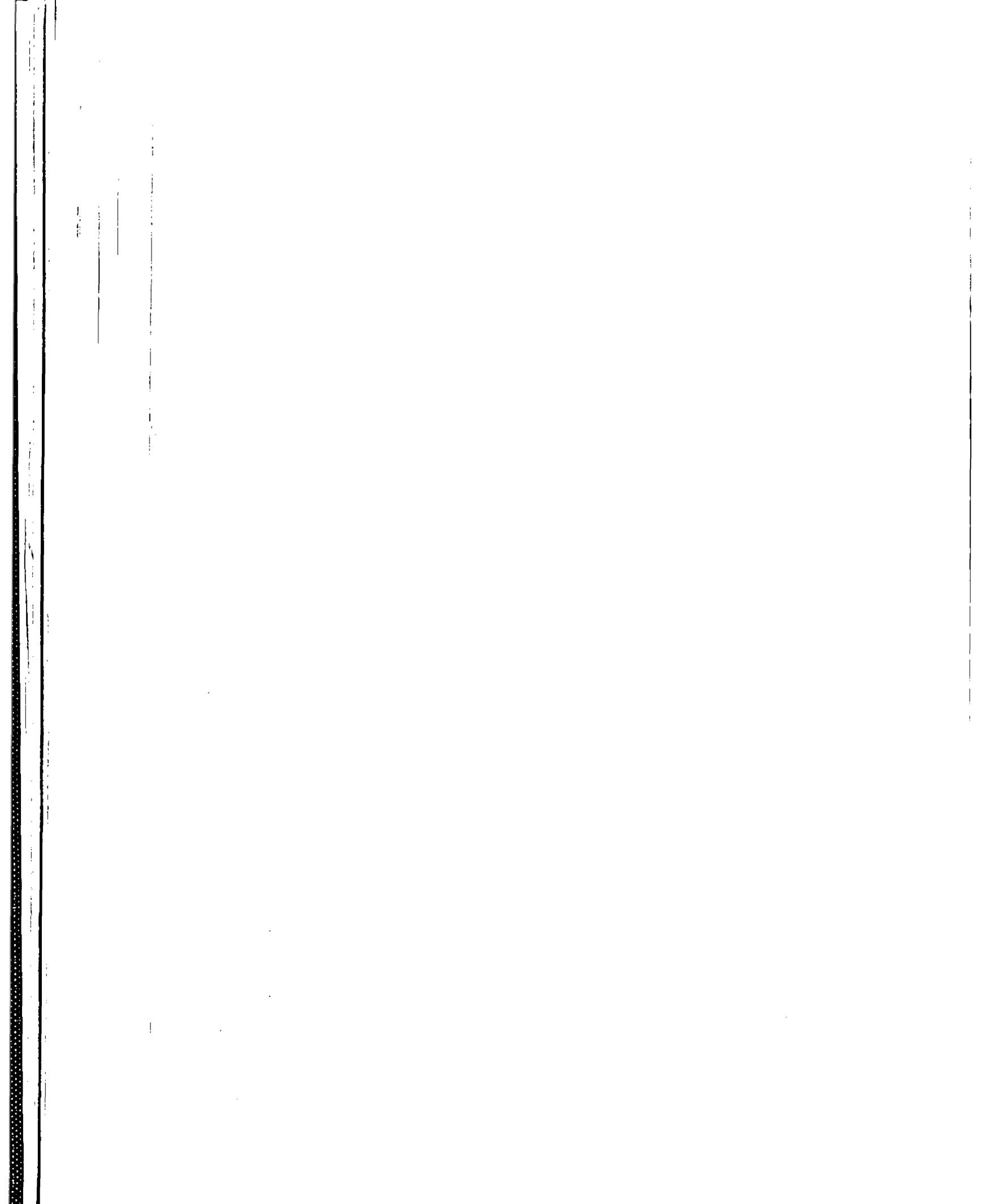
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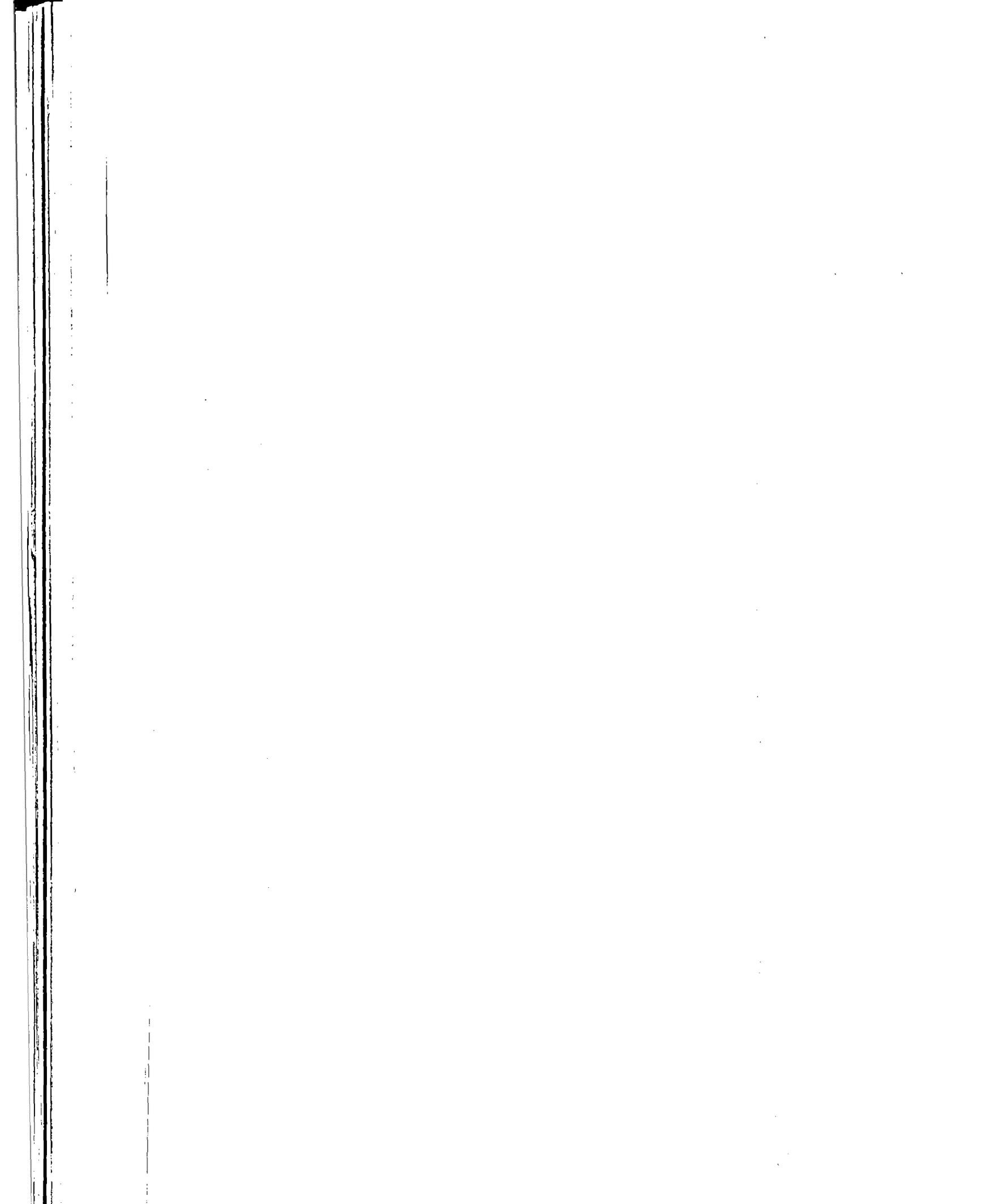
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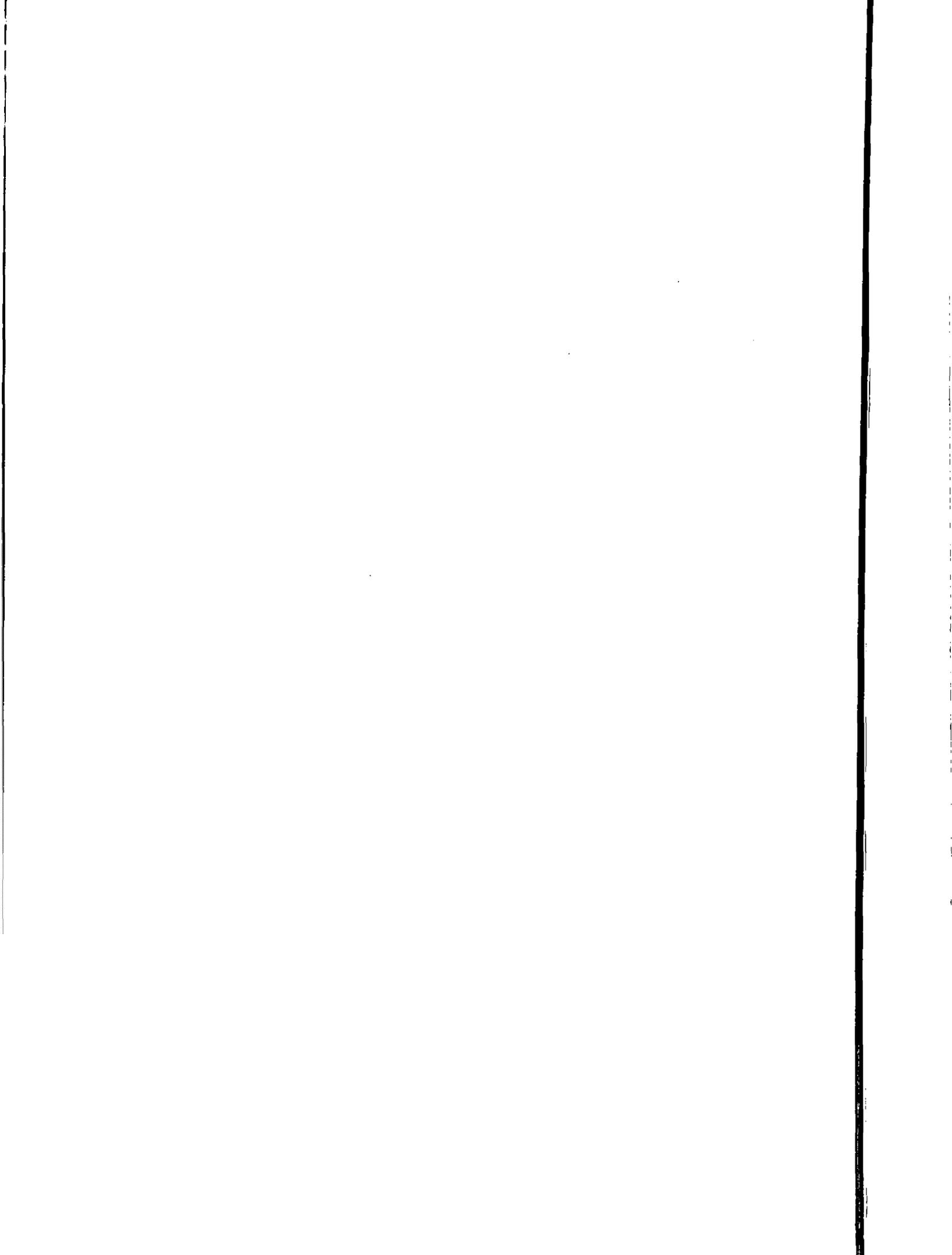
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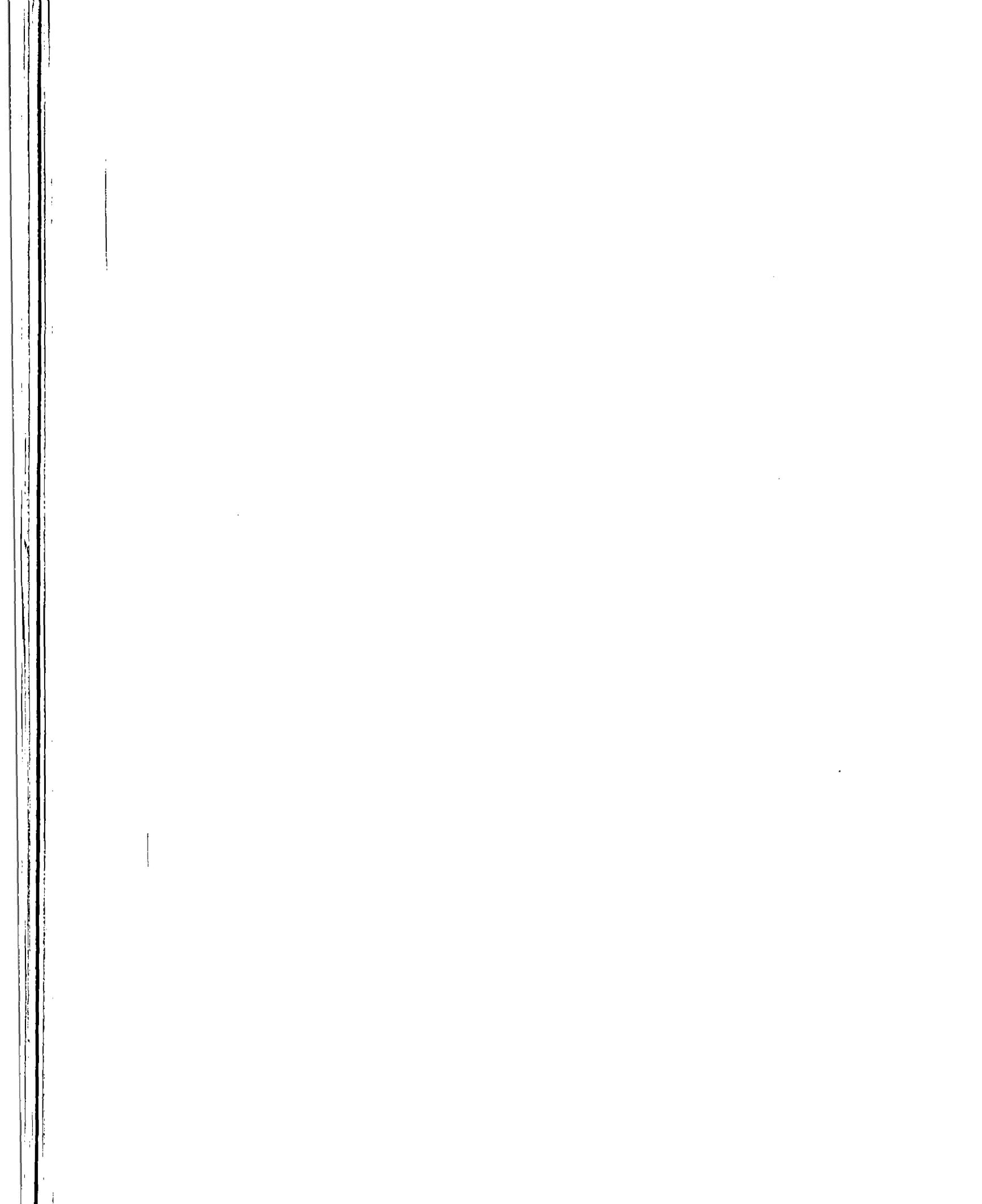


ANNEX :

COMMISSION PROPOSAL FOR A COUNCIL DIRECTIVE
ON INVESTMENT SERVICES IN THE SECURITIES FIELD.







COMMISSION

Amended proposal for a council directive on investment services in the securities field

(Submitted by the Commission on 8 February 1990)

(90/C 42/06)

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 57 thereof,

Having regard to the proposal from the Commission,

In cooperation with the European Parliament,

Having regard to the opinion of the Economic and Social Committee,

Whereas this Directive is to constitute an instrument which is essential for achieving the internal market, a course determined by the Single European Act and set out in timetable form in the Commission's White Paper, from the point of view of both freedom of establishment and freedom to provide financial services, in the field of investment firms;

Whereas the approach which has been adopted is to achieve only the essential harmonization necessary and sufficient to secure the mutual recognition of authorization and of prudential supervision systems, making possible the granting of a single authorization recognized throughout the Community and the application of the principle of home Member State prudential supervision;

Whereas it is necessary for reasons of fair competition, to ensure that non-bank investment firms benefit from similar freedom to create branches and provide services across frontiers as that provided for by the second Council Directive on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions;

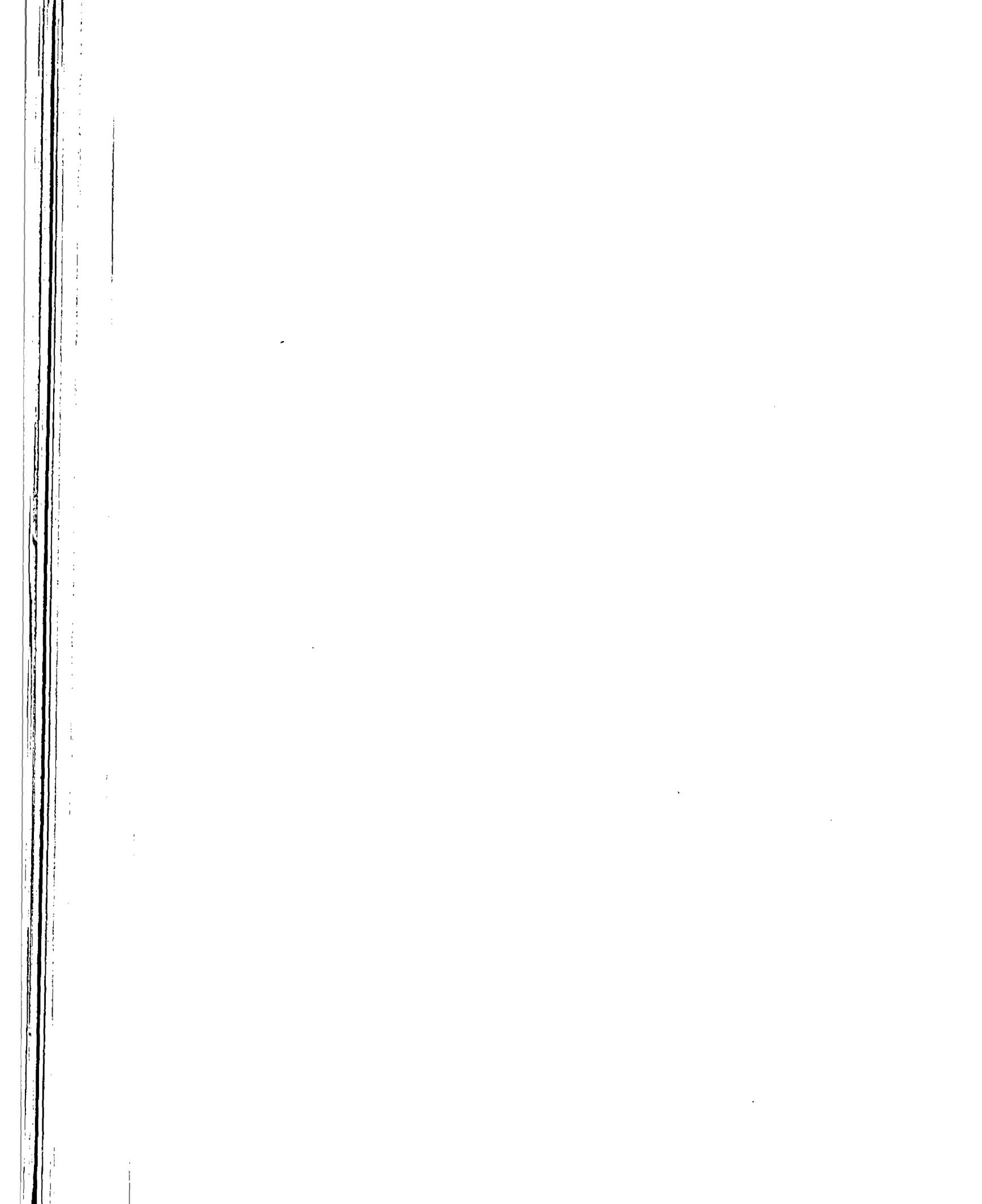
Whereas the principles of mutual recognition and of home Member State control require the competent authorities of each Member State not to grant authorization or to withdraw it where factors such as the activities programme, the geographical distribution or the activities actually carried on make it quite clear that an investment firm has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State in which it intends to carry on or carries on the greater part of its activities; whereas, for the purposes of this Directive, an investment firm which is a legal person shall be authorized in the Member State in which it has its registered office; whereas the Member States must require that the head office be situated in the same Member State as the registered office;

Whereas it is also necessary and appropriate to liberalize access to membership of stock exchange and financial futures and options markets in host Member States for investment firms authorized to carry out the relevant services in their home Member States;

Whereas responsibility for supervising the financial soundness of an investment firm will rest with the competent authorities of its home Member State and whereas to permit this responsibility to be assumed fully by such competent authorities a further Directive will be necessary to coordinate rules in the area of market risk;

Whereas the home Member State may also establish rules stricter than those laid down in Articles 3, 4, 10, 11 and 20 for investment firms authorized by its competent authorities;

Whereas, by virtue of mutual recognition, the approach chosen permits investment firms authorized in their home Member States to carry on, throughout the Community, any or all of the activities listed in the Annex by establishing branches or by providing services;



Whereas the carrying-on of activities not listed in the Annex shall be governed by the general provisions of the Treaty concerning the right of establishment and the freedom to provide services;

Whereas, the host Member State may, in connection with the exercise of the right of establishment and the freedom to provide services, require compliance with specific provisions of its own national laws or regulations on the part of firms not authorized as investment firms in their home Member States and with regard to activities not listed in the Annex provided that, on the one hand, such provisions are compatible with Community law and are intended to protect the general good and that, on the other hand, such firms or such activities are not subject to equivalent rules under the legislation or regulations of their home Member States;

Whereas the Member States must ensure that there are no obstacles to carrying on activities receiving mutual recognition in the same manner as in the home Member State, as long as the latter do not conflict with legal provisions protecting the general good in the host Member State;

Whereas the procedures for the authorization of branches of investment firms authorized in third countries will continue to apply to such firms; whereas those branches will not enjoy the freedom to provide services under the second paragraph of Article 59 of the Treaty or the freedom of establishment in Member States other than those in which they are established; whereas, however, requests for the authorization of subsidiaries or of the acquisition of holdings made by undertakings governed by the laws of third countries are subject to a procedure intended to ensure that Community investment firms receive reciprocal treatment in the third countries in question;

Whereas, the authorizations granted to investment firms by the competent national authorities pursuant to this Directive will have Community-wide, and no longer merely nation-wide, application, and whereas existing reciprocity clauses will henceforth have no effect; whereas a flexible procedure is therefore needed to make it possible to assess reciprocity on a Community basis; whereas the aim of this procedure is not to close the Community's financial markets but rather, as the Community intends to keep its financial markets open to the rest of the world, to improve the liberalization of the global financial markets in third countries; whereas, to that end, this Directive provides for procedures for negotiating with third countries and, as a last resort, for the possibility of taking measures involving the suspension of new applications for authorization or the restriction of new authorizations;

Whereas the smooth operation of the internal market in investment services will require not only legal rules but also close and regular cooperation between the

competent authorities of the Member States; whereas for the consideration of problems concerning individual investment firms the Contact Committee constituted under this Directive is the most appropriate forum; whereas that committee is a suitable body for the mutual exchange of information provided for in this Directive;

Whereas that mutual information procedure will not in any case replace the bilateral collaboration established by this Directive; whereas the competent host Member State authorities can, without prejudice to their powers of control proper, continue, either in an emergency, on their own initiative or following the initiative of the competent home Member State authorities, to verify that the activities of an investment firm established within their territories comply with the relevant laws and with the principles of sound administrative and accounting procedures and adequate internal control;

Whereas technical modifications to the detailed rules laid down in this Directive may from time to time be necessary to take account of new developments in the investment services sector; whereas the Commission shall accordingly make such modifications as are necessary, after consulting the committee constituted under this Directive.

HAS ADOPTED THIS DIRECTIVE:

TITLE I

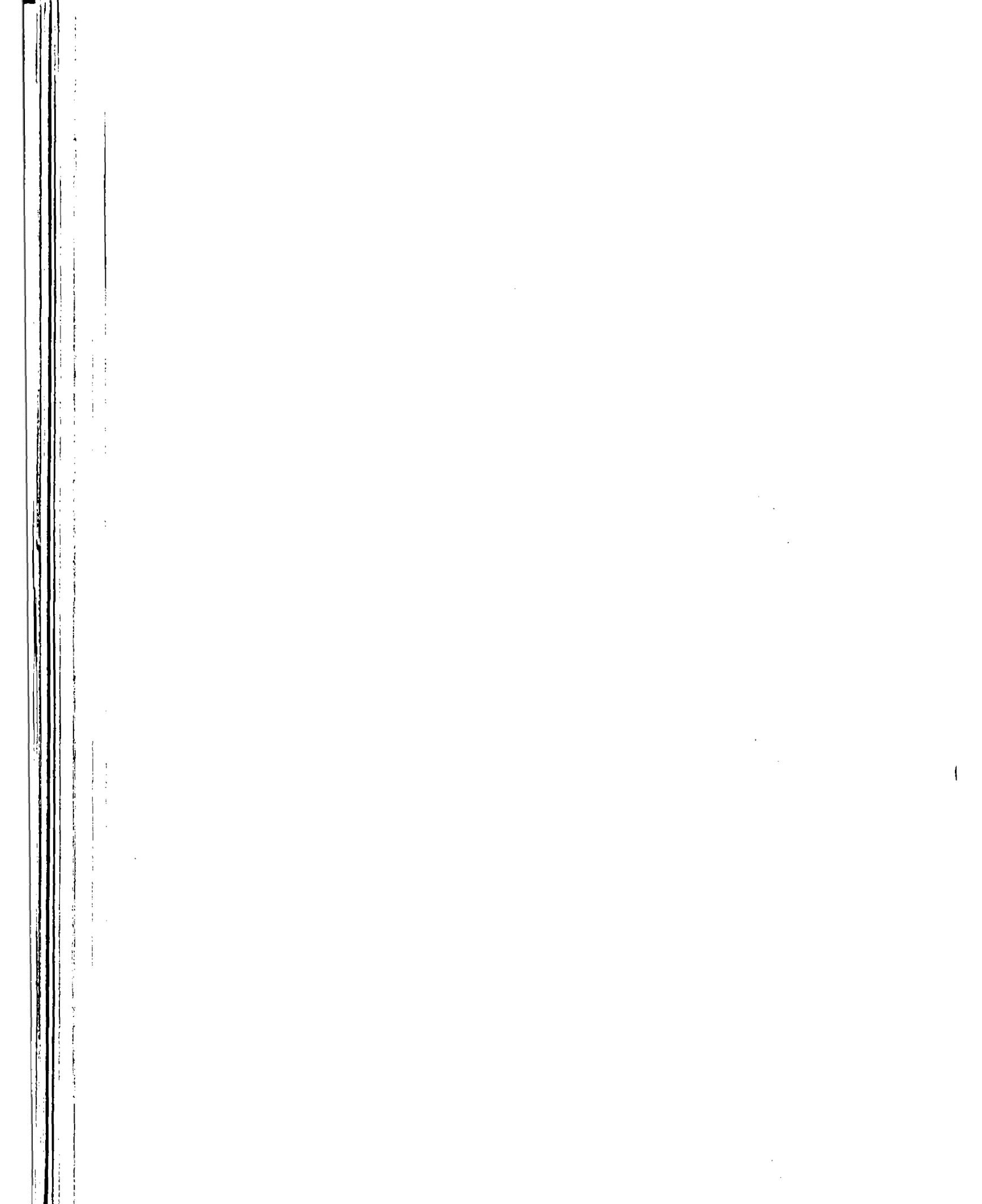
Definitions and scope

Article 1

For the purpose of this Directive:

1. *credit institution* shall mean a credit institution as defined with the first indent of Article 1 of Council Directive 77/780/EEC⁽¹⁾ other than the institutions referred to in Article 2 (2) thereof;
2. *investment service* shall mean any of the services relating to any of the instruments set out in the list in the Annex;
3. *investment firm* shall mean any natural or legal person whose business it is to provide any investment service;
4. *home Member State* shall mean:
 - (a) where the investment firm is a natural person, the Member State where that person has his principal place of business;

⁽¹⁾ OJ No L 322, 17. 12. 1977, p. 30.



(b) where the investment firm is a legal person, the Member State where its registered office is situated or if it has no registered office then the Member State where its head office is situated;

5. *host Member State* shall mean the Member State where an investment firm has a branch or in which it supplies services;

6. *branch* shall mean a place of business which forms a legally dependent part of an investment firm and which provides an investment service for which the investment firm has been authorized;

7. *qualifying holding* shall mean a direct or indirect holding in an investment firm which represents 10 % or more of the capital or of the voting rights or which makes it possible to exercise a significant influence over the management of the investment firm in which a holding subsists.

For the purpose of this definition, in the context of Articles 4 and 10 and of the other levels of holding referred to in Article 10, the voting rights referred to in Article 7 of Council Directive 88/627/EEC (*) shall be taken into consideration;

8. *parent undertaking* shall mean a parent undertaking as defined in Articles 1 and 2 of Council Directive 83/349/EEC (*);

9. *subsidiary* shall mean a subsidiary undertaking as defined in Articles 1 and 2 of Directive 83/349/EEC; any subsidiary of a subsidiary undertaking shall also be regarded as a subsidiary of the parent undertaking which is at the head of those undertakings;

10. *members of a stock exchange or organized market* shall mean any natural or legal person recognized by the relevant authorities of each organized market of the said country and placed under their supervision.

Article 2

This Directive shall apply to all investment firms. However, only Articles 9 (2), 11 and 13 shall apply to investment firms that are credit institutions authorized by their banking licence to engage in securities business.

(*) OJ No L 348, 17. 12. 1988, p. 62.

(*) OJ No L 193, 18. 7. 1983, p. 1.

TITLE II

Harmonization of authorization conditions

Article 3

1. Investment firms shall obtain authorization in their home Member State before commencing to provide investment services. Such authorization shall be granted by the home Member State's competent authorities designated in accordance with Article 17. Following the granting of authorization the investment service in question may be engaged in forthwith by the investment firm, together with any activities that are ancillary thereto.

2. Without prejudice to other conditions of general application laid down by national law, the competent authorities shall not grant authorization unless:

— the investment firm has sufficient initial capital in accordance with the rules prescribed in Directive ... having regard to the nature of the investment service in question,

— the persons who effectively direct the business of the investment firm are of sufficiently good repute and experience.

3. Member States shall also require applications for authorization to be accompanied by a programme of operations setting out *inter alia* the types of business envisaged and the structural organization of the investment firm.

4. The applicant shall be notified within three months of submission of a complete application whether or not authorization is granted. Reasons shall be given whenever an authorization is refused. If no decision is notified within six months of submission of the complete application this shall be deemed to be a refusal.

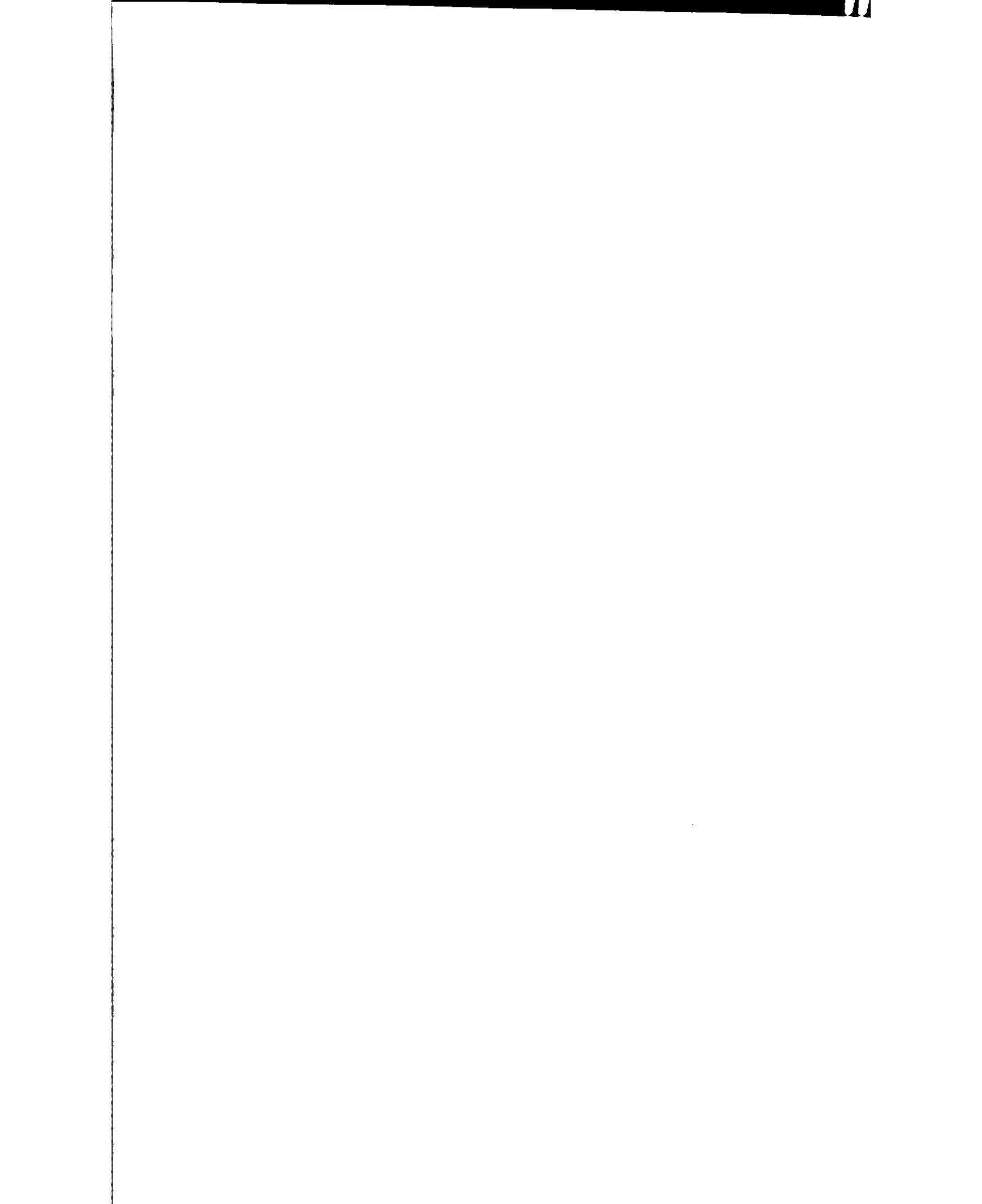
5. The competent authorities may withdraw the authorization issued to an investment firm subject to this Directive only where the investment firm:

(a) does not make use of the authorization within 12 months, expressly renounces the authorization or has ceased to engage in investment business for more than six months, if the Member State concerned has made no provision for the authorization to lapse in such cases;

(b) has obtained the authorization through false statements or any other irregular means;

(c) no longer fulfils the conditions under which authorization was granted;

(d) no longer possesses sufficient financial resources or can no longer be relied upon to fulfil its obligations towards its creditors, and in particular no longer provides security for the assets entrusted to it;



(e) falls within one of the other cases where national law provides for withdrawal of authorization.

Article 4

The competent authorities shall not grant authorization for the taking-up of the business of investment firms before they have been informed of the identities of the shareholders or members, whether direct or indirect, natural or legal persons, that have qualifying holdings, and of the amounts of those holdings.

The competent authorities shall refuse authorization if, taking into account the need to ensure the sound and prudent management of an investment firm, they are not satisfied as to the suitability of the abovementioned shareholders or members.

Article 5

Member States shall not apply to branches of investment firms having their registered office outside the Community, when commencing or carrying on their business, provisions that result in more favourable treatment than that accorded to branches of investment firms having their registered office in a Member State.

Article 6

There must be prior consultation with the competent authorities of the other Member State involved on the authorization of an investment firm which is:

- a subsidiary of an investment firm authorized in another Member State, or
- a subsidiary of the parent undertaking of an investment firm authorized in another Member State, or
- controlled by the same persons, whether natural or legal, as control an investment firm authorized in another Member State.

TITLE III

Relations with third countries

Article 7

1. The competent authorities of the Member States shall inform the Commission:

- (a) of any authorization of a direct or indirect subsidiary one or more parent undertakings of which are governed by the laws of a third country. The Commission shall inform the committee constituted under Article 23 accordingly;

(b) whenever such a parent undertaking acquires a holding in a Community investment firm such that the latter would become its subsidiary. The Commission shall inform the committee constituted under Article 23 accordingly.

When authorization is granted to the direct or indirect subsidiary of one or more parent undertakings governed by the law of third countries, the structure of the group shall be specified in the notification which the competent authorities shall address to the Commission.

2. The Member States shall inform the Commission of any general difficulties encountered by their investment firms in establishing themselves or carrying on activities in a third country.

3. Initially no later than six months before the application of this Directive and thereafter periodically, the Commission shall draw up a report examining the treatment accorded to Community investment firms in third countries, in the terms referred to in paragraphs 4 and 5, as regards establishment and the carrying on of investment activities, and the acquisition of holdings in third-country investment firms. The Commission shall submit those reports to the Council, together with any appropriate proposals.

4. Whenever it appears to the Commission, either on the basis of the reports referred to in paragraph 3 or on the basis of other information, that a third country is not granting Community investment firms effective market access comparable to that granted by the Community to investment firms from that third country, the Commission may submit proposals to the Council for the appropriate mandate for negotiation with a view to obtaining comparable competitive opportunities for Community investment firms. The Council shall decide by a qualified majority.

5. Whenever it appears to the Commission, either on the basis of the reports referred to in paragraph 3 or on the basis of other information, that Community investment firms in a third country do not receive national treatment offering the same competitive opportunities as are available to domestic investment firms and that the conditions of effective market access are not fulfilled, the Commission may initiate negotiations in order to remedy the situation.

In the circumstances described in the first subparagraph, it may also be decided at any time, and in addition to initiating negotiations, in accordance with the procedure laid down in Article 23, that the competent authorities of the Member States must limit or suspend their decisions regarding requests pending at the moment of the decision or future requests for authorizations and the



acquisition of holdings by direct or indirect parent undertakings governed by the laws of the third country in question. The duration of the measures referred to may not exceed six months.

Before the end of that six-month period, and in the light of the results of the negotiations, the Council may, acting on a proposal from the Commission, decide by a qualified majority whether the measures shall be continued.

Such limitations or suspension may not apply to the setting up of subsidiaries by investment firms duly authorized in the Community or by their subsidiaries, or to the acquisition of holdings in Community investment firms by such firms or subsidiaries.

6. Whenever it appears to the Commission that one of the situations described in paragraphs 4 and 5 obtains, the Member States shall inform it at its request:

- (a) of any request for the authorization of a direct or indirect subsidiary one or more parent undertakings of which are governed by the laws of the third country in question;
- (b) whenever they are informed in accordance with Article 10 that such an undertaking proposes to acquire a holding in a Community investment firm such that the latter would become its subsidiary.

This obligation to provide information shall lapse whenever an agreement is reached with the third country referred to in paragraph 4 or 5 or when the measures referred to in the second and third subparagraphs of paragraph 5 cease to apply.

7. Measures taken under this Article shall comply with the Community's obligations under any international agreements, bilateral or multilateral, governing the taking up and pursuit of the business of investment firms.

TITLE IV

Harmonization of the conditions governing pursuit of the business of investment firms

Article 8

1. An investment firm's own funds may not fall below the amount of initial capital required pursuant to Article 3 at the time of its authorization.

2. The Member States may decide that investment firms already in existence when the Directive is implemented, the own funds of which do not attain the levels for initial capital referred to in Article 3, may continue to carry on their activities. In that event, their own funds may not fall below the highest level reached after the date of the notification of this Directive.

3. If control of an investment firm falling within the category referred to in paragraph 2 is taken by a natural or legal person other than the person who controlled it previously, its own funds must attain at least the level for initial capital referred to in Article 3.

4. However, where there is a merger of two or more investment firms falling within the category referred to in paragraph 2, in certain specific circumstances and with the consent of the competent authorities, the own funds of the new investment firm resulting from the merger need not attain the level of initial capital referred to in Article 3. However, the own funds of the new investment firm may not fall below the total own funds of the merged firms at the time of the merger, as long as the appropriate levels referred to in Article 3 have not been obtained.

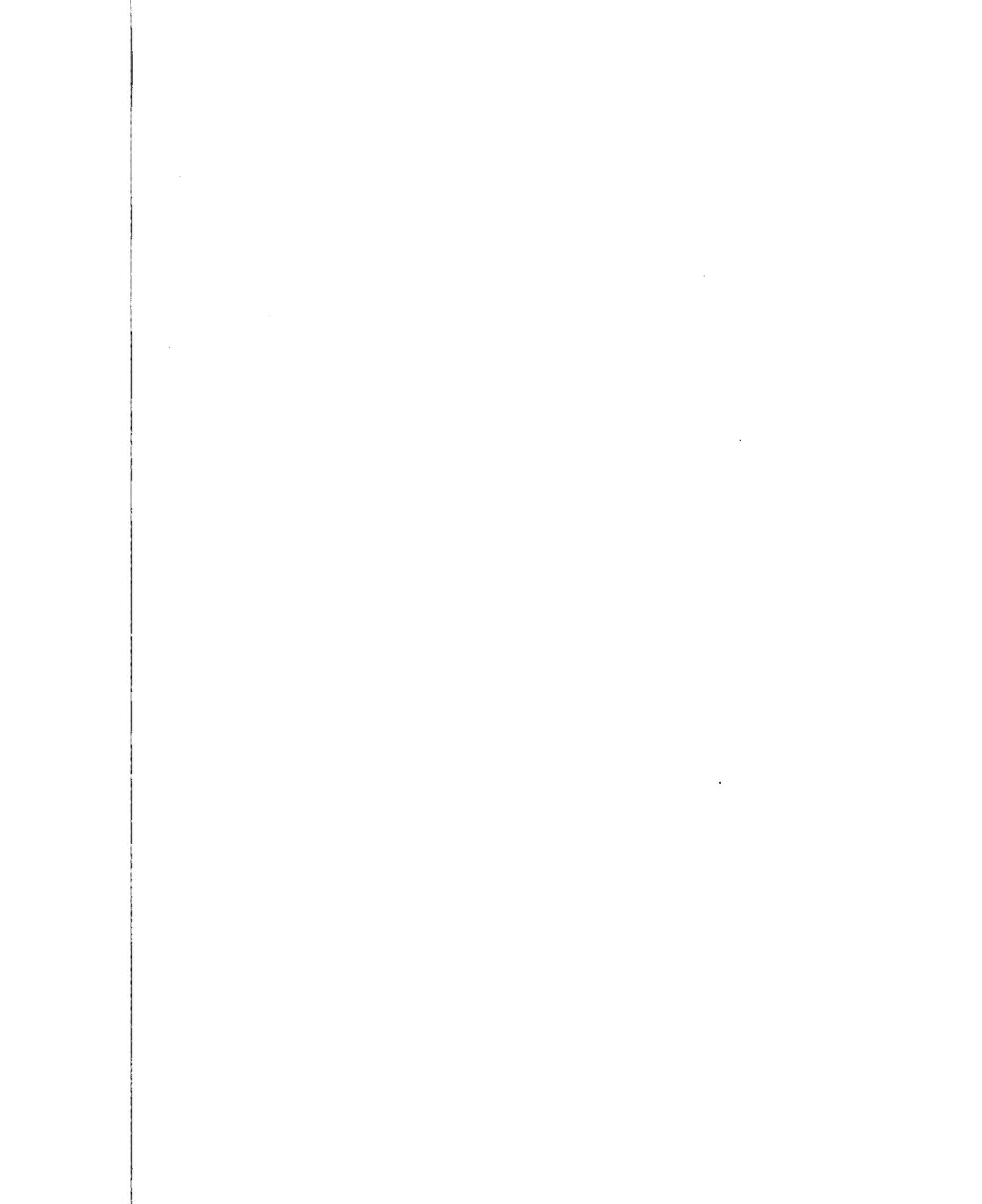
5. However, if, in the cases referred to in paragraphs 1, 2 and 4, the own funds should be reduced, the competent authorities may, where the circumstances justify it, allow an investment firm a limited period in which to rectify its situation or cease its activities.

Article 9

1. The competent authorities of the home Member State shall require continuing compliance by an investment firm authorized by them with the conditions referred to in Article 3 (2).

2. The competent authorities of the home Member State shall require that investment firms authorized by them make sufficient provision against market risk in accordance with the rules prescribed in Directive ...

3. The supervision of compliance with the conditions referred to in Articles 3 (2) and 4 shall be within the exclusive regulatory competence of the home Member State's competent authorities irrespective of whether or not the investment firm establishes a branch or provides services in another Member State.



Article 10

1. The Member States shall require any natural or legal person who proposes to acquire, directly or indirectly, a qualifying holding in an investment firm first to inform the competent authorities, telling them of the size of the intended holding. Such a person must likewise inform the competent authorities if he proposes to increase his qualifying holding so that the proportion of the voting rights or of the capital held by him would reach or exceed 20, 33 or 50 % or so that the investment firm would become his subsidiary.

Without prejudice to the provisions of paragraph 2, the competent authorities shall have a maximum of three months from the date of the notification provided for in the first subparagraph to oppose such a plan if, in view of the need to ensure sound and prudent management of the investment firm, they are not satisfied as to the suitability of the person referred to in the first subparagraph. If they do not oppose the plan, they may fix a maximum period for its implementation.

2. If the acquirer of the holdings referred to in paragraph 1 is an investment firm authorized in another Member State or the parent undertaking of an investment firm authorized in another Member State or a natural or legal person controlling an investment firm authorized in another Member State and if, as a result of that acquisition, the firm in which the acquirer proposes to acquire a holding would become a subsidiary or subject to the control of the acquirer, the assessment of the acquisition must be the subject of the prior consultation referred to in Article 6.

3. The Member States shall require any natural or legal person who proposes to dispose, directly or indirectly, of a qualifying holding in an investment firm first to inform the competent authorities. Such a person must likewise inform the competent authorities if he proposes to reduce his qualifying holding so that the proportion of the voting rights or of the capital held by him would fall below 20, 33 or 50 % or so that the investment firm would cease to be his subsidiary.

4. On becoming aware of them, investment firms shall inform the competent authorities of any acquisitions or disposals of holdings in their capital that cause holdings to exceed or fall below one of the thresholds referred to in paragraphs 1 and 3.

They shall also, at least once a year, inform them of the names of shareholders and members possessing qualifying holdings and the sizes of such holdings as shown,

for example, by the information received at the annual general meetings of shareholders and members or as a result of compliance with the regulations relating to companies listed on stock exchanges.

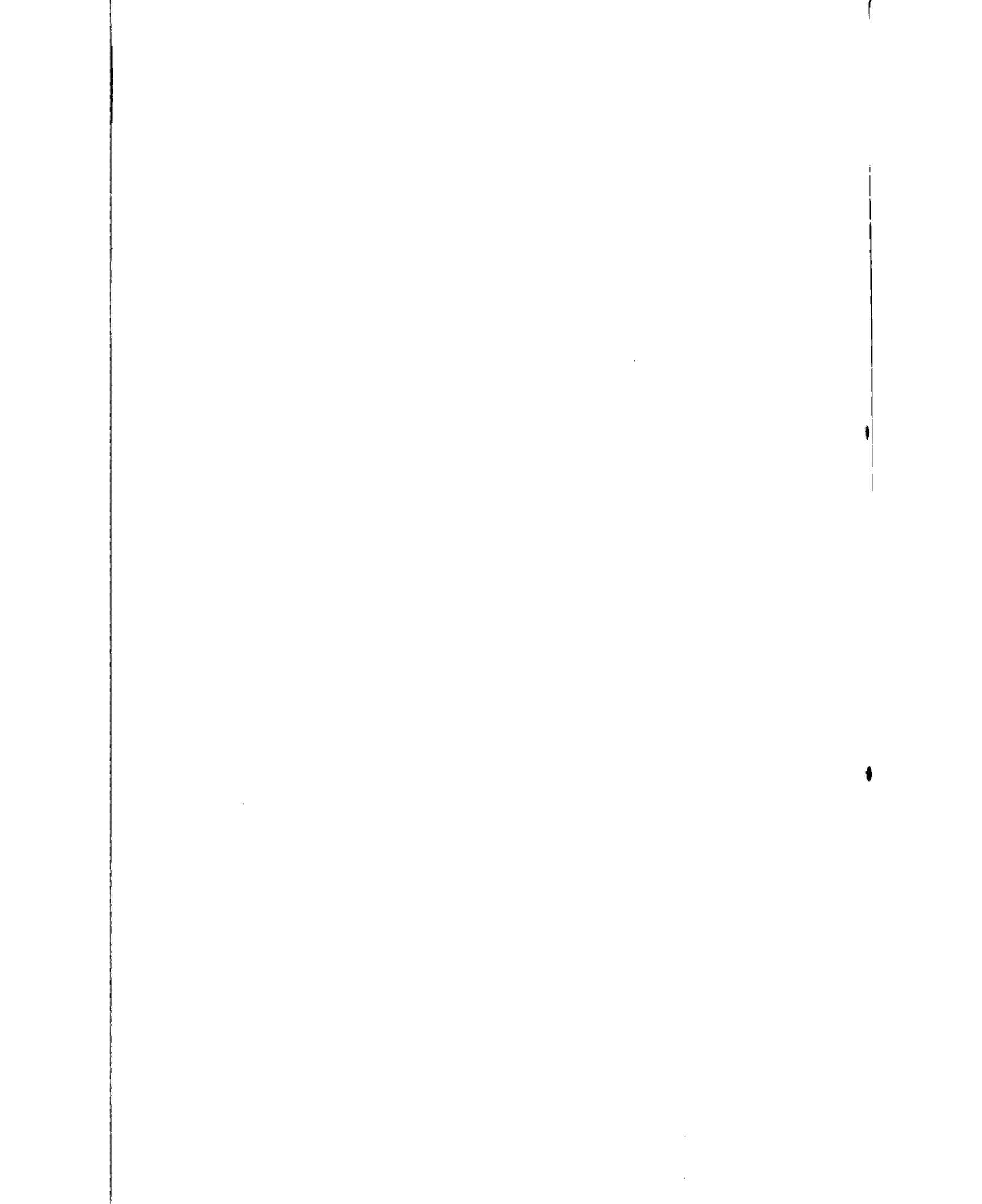
5. The Member States shall require that, where the influence exercised by the persons referred to in paragraph 1 is likely to operate to the detriment of the prudent and sound management of the investment firm, the competent authorities shall take appropriate measures to put an end to that situation. Such measures may consist, for example, in injunctions, sanctions against directors and managers, or the suspension of the exercise of the voting rights attaching to the shares held by the shareholders or members in question.

Similar measures shall apply to natural or legal persons failing to comply with the obligation to provide prior information, as laid down in paragraph 1. If a holding is acquired despite the opposition of the competent authorities, the Member States shall, regardless of any other sanctions to be adopted, provide either for exercise of the corresponding voting rights to be suspended, or for the nullity of votes cast or for the possibility of their annulment.

Article 11

1. Member States shall draw up prudential rules to be observed on a continuing basis by investment firms authorized by their competent authorities. Supervision of such prudential rules shall be within the exclusive competence of the home Member State's competent authorities irrespective of whether or not the investment firm establishes a branch or provides services in another Member State. Such rules shall require that the investment firm:

- has sound administrative and accounting procedures and internal control mechanisms,
- arranges for securities belonging to investors to be kept separately from its own securities,
- except in the case of investment firms that are credit institutions, arranges for money belonging to investors to be placed in an account or in accounts which are separate and distinct from the firm's own account,
- is either a member of a general compensation scheme designed to protect investors who are prevented from having claims satisfied because of the bankruptcy or default of the investment firm or makes individual arrangements which provide investors with equivalent protection. Pending further harmonization of compensation schemes branches of investment firms shall be subject to the compensation scheme in force in the host Member State provided that payment or contribution to such a compensation scheme shall be



calculated by reference to their income in respect of investment activity carried out in that State,

- provides the competent authorities of the home Member State with such information on request and at such intervals as they may determine (but not less frequently than quarterly) in order that they may assess its financial soundness, including the adequacy of its provision in respect of market risk,
- arranges for adequate records to be kept relating to executed transactions which shall be at least sufficient to enable the home Member State's authorities to monitor compliance with prudential rules which they are responsible for applying, including rules relating to market risk. Such records shall be retained for periods to be laid down by the competent authorities,
- is organized in such a way that conflicts of interest between the firm and its clients or between one of its clients and another do not result in clients' interests being prejudiced.

2. Member States may provide that the rules set out in the second, third and fourth indents of paragraph 1 shall not apply where the service is provided to business or professional investors or where the investment service does not involve the investment firm in handling any money or securities on behalf of clients.

TITLE V

Freedom of establishment and freedom to provide services

Article 12

1. Host Member States shall ensure that any investment service and any activities which are ancillary thereto may be provided in their territories, in accordance with the provisions of Articles 14 to 16, either by the establishment of a branch or by way of the provision of services, by an investment firm authorized to provide the relevant service under this Directive by the competent authorities of its home Member State.

2. Host Member States may not make the establishment of a branch or the provision of services under paragraph 1 subject to an authorization requirement or to a requirement to provide endowment capital or any measure having equivalent effect.

Article 13

1. Without prejudice to the exercise of the freedom of establishment and the freedom of services referred to in Article 12, host Member States shall ensure that

investment firms which are authorized to provide broking, dealing or market-making services by the competent authorities of their home Member State can have access, either directly or indirectly, to membership of stock exchanges and organized securities markets of host Member States where similar services are provided and also to membership of clearing and settlement systems there which are available to members of such exchanges and markets.

2. In order to meet their obligation set out in paragraph 1, host Member States shall ensure that the investment firms referred to in that paragraph have the option to become either:

- direct members of host Member States' stock exchanges or organized securities markets by setting up a branch in the host Member State, or
- indirect members by setting up a subsidiary in the host Member State or by the acquisition of an existing member firm.

In these cases membership shall be on the basis that the rules governing the structure and organization of the relevant host stock exchange or organized securities market and clearing and settlement systems are complied with.

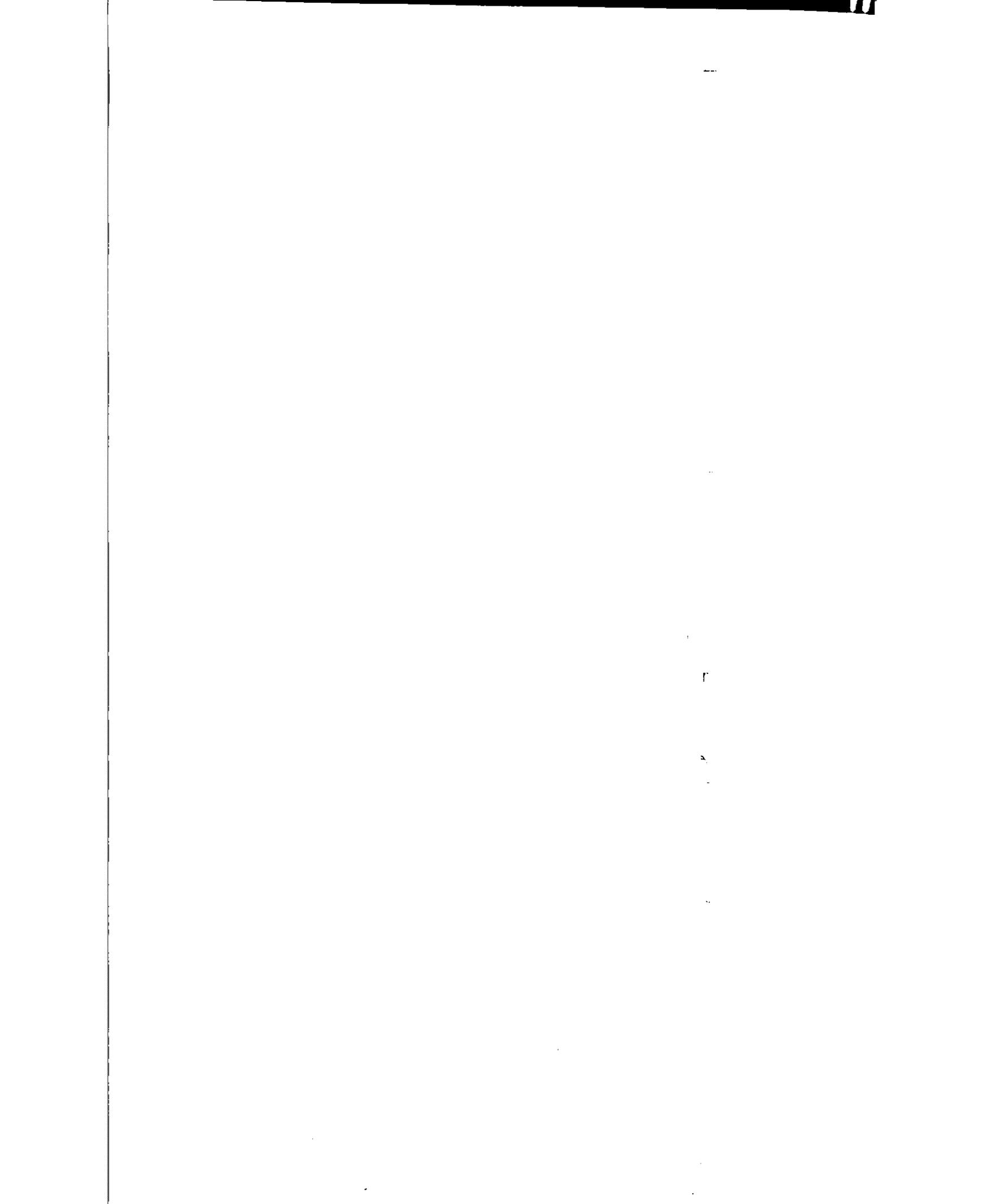
3. Where the stock exchange or organized securities market of the host Member State operates without any requirement for a physical presence the investment firms referred to in paragraph 1 may become members of it on a similar basis without having any establishment in the host Member State. Home Member States shall allow host stock exchanges or markets to provide appropriate facilities within the home Member States' territory so as to permit their investment firms to become members of the host exchange or market in accordance with this paragraph.

4. Host Member States shall likewise ensure that investment firms which are authorized to deal in financial futures and options by the competent authorities of their home Member State can have access to membership of financial futures and options exchanges and membership of clearing houses in the host Member State under the same conditions as are set out in paragraphs 1, 2 and 3.

Article 14

1. In addition to meeting the obligations set out in Article 3, an investment firm wishing to establish a branch in the territory of another Member State shall notify the competent authorities of its home Member State.

2. The Member States shall require every investment firm wishing to establish a branch in another Member State to provide the following information when effecting the notification referred to in paragraph 1:



- (a) the Member State within the territory of which it plans to establish a branch;
- (b) a programme of operations setting out *inter alia* the types of business envisaged and the structural organization of the branch;
- (c) the address in the host Member State from which documents may be obtained;
- (d) the names of the managers of the branch.

3. Unless the competent authorities of the home Member State have reason to doubt the adequacy of the administrative structure or the financial situation of the investment firm, taking into account the activities envisaged, they shall, within three months of receipt of the information referred to in paragraph 2, communicate that information to the competent authorities of the host Member State and shall inform the investment firm concerned accordingly.

The competent authorities of the home Member State shall also communicate the amount of own funds of the investment firm.

Where the competent authorities of the home Member State refuse to communicate the information referred to in paragraph 2 to the competent authorities of the host Member State, they shall give reasons for their refusal to the investment firm concerned within three months of receipt of all the information. That refusal or failure to reply shall be subject to a right to apply to the courts in the home Member State.

4. Before the branch of an investment firm commences its activities the competent authorities of the host Member State shall, within two months of receiving the information mentioned in paragraph 3, prepare for the supervision of the investment firm in accordance with Article 16 and, if necessary, indicate the conditions under which, in the interest of the general good, those activities must be carried on in the host Member State.

5. On receipt of a communication from the competent authorities of the host Member State, or in the event of the expiry of the period provided for in paragraph 4 without receipt of any communication from the latter, the branch may be established and commence its activities.

6. In the event of a change in any of the particulars communicated pursuant to paragraph 2 (b), (c) or, (d), an investment firm shall give written notice of the change in question to the competent authorities of the home and host Member States at least one month before making the change so as to enable the competent authorities of the home Member State to take a decision under paragraph 3 and the competent authorities of the host Member State to take a decision on the change under paragraph 4.

Article 15

1. Any investment firm wishing to exercise the freedom to provide services by carrying on its activities within the territory of another Member State for the first time shall notify the competent authorities of the home Member State of the investment service or services which it intends to carry on.

2. The competent authorities of the home Member State shall, within one month of receipt of the notification mentioned in paragraph 1, send that notification to the competent authorities of the host Member State.

Article 16

1. Host Member States may, for statistical purposes, require that all investment firms having branches within their territories shall report periodically on their activities in those host Member States to the competent authorities of those host Member States.

2. Where the competent authorities of a host Member State ascertain that an investment firm having a branch or providing services within its territory is not complying with the legal provisions adopted in that State pursuant to the provisions of this Directive involving powers of the host Member State competent authorities, those authorities shall require the investment firm concerned to put an end to the irregular situation.

3. If the investment firm concerned fails to take the necessary steps, the competent authorities of the host Member State shall inform the competent authorities of the home Member State accordingly. The competent authorities of the home Member State shall, at the earliest opportunity, take all appropriate measures to ensure that the investment firm concerned puts an end to that irregular situation. The nature of those measures shall be communicated to the competent authorities of the host Member State.

4. If, despite the measures taken by the home Member State or because such measures prove inadequate or are not available in the Member State in question, the investment firm persists in violating the legal rules referred to in paragraph 2 in force in the host Member State, the latter State may, after informing the competent authorities of the home Member State, take appropriate measures to prevent or to punish further irregularities and, insofar as is necessary, to prevent that investment firm from initiating further transactions within its territory. The Member States shall ensure that within their territories it is possible to serve the legal documents necessary for these measures on investment firms.



5. The foregoing provisions shall not affect the power of host Member States to take appropriate measures to prevent or to punish irregularities committed within their territories which are contrary to the legal rules they have adopted in the interest of the general good. This shall include the possibility of preventing offending investment firms from initiating any further transactions within their territories.

6. Any measure adopted pursuant to paragraphs 3, 4 and 5 involving penalties or restrictions on the activities of an investment firm must be properly justified and communicated to the investment firm concerned. Every such measure shall be subject to a right of appeal to the courts in the Member State the authorities of which adopted it.

7. Before following the procedure set out in paragraphs 2 to 4 the competent authorities of the host Member State may, in emergencies, take any precautionary measures necessary to protect the interests of investors and others to whom services are provided. The Commission and the competent authorities of the other Member States must be informed of such measures at the earliest opportunity.

The Commission may, after consulting the competent authorities of the Member States concerned, decide that the Member State in question must amend or abolish those measures.

8. In the event of withdrawal of authorization the competent authorities of the host Member State shall be informed and shall take appropriate measures to prevent the investment firm concerned from initiating further transactions within its territory and to safeguard the interests of investors. Every two years the Commission shall submit a report on such cases to the committee constituted under Article 23.

9. The Member States shall inform the Commission of the number and type of cases in which there has been a refusal pursuant to Article 14 or measures have been taken in accordance with the provisions of paragraph 4. Every two years, the Commission shall submit a report on such cases to the committee constituted under Article 23.

10. Nothing in this Article shall prevent investment firms authorized in other Member States from advertising their services through all available means of communication in the host Member State, subject to any rules governing the form and the content of such advertising adopted in the interest of the general good.

TITLE VI

The authorities responsible for authorization and supervision

Article 17

1. The Member States shall designate the authorities which are to carry out the duties provided for in this Directive. They shall inform the Commission thereof, indicating any division of duties.

2. The authorities referred to in paragraph 1 must be public authorities or bodies officially recognized by national law or by public authorities to be part of the supervisory system prevailing in the relevant Member State.

3. The authorities concerned must be granted all the powers necessary to carry out their task.

Article 18

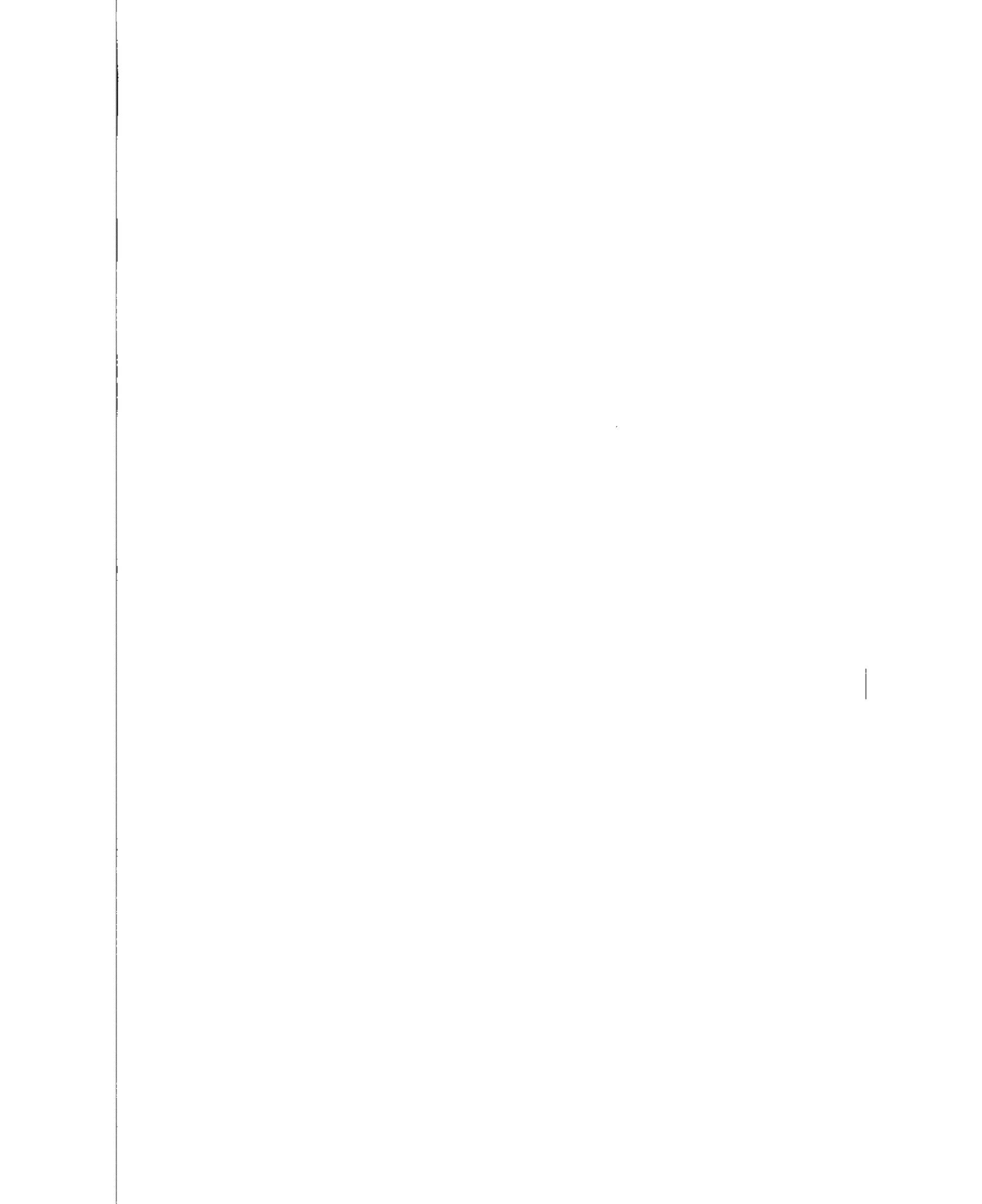
1. Where there are several competent authorities in the same Member State they shall collaborate closely in order to supervise the activities of investment firms operating there.

2. Member States shall also permit such collaboration to take place between such competent authorities and public authorities responsible for the supervision of credit and other financial institutions and insurance companies as regards the respective entities supervised by them.

3. Where investment services are provided on a services basis across frontiers or by the establishment of branches in one or more Member States other than the home Member State the competent authorities of the Member States concerned shall collaborate closely in order to supervise the activities of the investment firms concerned. They shall supply one another on request with all information concerning the management and ownership of such investment firms that is likely to facilitate their supervision and the examination of the conditions for their authorization and all information likely to facilitate the monitoring of such firms.

Article 19

1. Host Member States shall ensure that, where an investment firm authorized in another Member State carries on its activities there through a branch, the competent authorities of the home Member State may, after having first informed the competent authorities of the host Member State, carry out themselves or through the intermediary of persons they appoint for that purpose on-the-spot verification of the information referred to in Article 18 (3).



2. The competent authorities of the home Member States may also ask the competent authorities of the host Member State for this verification to be carried out. The authorities which have received such a request must, within the framework of their competence, act upon it either by carrying out the verification themselves, or by allowing the authorities who made the request to carry it out, or by allowing an auditor or expert to carry it out.

3. This Article shall not affect the right of the competent authorities of the host Member State to carry out, in the discharge of their responsibilities under this Directive, on-the-spot verifications of branches established within their territory.

Article 20

1. The Member States shall provide that all persons working or who have worked for the competent authorities, as well as auditors or experts acting on behalf of the competent authorities, shall be bound by the obligation of professional secrecy. This means that no confidential information which they may receive in the course of their duties may be divulged to any person or authority whatsoever, except in summary or collective form such that individual investment firms cannot be identified, without prejudice to cases covered by criminal law.

Nevertheless, where an investment firm has been declared bankrupt or is being compulsorily wound up, confidential information which does not concern third parties involved in attempts to rescue that investment firm may be divulged in civil or commercial proceedings.

2. Notwithstanding paragraph 1, the competent authorities of the various Member States and the public authorities responsible for the supervision of credit and other financial institutions shall be authorized to exchange information in accordance with the provisions of Article 18 where appropriate for the efficient discharge of their respective responsibilities. This information shall be subject to the conditions of professional secrecy referred to in paragraph 1.

3. Member States may conclude cooperation agreements, providing for exchanges of information, with the competent authorities of third countries only if the information disclosed is subject to guarantees of professional secrecy at least equivalent to those referred to in this Article.

4. Competent authorities receiving confidential information under paragraphs 1 or 2 may use it only in the course of their duties:

- to check that the conditions governing the taking-up of the business of the entities supervised by them are met and to facilitate the monitoring of the conduct of such business, the administrative and accounting procedures and the mechanisms of internal control,

or

- to impose sanctions,

or

- in an administrative appeal against a decision of the competent authority,

or

- in court proceedings instituted pursuant to Article 21.

5. Paragraphs 1 and 4 shall not preclude the exchange of information within a Member State, or between Member States, between competent authorities and:

- authorities responsible for the supervision of financial markets,
- bodies involved in the liquidation and bankruptcy of investment firms and in other similar procedures,
- persons responsible for carrying out statutory audits of the accounts of investment firms and other financial institutions,

in the discharge of their supervisory functions, and the disclosure to bodies which administer compensation schemes of information necessary to the exercise of their functions. This information shall be subject to the conditions of professional secrecy referred to in paragraph 1.

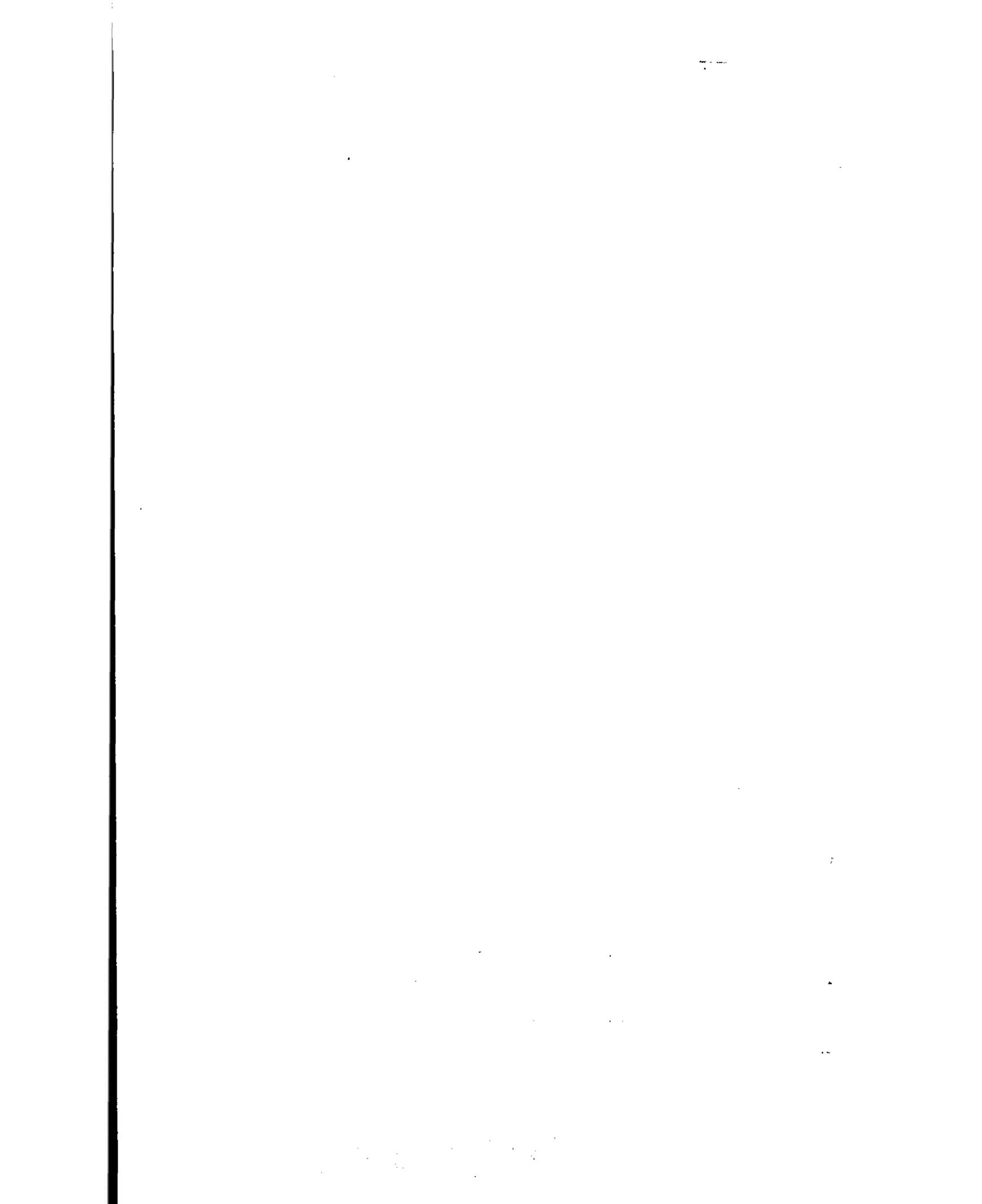
6. In addition, notwithstanding the provisions referred to in paragraphs 1 and 4, the Member States may, by virtue of provisions laid down by law, authorize the disclosure of certain information to other departments of their central government administrations responsible for legislation on the supervision of credit institutions, financial institutions, investment firms and insurance companies and to inspectors acting on behalf of those departments.

However, such disclosures may be made only where necessary for reasons of prudential control.

However, the Member States shall provide that information received under paragraphs 2 and 5 and that obtained by means of the on-the-spot verification referred to in Article 19 may never be disclosed in the cases referred to in this paragraph except with the express consent of the competent authorities which disclosed the information or of the competent authorities of the Member State in which on-the-spot verification was carried out.

Article 21

Member States shall ensure that decisions taken in respect of an investment firm pursuant to laws, regulations and administrative provisions adopted in accordance with this Directive may be subject to the right to apply to the courts. The same shall apply where an application for authorization is deemed to be refused in accordance with Article 3 (4).



Article 22

Without prejudice to the procedures for the withdrawal of authorizations and the provisions of criminal law, Member States shall provide that their respective competent authorities may, as against investment firms, or those who effectively control the business of such firms which infringe laws, regulations or administrative provisions concerning the supervision or pursuit of their activities, adopt or impose in respect of them penalties or measures aimed specifically at ending observed breaches or the causes of such breaches.

TITLE VII

Final provisions

Article 23

1. The technical adaptations to be made to this Directive in the following areas shall be adopted in accordance with the procedure laid down in paragraph 2:

- expansion of the content of the list in the Annex or adaptation of the terminology used in that list to take account of developments on financial markets,
- alteration of the amount of initial capital referred to in Article 3 to take account of developments in the economic and monetary field,
- the areas in which the competent authorities must exchange information as listed in Article 18,
- clarification of the definitions in order to ensure uniform application of this Directive throughout the Community,
- clarification of the definitions in order to take account in the implementation of this Directive of developments on financial markets,
- the alignment of terminology on and the framing of definitions in accordance with subsequent measures on investment firms and related matters.

2. The Commission shall be assisted by a committee composed of representatives of the Member States and chaired by a representative of the Commission.

The representative of the Commission shall submit to the committee a draft of the measures to be taken. The committee shall deliver its opinion on the draft within a time limit which the chairman may lay down according to the urgency of the matter. The opinion shall be delivered by the majority laid down in Article 148 (2) of the Treaty in the case of decisions which the Council is required to adopt on a proposal from the Commission. The votes of the representatives of the Member States

within the committee shall be weighted in the manner set out in that Article. The chairman shall not vote.

The Commission shall adopt the measures envisaged if they are in accordance with the opinion of the committee.

If the measures envisaged are not in accordance with the opinion of the committee, or if no opinion is delivered, the Commission shall, without delay, submit to the Council a proposal relating to the measures to be taken. The Council shall act by a qualified majority.

If, on the expiry of three months from the date of referral to the Council, the Council has not acted, the proposed measures shall be adopted by the Commission.

Article 24

1. Investment firms already authorized to provide investment services in their home Member State before the entry into force of the provisions adopted in implementation of this Directive shall be deemed to be authorized for the purposes of this Directive provided that the authorization was given under equivalent conditions to those set out in Articles 3 (2) and 4.

2. Branches which have commenced their activities; in accordance with the provisions in force in their host Member States, before the entry into force of the provisions adopted in implementation of this Directive shall be presumed to have been subject to the procedures envisaged in Article 14 (1), (2) and (3). They shall be governed, from the date of that entry into force, by the provisions of Articles 12, 14 (6), 16 and 19.

3. Article 15 shall not affect rights acquired before the entry into force of the provisions adopted in implementation of this Directive by investment firms providing services.

Article 25

1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 1 January 1993. They shall forthwith inform the Commission thereof.

The provisions adopted pursuant to the first subparagraph shall make express reference to this Directive.

2. Member States shall communicate to the Commission the texts of the main provisions of national law which they adopt in the field covered by this Directive.

Article 26

This Directive is addressed to the Member States.



ANNEX

INVESTMENT SERVICES COMING WITHIN THE SCOPE OF THIS DIRECTIVE

SECTION A

Services

1. Brokerage, i.e. the acceptance of investors' orders relating to any or all of the instruments referred to in Section B below and/or the execution of such orders on an exchange or market on an agency basis against payment of commission.
2. Dealing as principal, i.e. the purchase and sale of any or all of the instruments referred to in Section B below for own account and at own risk with a view to profiting from the margin between bid and offer prices.
3. Market making, i.e. maintenance of a market in any or all of the instruments referred to in Section B below by dealing in such instruments on the basis of a commitment to make two-way prices.
4. Portfolio management, i.e. the management against payment of portfolios composed of any or all of the instruments referred to in Section B below undertaken for investors otherwise than on a collective basis.
5. Arranging or offering underwriting services in respect of issues of the instruments referred to in point 1 of Section B below and distribution of such issues to the public.
6. Professional investment advice given to investors on an individual basis or on the basis of private subscription in connection with any or all of the instruments referred to in Section B below.
7. Safekeeping and administration of any of the instruments referred to in Section B below otherwise than in connection with the management of a clearing system.

SECTION B

Instruments

1. Transferable securities including units in undertakings for collective investment in transferable securities.
 2. Money market instruments (including certificates of deposit and Eurocommercial paper).
 3. Financial futures and options.
 4. Exchange rate and interest rate instruments.
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