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EU Financial Market Supervision Revisited:
The European Securities Regulator

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EU Financial Market Supervision Revisited: The European Securities Regulator

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Abstract

This paper deals with the regulation and supervision of financial markets within the European Union (EU). Recent developments in financial services at EU level as well as regulatory and institutional developments at national level have recently moved the question of the institutional structure of the EU financial services regulation and supervision beyond the purely academic domain to form the subject of specific political debate. The new Lamfalussy method promises a fast-track decision-making structure, which will be more transparent, flexible and effective. Specific legal, economic and institutional hurdles, however, will further slow down and undermine the creation of the Single Financial Market. The aim of this paper is to contribute to this debate by critically assessing the current regulatory and supervisory regime in EU financial services with a view to drawing policy lessons and recommendations on more effective and efficient institutional alternatives.

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EU FINANCIAL MARKET SUPERVISION REVISITED: THE EUROPEAN SECURITIES REGULATOR*

A. PROLOGUE: FINANCIAL MARKET REVOLUTION AND REGULATORY EVOLUTION IN THE EU

European financial markets witness an era of breathtaking change. Over the past dozen years, the European Union (EU)[1] has experienced a revolutionary change regarding investment and financial services. From the introduction of the euro and the creation of the European Central Bank (ECB) to the dominant appearance of financial conglomerates, complex financial products and the electronisation of securities markets, the revolution is more than evident.

The European financial market industry has changed dramatically. This can be seen chiefly as the consequence of the globalisation of financial services in general. Developments, such as fast storage, transmission and processing of information, increasing consolidation and conglomeration and electronic commerce, cause institutions not only to reconsider their geographical structure, to move bulk processing to lower cost centres and to outsource, but also oblige them to adjust their management structures and traditions based on location and regional geography. Globalisation and the need to create an appropriate and efficient regulatory and supervisory framework of the global economy form part of the background to the current debate. More developments are to come in the future, which will require imaginative and innovative responses from supervisory authorities. The impetus for some of these changes can be sourced to the European

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[1] For the purposes of this paper, unless otherwise indicated, the term 'regulation' will be used to refer to the legal rules or administrative requirements established by financial authorities or markets to limit or control the risks assumed by financial firms and to the imposition of such provisions either generally or on the activities of an individual institution. 'Supervision' shall refer to the associated or complimentary process of monitoring or reviewing the behaviour of financial firms with any specific sets of regulatory provisions imposed or with more general standards of prudent or proper behaviour. See, for instance, Gardener, E.P., *Theory and Practice in Banking Supervision: Some Reflections* (IES Institute of European Finance, RP 86/2) 2; Llewellyn, D., *The Regulation and Supervision of Financial Institutions* (Gilbart Lectures on Banking, 1986) 9; Goodhart, C., *et al*, *Financial Regulation: Why, How and Where Now?* (London: Routledge, 1998) 189; Walker, G., *International Banking Regulation: Law, Policy and Practice* (London, Kluwer, 2001) 1. For a US perspective, see Breyer, S., *Regulation and Its Reform* (Cambridge: Harvard University Press, 1982); Spulber, D., *Regulation and Markets* (Campridge: MIT Press, 1989) 21. The terms 'regulator' and 'supervisor', however, may be used in a broader sense, including all authorities that regulate, supervise or review compliance by financial institutions.

The European Union was created under Article A of the Maastricht Treaty and is stated to be founded on the European Communities, namely the European Community, the European Coal and Steel Community and the European Atomic Energy Community. The Maastricht Treaty was subsequently consolidated under the Amsterdam Treaty (Consolidated Treaty establishing the European Community, OJ C 340/173, 10 November 1997, hereinafter 'EC Treaty').

Economic and Monetary Union (EMU). Yet, there are other powerful forces at work such as technological changes and new competitive dynamics.[2]

The financial revolution notwithstanding, European financial markets are currently going through a difficult period, reflecting the uncertain global macro-economic situation. These difficulties have been compounded by a number of factors such as the severe correction in stock market valuations since 2000, increased risk-aversion by investors triggered by a series of corporate governance scandals, and the war in Iraq. The overall outlook strengthens the political case further for the completion of the Financial Services Action Plan (FSAP)[3] and the subsequent regulatory integration.

Moving to the regulatory sphere, one cannot ignore the considerable progress made over the last twenty years. The starting point for EU financial services regulation and supervision is that their regulatory and supervisory framework matters as a precondition for the objectives of financial stability, consumer protection and competition promotion.[4] Supervisors acknowledge that consumers want fair, honest, orderly, effective and efficient financial markets. This is an important matter of public interest and regulators should take necessary actions to promote these objectives. Moreover, past and recent financial institutions' failures worldwide justify the attention currently given to the reinforcement, or even to the complete reform, of current regulatory and supervisory arrangements.

In keeping with the overall objectives of the EC Treaty, mainly the concepts of freedom of establishment (Articles 49-55 EC) and freedom to provide services (Articles 43-48 EC), the European Union has been concerned to create an environment, in which all financial institutions within the EU and the European Economic Area (EEA) should be able to offer their services throughout the Union on the same, or a similar, supervisory foundation. Investment and financial services regulation is based on the Treaty objective

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[2] EU securities markets have benefited from new trends: the total volume of international bond issues in euros is now practically equivalent to the volume of issues in US dollars and the volume of derivatives contracts traded has multiplied every quarter since mid-1998. However, indicators show substantial scope for further capital market integration in Europe. Using a survey on business services carried out by the Commission, it can be estimated that eliminating barriers to cross-border trade would increase current EU GDP by between 1.1 and 4.2 per cent; see European Commission, *Economic Reform: Report on the functioning of Community product and capital markets* (COM(2001), 7 December 2001) 17. Another study estimates that an integrated financial sector could add between 0.5 and 0.7 per cent to EU GDP or 43 billion euro; see F. Heinemann & M. Jopp, *The Benefits of a working European Retail Market for Financial Services* (Report to European Financial Services Round Table, 2002) 12. Moreover, a single infrastructure for clearing and settlement could be expected to reduce costs further by as much as 42 to 52 per cent; see European Commission, Financial *Services: Meeting the Barcelona Priorotoes & Looking Ahead* (3 December 2003). Although such figures might turn out to be exaggerated, the effects are, no doubt, big enough to deserve increasing political attention.

[3] The FSAP, adopted by the European Commission in May 1999, outlined a series of policy objectives and specific measures to improve the Single Market for financial services over the next five years; European Commission, *Financial Services: Implementing the Framework for Financial Markets: Action Plan* (COM(99) 232, 11 May 1999).

[4] Key objectives of financial regulation have been identified in various international reviews; for banking, see OECD, *Banks under stress* (Paris, 1992); Basel Committee, *Core Principles for Effective Banking Supervision* (September 1997); for securities, see IOSCO, *Objectives and Principles of Securities Regulation* (February 2002); for insurance, see IAIS, *Insurance Core Principles* (October 2000); for cross-sectoral issues, see Joint Forum, *Core Principles: Cross-sectoral Comparison* (November 2001).

of developing a common market.[5] The Internal Market in financial services, introduced by the European Commission's 1985 White Paper[6] constitutes part of a wider project to create a single market comprising 'an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured'.[7] Accordingly, capital markets have been liberalised and integrated, their access has been freed, rules in all the fifteen Member States are more or less harmonised and services circulate freely all over Europe under the 'European passport' and homogenous prudential rules, all of which have resulted in a true European securities market carried within a single currency. These achievements are far from negligible. However, the cessation of any substantial developments during the last ten years – i.e. after the Investment Services Directive (ISD) and the Second Banking Directive (SBD)[8] – makes one wonder: could there have been more liberalisation and could it have been better?

As envisaged in the European Commission's White Paper of 1985 and adopted by subsequent secondary EU law, European financial sector liberalisation is based on the three principles of minimum harmonisation, mutual recognition and home country control.[9] Following the failure of previous complete harmonisation efforts by the European Community, this approach has been seen as the most appropriate to achieve a single market and has been subsequently followed by financial services secondary legislation. Its advantages are obvious: mutual recognition allows products and services legally circulated in one Member State to be admitted to other Member States without being required to meet additional regulatory requirements. Costly duplications are thus theoretically avoided without the need for complete harmonisation of national legislation at Community level. Thanks to mutual recognition, not all sectors of the Single Market needed to be harmonised, or harmonisation has been restricted to the 'essential requirements'. Hence, minimum harmonisation of basic standards allows a certain degree of regulatory competition between Member States and accommodates flexibility, innovation, simplification and experimentation. Furthermore, and perhaps most importantly, EU policy and law making remains sensible to local and regional interests, while the maintenance of specific national characteristics is ensured.

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[5] Article 2, EC Treaty.

[6] European Commission, *Completing the Internal Market: White Paper to the European Council* (COM(85) 310 final, 28 June 1985).

[7] Article 14(2) (former Article 7a) EC Treaty.

[8] *Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field* (OJ L 141/27, 11 June 1993); *Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions* (OJ L 386/1, 30 December 1989). All banking directives have recently been codified in Council and Parliament Directive 2000/12/EC (OJ L 126/1, 26 May 2000).

[9] White Paper, *op.cit.*, note 6. Paragraphs 102-103 provide that 'The accent is now put increasingly on the free circulation of "financial products" (…) The Commission considers that it should be possible to facilitate the exchange of such "financial products" at the Community level, using a minimal coordination of rules as the basis for mutual recognition by Member States of what each does to safeguard the interests of the public. Such harmonisation (…) should be guided by the principle of "home country control". This means attributing the primary task of supervising the financial institution to the competent authorities of its Member State of origin (…) [and] there would have to be a minimum harmonisation of surveillance standards'.

Albeit their initial success, however, a debate has started in Europe regarding the current status of the principles and their applicability to modern financial institutions and markets. Especially acute are the problems arising from the principles of home country control and mutual recognition, as originated and developed by the Basel Committee on Banking Supervision and the European Court of Justice. The 1985 Internal Market Programme has created a complex web of harmonised EU rules and un-harmonised national regimes while many exceptions apply to home country control and mutual recognition.

Even in areas where harmonisation has been achieved, this should not be seen as an attempt to apply uniformity of laws and regulations throughout the Union. There remain differences in national laws implementing secondary legislation. Divergences can also be observed in the laws on the supervision of financial services providers. As a result, the focus has been concentrated on the determination of the respective supervisory roles of EU institutions and Member States on the one hand, and of home and host Member States on the other. The relevant investment services and other financial services directives hardly manage to face the challenge and solve the problem.[10] In addition, the principle of subsidiarity, as introduced by the Maastricht Treaty and set out in Article 5 EC (former Article 3b) and revisited by the members of the European Convention, has brought about a major shift in EU policy and law making. Ambiguous and controversial, this principle has impacted on the form, length and content of legislation and has the potential to undermine the full liberalisation of investment services and the integration of financial markets.

These major regulatory developments have not been followed by increased financial cross-border flows, as one would expect. Regretfully, the European picture resulting from this restructuring process is not very clear. One thing, however, is certain: cross-border market integration remains very limited. Cross-border merger and acquisition (M&A) activity could reduce operating costs by as much as 1.2 to 1.3 per cent. Capital and financial service markets are also reflecting the deterioration of general business conditions: stock market capitalisation of domestic firms fell 3.8 per cent in 2000 compared to the previous year.[11] Moreover, the market share of branches and subsidiaries from other EU and EEA countries is still limited in most EU countries.

Towards the aforementioned evolving environment, the current structure of investment services supervision appears old-fashioned and anachronistic. Rules and provisions of the 1992 ‘new approach’ are now becoming out of date and require a thorough overhauling. The current debate among academic scholars, EU institutions’ and Member States’ representatives and – lately – members of the Lamfalussy Committee[12]

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[10] Regarding the ISD, see the Opinion of Advocate General Jacobs in Case C-384/93 *Alpine Investments* [1995] ECR I-1141, Paragraph 19.

[11] Even before the tragic events of September 2001 in the US, eurozone stock market capitalisation had fallen 19 per cent between January and August 2001.

[12] The Lamfalussy Committee was established by ECOFIN on 17 July 2000, with a mandate to assess the current conditions for the implementation of the regulation of securities markets in the EU. Its final report, published in February 2001, proposed precise and innovative but also controversial recommendations for more open, secure and efficient European financial markets.

and the Financial Services Committee (FSC),[13] leaves a feeling that something is moving at European level in financial regulation. The FSAP supports this assumption. Economic governance also constitutes one of the issues discussed in the European Convention. Yet financial supervision deliberately remains out of the agenda.

Admittedly, the task of financial services supervision is very different today from what it was a decade ago. With the loss of the local or domestic character of the securities markets and the cross-border provision of investment services, national supervisory authorities suddenly found themselves exposed to new problems and challenges. As a result of historic market structures, traditional administrative approaches and existing European constitutional realities, supervisors are often thinking (only) in terms of national jurisdictions. As markets change, inadequate supervision can jeopardise the stability of the European and world financial system, competition neutrality and consumer protection.

The logical method for defining the trade-off relationship between effectiveness of supervision and its costs is built upon a simple three-step axiom. The first step is the definition of the objectives and rationale for financial supervision in the EU. Second, the marginal analysis of the current home country based supervisory arrangements in connection with the aforementioned objectives. If the current structure provides overall costs charged on market participants so higher than marginal benefits, so as to make the Internal Market and investment services unable to function and compete with other markets, the third step must follow: the examination of alternative arrangements and the possibility of transferring policy at a more centralised EU level. An analysis of the issue of Member State competence versus federal EU competence involves identifying the costs and benefits of each. Accordingly, action at EU level is justified by way of *two* criteria, complementary to one another:

a) The absence of action at the European level might have negative consequences for the effectiveness of instruments envisaged by the Member States and/or be contrary to the requirements of the Treaty.
b) Action at Community level would produce clear benefits by reason of its scale or effects compared with action at the level of the Member States.[14]

Where Union action is required, the combination of different policy tools should be considered.[15] Does Europe need a pan-European securities regulator? If yes, is the creation of such a body feasible within the legal, political and economic context of Europe? These questions have recently gone beyond the purely academic domain to form the subject of specific political debate between regulators, practitioners and market participants. Although the results of these debates usually end up giving a negative

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[13] By the Council decision of 3 December 2002, the Financial Services Policy Group (FSPG) was reconfigured into the FSC. The main task of the FSC is to provide political oversight and advice to the ECOFIN Council and the Commission on issues related to the regulatory framework for financial markets.

[14] See European Commission, *Better Lawmaking 2000* (COM(2000) 772 final, 30 November 2000) 15.

[15] European Commission, *European Governance: A White Paper* (COM(2001) 428 final, 12 October 2001) 5.

dimension to such a suggestion,[16] the very fact that this question is raised up in this particular period of time reveals that something is wrong with the present regulatory and supervisory financial architecture.

It is argued that, in order to prevent institutional structure from being a purely arbitrary and *ad hoc* process, several key issues need to be considered, such as the clarity of regulatory agencies' remit, the costs of a particular institutional structure, the accountability of regulatory agencies, questions relating to the efficiency of the regulatory process, the merits of a degree of competition in regulation and issues relating to the concentration of power.[17] In addition to these, the following paragraphs suggest the need for examining three more issues: issues relating to administrative efficiency, externalities and enforcement. At the end of the day, the solid rationale of a single ESR stands on whether the financial supervisory objectives will significantly be better served under the proposed centralised regime.

For the purposes of this discussion and because law on its own may not provide sufficiently accurate and reliable standards for evaluating the effects of legal rules and institutional structures, economic theory will also be incorporated into this legal analysis. In this light, by stressing the need to take the effects of the proposed action into account, the EC Treaty itself also rejects a pure legal formalistic approach.[18]

Naturally, as in any great reform, bringing investment services supervision to the centre of Europe may involve the imposition of legal hurdles or practical drawbacks. Some scholars do not find centralisation particularly attractive, since such a move could open the way to excessive federalism and over-regulation, resulting from the lack of regulatory competition, and the disregard of the special characteristics of national markets.[19] However, vertical centralisation of investment services supervision responds to the need for an authority free not only from all national leanings but also from other EU institutions. Therefore, regulatory and supervisory centralisation could also be seen as decentralisation at horizontal level, as far as certain Community competences are moved to a specialised pan-European authority.

In addressing the effect of different supervision policies, it is an important part of any policy assessment to weigh the costs and benefits of alternative proposals. Although a number of factors cause significant difficulty for such an approach, it is still worth considering the cost and benefit analysis of the choice of the relevant supervisor within a structured framework. When the regulatory and supervisory divergence of home country control and mutual recognition fails to deliver in the EU, centralisation appears to be the

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[16] See, for instance, the Reports originated from discussions among the FESE and the Wise Men Group, chaired by Alexandre Lamfalussy: FESE, *Report and Recommendations on European Regulatory Structures* (September 2000); Committee of Wise Men, *Initial Report on Regulation of European Securities Markets* (9 November 2000, hereinafter 'Initial Lamfalussy Report').

[17] See Goodhart, C. *et al*, *op.cit.,* note 1, 150.

[18] The wording of Article 5 EC Treaty (former Article 3b) invites such an economic analysis; to justify the exercise of powers by European Community institutions, 'the scale or effects of the proposed action' must be taken into account.

[19] See, for instance, Lomax, R., 'Supervision in the Single Market' (1993) 3 Central Banking 36, 39. On the political feasibility of centralised regulation as well as on the possibility of dealing effectively with *sui generis* problems of international finance, see Cranston, R. *Principles of Banking Law* (Oxford : OUP, 1997) 116.

best solution for free and efficient movement of investment services. Many commentators maintain that the present arrangement of supervisory tasks at national level cannot be sustained in a monetary union.[20] The following paragraphs argue that economies of scale and great power over individual regulated entities should make a EU securities supervisor more effective than national competent authorities. In turn, the reduction in the latter's responsibilities would permit more resources to be devoted to the more local areas that remain within their supervisory power, increasing their effectiveness. Centralisation in supervision and more flexible regulation will be the only answer to the hurdles of inconsistencies and loopholes, systemic inflexibility, high transaction cost, problematic cooperation and coordination and the Union's failure to 'speak with one voice' at international negotiations.

This paper considers the case for an alternative supervisory approach within the field of EU investment services, namely the establishment of a European Securities Regulator (ESR). It signals the ways – if any - in which the EU institutional structure might be changed in order to remedy legal, economic and political problems. To this end, this paper provides a cost-benefit analysis for centralisation and the potential establishment of a pan-European Securities Regulator by explaining its legal base with or without a Treaty amendment, its rationale and its legal, political and economic position within the Single Financial Market. More specifically, the second Part will discuss the legal base of a European Supervisor with or without a Treaty amendment. The third Part will analyse the rationale for establishing a central regulatory body, by focusing on issues regarding transaction costs, independence and accountability, legislative incapacity, consolidation and alliances of securities markets, the impact of the euro, crisis management, imperfect information and deficient cooperation of national authorities and the relationship with third countries. Finally, the question will be raised, whether at the end of the day the reasons for 'sabotaging' the establishment of the single regulator do not relate with its 'drawbacks' but with the political unwillingness of national regulators to lose their sovereignty. The final Part of this paper will draw its main conclusions.

B. THE LEGAL BASIS FOR A SINGLE REGULATOR

1. The extent of legal authority

Before any discussion is commenced on the rationale for a pan-European Securities Regulator, this Section seeks a stable basis in law. Generally, the legal problems of establishing European bodies are considerable. EU law does not have any powers to set up autonomous institutions not provided for in the Treaty. It is, thus, clear that the Community may not create a European securities authority unless it has the necessary power, competence and legal authority to do so. The extent of that legal authority is considered below.

The first paragraph of Article 5 of the EC Treaty (former Article 3b) states that:

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[20] See, for instance, Kenen, P., *Economic and Monetary Union in Europe: Moving beyond Maastricht* (Cambridge: CUP, 1995) 32-5; Eichengreen, B., *Should the Maastricht Treaty be saved?* (Princeton: Princeton University, 1992) 42-4.

'The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein.'

The Article establishes what is better known as the principle of 'conferred powers', under which the EU only enjoys the powers expressly conferred on it by the Treaty.[21] It may be construed, however, that this position is more complicated, because, by referring also to 'objectives', the definition admits the possibility of additional, less certain, 'implied powers'.[22]

Member State competence is the rule, EU competence is the exception. The EU must accordingly first establish its Treaty-based individual competence and then check whether the Community objective cannot be adequately realised by the Member State and can therefore be achieved better at the EU level.[23] The Union is, therefore, empowered and mandated to act in certain areas by the Treaty as interpreted by ECJ case law. The Community's power to take actions is constrained by a number of general concepts including:

- subsidiarity
- proportionality, and
- non-discrimination

1.1 Subsidiarity

The EU may only create a European Securities Regulator if the necessary powers for the intended action have been transferred by Member States to the Community. The latter may either have exclusive competence or concurrent competence to act with Member States. In the latter case, the Community can only exercise its powers if the subsidiarity test is satisfied.[24]

However, one may wonder whether this form of attribution of powers still corresponds with the present legal form of the EU and its state of development.[25] The

[21] The principle of attribution of conferred powers to the Community has been confirmed by the SEA, Article 32, incorporated in Article 5 EC Treaty.

[22] 'Implied powers', in their widest formulation, were invoked by the ECJ in *Commission v Germany*. The Court held that, whenever a provision of the Treaty confers a specific task on the Commission, that provision must also be regarded, by implication, as conferring on the Commission, within some limits, 'necessarily and per se the powers which are indispensable in order to carry out the task'. See Joined Cases 281, 283 to 285 and 287/85 *Commission v Germany* [1987] ECR 3203, Paragraph 28.

[23] See Kirchhof, P., 'The Balance of Powers between the National and European Institutions' (1999) 3 ELJ 225, 234.

[24] See Article 5 EC Treaty (former Article 3b). The positive concept of subsidiarity represents the possibility or even the obligation of interventions from the Community, both aiming to fulfil and enhance human life. *Per contra*, negative subsidiarity refers to the limitations of competences of the Community in relation to its Member States; see Endo, K., 'The Principle of Subsidiarity: from Johannes Althusius to Jacques Delors' (1994) 6 Hokkaido Law Review 553.

[25] See Lang, J., 'European Community Constitutional Law: The division of powers between the Community and the Member States' (1988) Northern Ireland Legal Quarterly 209.

subsidiarity hurdle should not be difficult to be legally overcome, since it is principally a political concept; the ECJ has never decided that an act was illegal for lack of EU competence (as opposed to institutional competence or wrong legal basis).[26]

The principle of subsidiarity is currently already under examination and scrutiny by the European institutions taking part in the legislative procedure on the basis of the criteria established in the Treaty and in particular in the Protocol on the principles of subsidiarity and proportionality.[27] The principle of subsidiarity is also subject to *ex post* judicial review by the Court of Justice. Nevertheless, the European Convention considered that the principle could still be improved upon, as regards both application and monitoring.[28]

The problem set out above has obtained a new dimension as a consequence of a ruling of the ECJ. In *Commission v Council,*[29] the Court held that the concept of the Internal Market referred to in Articles 95 (former 100a) and 175 (former 130s) EC Treaty has to be interpreted very widely. Consequently, the scope of the Community's power to harmonise national legislation has become so vast that one may allege that this provision can no longer be seen as the attribution of a specific power.[30] Instead, it amounts to a general authorisation for the Community to legislate in nearly all areas, which directly or indirectly concern the Internal Market.[31] More specifically, the European Court has recently decided that when the scope of a proposed measure 'has immediate effects on intra-Community trade, it is clear that, given the scale and effects of the proposed action, the objective in question can be better achieved by the Community'.[32]

It is important in this respect to take account of the interdependence of Member States in the outcome of a specific policy, such as investment services regulation and supervision. McDonald suggests that sound reasons for supranational policies in a particular area exist only if national policies have significant spill-overs to other

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[26] However, for a national court's different view, see Case 2 BVR 2134/92 & 2159/92, *Manfred Brunner v The Treaty on European Union* [1994] 1 CMLR 57. The German Federal Constitutional Court held that any measure based on a wide interpretation of the Community's implied powers would not have binding effect in Germany. It referred to the interpretation of Article 308 EC Treaty (former Article 235), which 'may not have effects that are equivalent to an extension of the Treaty'.

[27] According to Article 5 of the Treaty, "in areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community. Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty."

[28] Working on the basis of this mandate, the Working Group on the Principle of Subsidiarity of the European Convention has devoted several meetings to examining this question. Discussions within the Group made it possible to reach consensus on certain approaches and proposals, contained in its final report, and to establish a number of principles ("golden rules") and guidelines for improving the application of the principle of subsidiarity; See European Convention, *Conclusions of Working Group I on the Principle of Subsidiarity* (CONV 286/02, 23 September 2002).

[29] Case 300/89 *Commission v Council* [1991] ECR 2867, better known as the 'titanium dioxide judgement'. For a detailed analysis of the case, see Barents, R., 'The Internal Market Unlimited: Some Observations on the Legal Basis of Community Legislation' (1993) 30 CMLRev 85, 87 *et seq.*

[30] On this question, see Arnull, A., 'Does the Court of Justice have inherent jurisdiction' (1990) 27 CMLRev 683.

[31] See Barents, *op.cit*., note 29, 87-8.

[32] See Case C-377/98 *Netherlands v Parliament and Council* [2001] ECR I-7079, Paragraph 32.

countries.[33] In some cases, potential cross-border spill-overs can be addressed by coordination efforts and not necessarily by a common centralised response. However, if the costs of coordination are greater than the benefits of taking into account spill-over effects, it is not efficient to coordinate policies.[34] It is, thus, suggested that solid reasons for centralisation and Community action may arise when the costs of reaching coordination agreements or preventing spill-overs is high. Section B of this paper reveals these costs in relation to the supervisory system of home country control and the coordination of multiple agencies.

On the whole, the importance of subsidiarity should be acknowledged. Nevertheless, the principle may be less relevant in areas, such as financial services, where businesses, including SMEs, as well as consumers are better off with single pan-European standards and common regulatory and supervisory practices.[35] Article 5 of the Treaty clearly gives priority to the general objectives of the EU concerning transnational action. Where the intention is to have an impact throughout the EU, 'Community-level action is undoubtedly the best way of ensuring homogeneous treatment within national systems'.[36] Consequently, any decision of the European Council allocating specific prudential tasks to a supranational body, should be accompanied by a justification that centralised supervision would present manifest advantages in comparison with action at Member State level. *A fortiori*, given the comparative advantage of regulatory and supervisory centralisation, both the Community and the Member States should have legitimate interest to intervene. Since such a transfer of responsibility would require unanimity and a potential Treaty amendment, the unanimous consent of all Member States would render the question of subsidiarity purely academic. This view is further reinforced by the Treaty itself. Article 105(6) already enables the Council to confer upon the ECB specific tasks concerning prudential supervision policies of credit and other financial institutions. Therefore, Community institutions can clearly arrange the delegation of Member States' responsibilities to other European bodies. In this light, they could also provide the institutional framework to determine such solutions for the Member States.

1.2 Proportionality

Even when the home country control and mutual recognition principles incorporated in the investment services directives may be argued to fulfil the legal and substantive criterion of subsidiarity, they must also be shown to be proportionate with their expressed aims. The principle of proportionality of Article 5 EC reflects the well-established jurisprudence of the European Court of Justice.[37] Pertinent questions for the Commission

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[33] McDonald, F. & Dearden, S., *European Economic Integration* (Essex: Longman, 3rd ed., 1999) 29.
[34] *Ibid*.
[35] The Economic and Social Committee shares this view; see its *Opinion on 'Mutual Recognition in the Single Market'* (OJ C 116/14, 20 April 2001). *Per contra*, the UK clearly favours mutual recognition over harmonisation; see HM Treasury, *Realising Europe's Potential: Economic Reform in Europe* (White Paper, February 2002) 81.
[36] This has recently been the clear position of the Commission; see European Commission, *Better Lawmaking 2000* (COM(2000) 772 final, 30 November 2000) 6.
[37] The third paragraph states that 'any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty'; See also the *Protocol (No 30) on the Application of the Principles of*

to ask before framing its proposal for the establishment of a European Supervisory Authority may be: is it necessary to establish a European Regulator to achieve the objectives of the EC Treaty in the investment services area? Could the objectives be achieved by other means? Will the detriment to those adversely affected be disproportionate to the benefit to financial institutions and investors?

In the case of a Securities Supervisor, if a balanced approach is adopted and if the arguments in favour are sufficient to rise above the subsidiarity threshold, they are also likely to satisfy the proportionality test. This paper will show that the benefits of the establishment of a European Regulator outweigh any costs, which constitutes it as the only feasible solution.

1.3 Non-discrimination

A further principle governing EU institutions is that of non-discrimination or equality. When one refers to discrimination, the European Court clearly states that the Treaty not only prohibits overt, but also all forms of covert or disguised discrimination, which, although based on criteria that appear neutral, do lead in practice to the same result.[38]

In practice, the establishment of a European Securities Regulator should not offend against the principle of non-discrimination, but rather promote it. Its *de facto* and *de iure* independence will ensure that it will refrain from discriminatory measures.[39] Care, however, will be needed when formulating its procedures and competences.

Given the posture that the general concepts of subsidiarity, proportionality and non-discrimination do not constrain the centralisation of securities regulation and supervision, a further question arises as to whether the legal and institutional framework is provided in order to meet this objective. Is a Treaty amendment necessary in order to establish a pan-European regulator? This is considered in the following paragraphs.

2. Is a Treaty amendment required?

It has been well documented that for a European Securities Regulator to be created, an amendment of the EC Treaty is required.[40] This, however, may not always be the case. This Section shall examine the extent, to which the creation of an ESR would require an amendment to the Treaty. ECJ case law dictates that the ESR would require an amendment, if it were given very wide power and discretion in its activities. If, however,

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Subsidiarity and Proportionality Annexed to the Treaty of Amsterdam 1997, Paragraph 6, which states that 'the Community shall legislate only to the extent necessary'.

[38] See Case 71/76 *Thieffry* [1977] ECR 765, Paragraph 13; Cases 62/81 & 63/81 *Seco v Evi* [1982] ECR 223, Paragraph 8.

[39] See below Section C.2.

[40] See, for instance, Davies, H., *Euro-Regulation* (European Financial Forum Lecture, Brussels, 8 April 1999); Hopt, K., 'Special Issue on the Economic Law of the Member States in an Economic and Monetary Union: Report' (1976) 13 CMLRev 147, 250; Avgouleas, E., 'The Harmonisation of Rules of Conduct in EU Financial Markets: Economic Analysis, Subsidiarity and Investor Protection' (2000) 1 ELJ 72, 84; Initial Lamfalussy Report, 26.

it is created on the basis of a more specific and narrowly defined set of tasks, then it is possible to create such a body without the need to amend the Treaty.

In *Meroni v High Authority,*[41] the ECJ held that delegation of powers to a Community agency is permissible, but only when

> *'it involves clearly defined executive powers, the exercise of which can, therefore, be subject to strict review in the light of objective criteria determined by the delegating authority.'*

The Court justified its reasoning by referring to the 'balance of powers which is characteristic of the institutional structure of the Community'.

On the other hand, the ECJ found that a delegation of authority which involves a discretionary power and implies 'a wide margin of discretion which may, according to the use which is made of it, make possible the execution of actual economic policy' may not be authorised as 'it replaces the choices of the delegator by the choices of the delegate, bring[ing] about an actual transfer of responsibility'.[42] In the following paragraphs we shall examine the legal basis (and its limits) of a new Community body without and with amendment of the Treaty.

2.1 Establishment of a European Securities Regulator without a Treaty amendment

According to ECJ case law, the several Treaty provisions, which confer legislative powers on the EU, may form a sufficient legal basis for establishing an agency at the EU level. Defined tasks may be delegated to that agency, but only within the limitations set by *Meroni* and only when its establishment contributes to the pursuit of the objectives, for which the legislative power in question has been granted. These limitations have been restricted even further by the Court in *Romano*. It held in that decision that the body under question 'may not be empowered by the Council to adopt acts having the force of law'.[43] The reasoning was mainly due to the fact that, under the judicial system of the Treaty, acts of such an agency could not be subjected to review by the Court. Therefore, the ECJ decided that the delegation of decision-making powers to an agency, even subject to the restrictions laid down in *Meroni*, is not possible if such an agency adopted acts having the force of law.

Applying the principles of *Meroni* and *Romano* to a potential ESR, it appears that its potential enabling legislation would need to dictate specific executive functions for an ESR to perform, while leaving high-level decisions affecting economic policy in the hands of the Commission. Furthermore, the establishment of a Securities Regulator will require a choice of legal basis on the present Treaty.

2.1.1 Choice of legal basis

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[41] Case 9/56 *Meroni v High Authority* [1957-1958] ECR 133, 157.
[42] *Ibid*.
[43] Case C-98/80 *Romano v INAMI* [1981] ECR 1241, Paragraph 20.

On numerous occasions, the European Court has confirmed that the choice of legal basis for EU measures is a matter of law rather than a matter of discretion. The choice must be based on objective factors, which may be amendable to judicial review.[44] These factors, which form the standing doctrine of the Council of 'principal objective' or 'centre of gravity',[45] include the aim and content of the measure concerned.[46] The significance of the issue has been consistently acknowledged by the ECJ.[47] As long as a conflict between EU institutions[48] about the choice of legal basis takes place and the Court has not pronounced its opinion, the risk remains that the choice of a particular legal basis will turn out to be wrong. In turn, if the wrong legal basis is actually chosen, the Court will not merely declare that the decision is vitiated by a purely formal defect, but that there has been a breach of an essential procedural requirement invalidating the measure. Finally, the selection of the legal basis may also have a decisive influence on the content of the measure, that is when it requires unanimous act from the Council or when it requires simple consultation or co-decision procedure.[49]

For the purposes of this analysis, the principal candidates for forming the legal basis for the creation of a ESR are examined as follows:

- Article 86 (former Article 90)
- Article 95 (former Article 100a)
- Article 308 (former Article 235)

2.1.1.1 Article 86 EC (former Article 90)

Article 86 permits the Commission to impose, by the adoption of Directives or Decisions, general obligations, with which public undertakings must comply under the Treaty. In theory, this Article could constitute a legal basis for further Community action in the investment services area. However, there are reasons to believe that a sufficient basis cannot be established for the creation of a Securities Regulator:

First, Article 86 is designed to deal with actions of Member States and not actions of undertakings, the proper legal basis for which would be Articles 81 or 82 (former Articles 85 and 86).[50] Therefore, while Article 86 could be an appropriate legal base for regulating the relationship between national supervisors and investment firms, it would

[44] Case 45/86 *Commission v Council* [1987] ECR 1493, Paragraph 11**.**

[45] For an analysis of these theories, see Barents, *op.cit*., note 29, 100 *et seq*.

[46] Case C-300/89, *op.cit,* note 29, Paragraph 10; Case C-426/93 *Germany v Council* [1995] ECR I-3723, Paragraph 29.

[47] See, *inter alia*, Case 45/86, *op.cit,* note 44, Paragraph 12; Case 68/86 *United Kingdom v Council* [1988] ECR 855, Paragraph 51; Case C-62/88 *Greece v Council* [1994] ECR I-1527, Paragraph 10.

[48] As a result of the stronger role of EU legislature in the process of integration and the addition of new powers, the number of such conflicts has considerably increased. See Ehlermann, C.D., 'The European Community, its law and lawyers' (1992) 29 CMLRev 213, 216-7.

[49] For more details, see Toth, A.G., *Oxford Encyclopedia of European Community Law: Vol I* (Oxford: OUP, 1990) 303-10; Emiliou, N., 'Opening Pandora's Box: the Legal Basis of Community Measures before the Court of Justice' (1994) 5 ELRev 488, 492-95.

[50] Case C-202/88 *France v Commission* [1991] ECR I-1223, Paragraph 24.

not appear to allow regulation and supervision of investment services providers by the ESR.

The second reason is that Article 86 may be used to remedy breaches of the Treaty rules, flowing, *inter alia*, from the existence of special and exclusive rights. The establishment of an ESR would be creating an administrative framework rather than remedying breaches of the Treaty or effects inherent in monopoly situations.

2.1.1.2 Article 95 EC (former Article 100a)

Article 95 EC, stemmed from the radical Article 100a,[51] prescribes the 'long and winding' cooperation procedure as set out in Article 251 EC (former Article 189b).[52] Here lies one of its major differences with Article 86, under which the Commission is the only institution involved in the adoption of a measure. Article 95 requires the Council to harmonise all national legislation, which, because of disparities between national laws, may exercise an effect on cross-border trade. It may well, thus, be alleged that the scope of this provision may be characterised as extremely wide, which could provide the Community with an almost free choice to legislate.[53]

Nevertheless, the case law indicates that this provision will only be the appropriate legal basis where the measure intended has a harmonising effect.[54] The 'object' of this provision must 'necessarily and specifically be the establishment and functioning of the internal market'.[55] Article 95 cannot oust other valid legal bases, as the expression 'save where otherwise provided in this Treaty' establishes.[56] On the other hand, systematic misuse of this provision will weaken its effect and lead to confusion.[57]

Whilst the establishment of an ESR will doubtless further the single internal market and harmonisation of Member States' regulations, it is far from clear whether Article 95 is a sufficient legal basis in itself. In *Spain* v *Council,* the European Court justified

[51] Weiler describes Article 100a as 'the single most important provision of the SEA' for introducing majority voting in the Council; see Weiler, J., *The Constitution of Europe: 'Do the New Clothes have an Emperor?' and other Essays on European Integration* (Cambridge: CUP, 1999) 68.
[52] The first paragraph of this provision states that 'by way of derogation from Article 94 and save where otherwise in this Treaty, the following provisions shall apply for the achievement of the objectives set out in Article 14. The Council shall, acting in accordance with the procedure referred to in Article 251 and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market'.
[53] See Reich, N., 'Binnenmarkt als Rechsbegriff' (1991) Europäisches Zeitscrift fur Wirtschaftsrecht 203, 207.
[54] See, for instance, Case C-155/91 *Commission v Council* [1993] ECR I-939, Paragraph 19. In its judgement, the Court stated that 'the mere fact that the establishment of functioning of the internal market is affected is not sufficient for Article 100a (sic) of the Treaty to apply. It appears from the Court's case law that resource to Article 100a is not justified where the measure to be adopted has only the incidental effect of harmonising market conditions within the Community'.
[55] See Opinion of Advocate General La Pergola in Case C-271/94 *Parliament v Council* [1996] ECR I-1689, Paragraph 14.
[56] See Ehlermann, C.D., 'The Internal Market following the Single European Act' (1987) 24 CMLRev 361, 382.
[57] See Crosby, S., 'The Single Market and the Rule of Law' (1991) 16 ELRev 451.

recourse to Article 95 when harmonising measures are necessary to deal with disparities between the laws of the Member States in areas where such disparities are liable to create or maintain distorted conditions of competition [or] in so far as such disparities are liable to hinder the free movement of goods within the Community.[58] The Court has recently refined the aforementioned principles: resource to Article 95 as legal basis is possible if 'the aim is to prevent the emergence of future obstacles to trade resulting from multifarious development of national laws provided that the emergence of such obstacles is likely and the measure in question is designed to prevent them'.[59] Nevertheless, it is doubtful in this context whether EU measures of a mere institutional character may constitute harmonisation measures in the sense of Article 95. In light of this suggestion, it is, thus, not easy to hold that the conditions laid down by the case law of the ECJ for the application of Article 95 will be fulfilled in the creation of an ESR in the future.

2.1.1.3 Article 308 EC (former Article 235)

Article 308 fully embraces the concept of implied powers.[60] It becomes evident from its wording that its use as a legal basis for a measure is justified only when no other Treaty Articles give the EU institutions the necessary power to adopt this measure.[61] Although the Article is silent on the formation of a body, as the proposed ESR, it should not lead us to the conclusion that this will prevent its establishment altogether.[62] As Weiler puts it, this provision has been interpreted in such a wide and radical manner that 'it would become virtually impossible to find an activity which could not be brought within the objectives of the Treaty'.[63]

Nevertheless, one shall not argue that Article 308 is limitless. Opinion 2/94 of the ECJ stated that this provision 'cannot serve as a basis for widening the scope of Community powers beyond the general framework created by the provisions of the Treaty as a whole and, in particular, by those that define the tasks and the activities of the Community'.[64] However, Thieffry is right to contend that these limitations are not relevant to the proposed creation of an ESR. Instead, he proposes to focus more on what,

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[58] Case C-350/92 *Spain v Council* [1995] ECR I-1985, Paragraphs 32-33.
[59] See Case C-377/98, *op.cit,* note 32, Paragraph 15; also, Case C-376/98 *Germany v Parliament and Council* [2000] ECR I-8419, Paragraph 86.
[60] Article 308 provides that 'if action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community and this Treaty has not provided the necessary powers, the Council shall, acting unanimously on the proposal from the Commission and after consulting the European Parliament, take the appropriate measures'.
[61] This point was clearly made in the *Edicom* case, which concerned the adoption of Decision 94/445/EC by the Council on the basis of Article 308. The ECJ annulled the Decision on the grounds that it was covered by Article 155 (former Article 129c), which should have formed the legal basis and not Article 308. Practically, this was important because the two Articles have different procedural bases. See Case C-271/94, *op.cit,* note 55.
[62] See Thieffry, G., 'Towards a European Securities Commission' (1999) 10 IFLR 14, 15.
[63] Weiler, J., 'The Transformation of Europe' (1991) 8 Yale Law Journal 2403, 2445.
[64] Opinion 2/94 *pursuant to Article 228(6) of the EC Treaty* [1996] ECR I-1759, Paragraph 30.

in practice, Article 308 has been used to achieve, namely the objectives of the Treaty.[65] To this end, by filling the gap where it did not possess more specific legislative authority, this Article has been a useful residual legislative power for the EU.

Another argument in favour of using Article 308 as a legal base can be found in the ECJ's *Massey-Ferguson* ruling.[66] It was argued in that case that the necessary power to adopt a regulation was granted already by other provisions of the Treaty, provided that these were given a sufficiently broad interpretation. It was thus, maintained that Article 308 could not be used as the appropriate legal base. However, the Court held that even if, given a broad interpretation, other Articles did grant the necessary powers, this interpretation was subject to doubt and, therefore, recourse to Article 308 was legitimate.[67]

The Commission, on the other hand, has changed its view on Article 308 since the introduction of the SEA. It used to invoke this provision quite frequently as a way of avoiding squabbles about legal bases and EU competence, since nearly everything could go under Article 308.[68] Now, the Commission seems more anxious to shift the legal basis of EU legislation away from Article 308 and towards other Treaty provisions that require qualified majority, particularly Article 95.[69] Article 95 has been used, for example, for the newly established European Food Safety Authority. Nonetheless, as we have seen, the European Court does not seem to share the same views with the Commission.

Even under the burden of unanimity, Article 308 appears to be the most appropriate and logical basis for establishing a Securities Regulator. This conclusion is supported by the fact that it has been used as the basis for creation of several new legal entities in the past, such as the European Economic Interest Groupings (EEIGs), the Office for Harmonisation and the European Medicines Evaluation Agency. To be beyond challenge by current EU institutions, legislation for the creation of the ESR must attain the objectives of the Treaty.[70] The objectives are included in Articles 2 and 3 of the Treaty and the ECJ is not likely to reject their use, since these provisions exactly 'define the tasks and activities of the EC'. Yet, the difficulty remains in conferring upon such a body the power to exercise mere political discretion without further control by the EU institutions interacting in accordance with the applicable Treaty provisions. The decisional content of regulatory and supervisory powers delegated to the Securities

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[65] Thieffry rightly argues that the formation of the ESR falls within the scope of Article 308 on the basis that such a body is required to foster 'greater economic (…) cohesion', as is the wording of Article 2 of the Treaty; see Thieffry, *op.cit*., note 62, 16-7.

[66] Case 8/73 *Massey-Ferguson* [1973] ECR 897.

[67] *Ibid*, Paragraph 4.

[68] Emiliou, *op.cit*., note 49, 505.

[69] The rationale for this trend may be traced to a main difference between a specific Treaty provision and Article 308 serving as the legal basis for the establishment of a new body: it may be alleged that the substantive range of its activities will tend to be narrower in the first case than in the second, because in the latter case the Council, acting unanimously on a proposal from the Commission and after consulting the Parliament, has a wide margin of discretion in determining the necessity of EU action in order to attain one of the objectives of the Treaty. See Lenaerts, K., 'Regulating the regulatory process: "delegation of powers" in the European Community' (1993) 18 ELRev 23, 43.

[70] Thieffry, G., 'After the "Lamfalussy" Report: the First Steps towards a European Securities Commission (ESC)', in M. Andenas & Y. Avgerinos (eds), *Financial Markets in Europe* (London: Kluwer, forthcoming 2003).

Regulator will be limited, for the *Meroni* constitutional requirement that the 'balance of powers' be preserved remains in force. In this light, the following paragraphs examine the possibility of creating a Securities Regulator by amending the EC Treaty.

2.2 Establishment of a European Securities Regulator with a Treaty amendment

Amendment of the Treaty will be required if it is considered that an ESR should have more than an executive function, including the power to undertake policy decisions with certainty and in complete, unfettered independence. However, the distinction between constrained discretion and policy-making powers is sometimes difficult to draw, particularly in the absence of more or clearer guidance from the ECJ. In this light, it would be useful to look for guidance by examining the degree of power granted to existing EU agencies in the financial services sector. A brief review of some of these agencies, their powers of decision-making and the nature of their decisions demonstrates the various levels of authority the Commission has conferred, which may be instructive when considering the establishment of a Securities Authority.

2.2.1 The European Investment Bank (EIB) and the European Central Bank (ECB)

Paradigms of bodies created through amendment of the Treaty include the EIB and the ECB. Both are autonomous legal entities, which have policy-making functions within the EU institutional framework. The EIB was created in 1958 as an autonomous body set up to finance capital investment furthering European integration by promoting EU economic policies,[71] while the man function of the ECB is to define and implement the monetary policy of the Community.[72] Moreover, the latter has the capacity of producing regulations on monetary policy that are binding and directly applicable to all Member States. However, the policy-making operation of these bodies should not be construed as being without restraints. They both have to comply with their founding agreements and the provisions of the Treaty and are subject to judicial review by the ECJ. In addition, the Council and the Commission also have some input into the decisions made by the policy and executive arms of these entities as they may designate who serves on the representative boards.

2.2.2 A time-consuming process?

Critics of supervisory centralisation may allege that a Treaty amendment would require long time-consuming negotiations between Member States, which could eliminate the scope and purpose for the establishment of an ESC. However, 'where there is a will there is a way'. The passage of the SEA, for instance, which made major changes to the

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[71] The EIB's Statute is drawn up as a Protocol (No 10) annexed to the Treaty establishing the European Community. It forms an integral part of the Treaty (as provided for under Article 311 *et seq*) and has the same legal value.
[72] The ECB's Statute is also drawn up as a Protocol (No 18) (ex No 3) annexed to the Treaty.

Treaty, demonstrates that even this apparently cumbersome process can be completed with surprising rapidity when sufficient political clout exists.[73]

Ideally, the potential future European Securities Regulator would have specific policy responsibilities adhered to the supervision of European financial firms and securities markets. However, if such a solution fails or finds itself unable to overcome in practice political conflicts between Member States, EU regulators and Member States' leaders should consider – and they have already done so, but without first even considering the best solution[74] - the second-best solution, the establishment of a Securities Committee without Treaty amendment, but also with less or no regulatory and supervisory tasks. For the reasons analysed in this paper, it seems inconceivable to compromise the stability and further development of European financial markets because of national controversies. It is ironic that while the international financial community is studying the possibility of setting up a 'world financial regulator', petty national jealousies appear to be preventing this from happening at the European level.[75]

3. The need for a 'hard' Regulator

The Treaty provisions, which allow for law approximation to the extent necessary for the establishment and the functioning of the internal market, continue to be applicable. The existence of different national legal systems and Member State supervision is not contrary to the Treaty. Even if we identify the weaknesses of the present supervisory structure in investment services to create a real Single Financial Market within the EU, the specific legal base of a new federal securities body will draw heavily on the justification of EU action.

By establishing a Securities Regulator on the basis of provisions of the present Treaty, its weaknesses will soon be revealed. It is far from clear whether the practical consequence of ECJ case law permits the delegation of decision-making powers to outside bodies. The several Treaty provisions granting legislative powers to the Community may form a sufficient legal basis to establish an 'internal body' having a distinct legal personality and to entrust it with tasks, which do not involve the autonomous exercise of mere political discretion, provided that the establishment of such a body contributes to the pursuit of the objectives for which the legislative and supervisory power in question has been granted to the Community.[76] The Commission, which already suffers from insufficient personnel resources, will face therefore difficulties in reducing the pressure by delegating powers to external bodies, and the design and implementation of basic acts will remain mainly within its competencies. This directly strengthens the comitology system, since the Council, by delegating implementing powers to the Commission, can fully supervise it via committees.[77] Given,

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[73] Negotiations on the SEA began in June 1985 and the Treaty amendments entered into force in July 1987.
[74] See Committee of Wise Men, *Final Report on the Regulation of European Securities Markets* (15 February 2001).
[75] Danthine J. *et al, The Future of European Banking* (London: CEPR, 1999) 98; see also below, note 255.
[76] Lenaerts, *op.cit*, note 69, 42.
[77] See Türk, A., 'The Role of the Court of Justice' in M. Andenas & A. Türk (eds), *Delegated Legislation and the Role of Committees in the EC*, (London: Kluwer, 2000) 248.

however, the importance of the need of a 'hard' Regulator, a comitology committee such as the ESC does not suffice as a solution.[78]

To the extent that it appeared appropriate to create a Community body outside the traditional EU institutional structure laid down in Article 7 EC Treaty (former Article 4), to take the necessary political decisions in complete independence, it would be for the constitution itself to create such a body. An amendment of the Treaty will be required if national governments and EU institutions wish to provide the ESR with the power it needs. The inclusion of clearly defined objectives and regulations of the Regulator in the Treaty, which constitutes primary law and has direct effect on and within Member States, would furnish the ESR with stronger law-based competence to achieve its goals. Since the Treaty can merely be amended if all Member States agree on and ratify changes, the ESR will have a very high legal, *de facto* constitutional status. Does the creation of a single securities supervisor constitute the 'centre of gravity', which will demand EU action? Is the ESR necessary to foster greater economic cohesion? In light of these questions, the following Section will endeavour to critically respond to the call for a pan-European Securities Regulator, by establishing its rationale and examining its contribution to the creation of a Single Market for EU investment services.

C. THE RATIONALE FOR A SINGLE REGULATOR

After drawing the legal umbrella, under which the central European body could be established, we now come to the question: why do we need a central European Securities Regulator and why action at the EU level would clearly produce benefits by reason of its scale or effects to the free provision of investment services? A question that can be easily posed *vis-à-vis* the assessment that the current EU financial supervisory structure is ineffective.

In an effort to explain the rationale for a single European securities market regulator, this analysis may borrow inspiration and arguments from the theory of neo-functionalism. Neo-functionalism originated as an optimistic analysis of the benefits of informal cooperation. The theory developed from the English political scientist David Mitrany's functional approach to world unification. However, its interpretation has evolved over time. Ernst Haas reformulated Mitrany's idealistic functionalism and applied it to European integration.[79] Haas questioned 'how and why nation-states cease to be wholly sovereign, [and] how and why they voluntarily mingle, merge, and mix with their neighbours so as to lose the factual attributes of sovereignty while acquiring new techniques for resolving conflicts between themselves'.[80]

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[78] For the different functions of agencies and committees, see Everson, M., 'Administrating Europe?' (1998) 2 JCMS 195, 198. The superiority of an independent body is obvious, as the latter would be 'largely shielded from explicitly political processes by their founding statutes, permanent staff, organisational independence, varying degrees of budgetary autonomy and direct networking with national administrators, whereas committees, born of a strong national desire to retain control over the setting and consequences of European regulatory norms, are more fluid in their composition and so deeply implicated in political processes that their status as "administrative" bodies is questioned'.

[79] Haas, E. (1958), 'The Uniting of Europe' in B. Nelsen & A. Stubb (eds), *The European Union. Readings on the Theory and Practice of European Integration* (London: Macmillan, 2nd edn, 1998) 139-44.

[80] *Ibid*.

Whatever the drawbacks and the criticisms levelled at neo-functionalism,[81] it is argued herein that the theory has a role to play in explaining the emergence of the need for centralisation in the investment services field. Minimum harmonisation should be seen today as a transitory stage on the way towards European legal unity.[82] Even if they were initially designed to keep open competition between national legal orders, the principles of minimum harmonisation and home country control have failed their mission. On the other hand, competition among rules cannot be seen as an end in itself, but must be critically assessed against a range of possibilities, such as the desirability of transferring power to EU institutions. To this end, centralisation is important to avoid a reversion to regressive national tendencies.[83] The introduction of a EU supervisory authority with responsibilities in the investment services sphere would assist in ensuring that rules would be applied in the same way in all Member States.

Neo-functionalists were undoubtedly correct in assuming that the functional needs of an integrated European market would necessitate a considerable transfer of policy-making powers to EU level.[84] With a single currency and a single market base, the lack of a single regulator remains a dangerous absurdity. Indeed, an important reason for delegating powers to a politically independent regulator is to enhance the credibility of the Union's long-term policy commitment to create a single financial market. Furthermore, certain drawbacks, such as the cost of the investment services industry originating from the blurred home and host supervisory powers, slow and inefficient legislation, imperfect information exchange and deficient cooperation between Member States supervisors, doubtful credibility and independence and lack of efficient crisis management in emergency situations, will support this analysis. Given this general posture, it is necessary to analyse the particular reasons that are relevant to the arguments for the establishment of a single regulator.

1. Transaction costs

The initial simple reason why we need centralisation of investment services supervisory responsibilities is to exploit regulatory economies of scale and scope, especially for financial intermediaries, which already provide cross-border services in

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[81] Some scholars conclude that neo-functionalism failed to provide an adequate explanation of the process of European integration. See, for instance, Keohane, R., & Hoffmann, S., 'Institutional Change in Europe in the 1980s', in Keohanne & Hoffman (eds), *The New European Community – Decisionmaking and Institutional Change* (Boulder: Westview, 1991) 1-40; Moravcsik, A. 'Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach' (1993) 4 JCMS 473, 478-80; Taylor, P., *International Organization in the Modern World* (New York: Pinter, 1993) 9.

[82] For the opposite view see Kondgen, J., 'Rules of Conduct: Further Harmonisation?', in G. Ferrarini (ed), *European Securities Markets: The Investment Services Directive and Beyond* (London: Kluwer, 1998) 129. Kondgen believes that minimum harmonisation was designed to safeguard national autonomy and to preserve competition among Member States rules.

[83] See Bratton, W. *et al*, *International Regulatory Competition and Coordination* (Oxford: Clarendon Press, 1996) 35.

[84] Majone, G., *Regulating Europe*, (London: Routledge, 1996) 66.

more than one Member States, and to consumers.[85] If scale economies are important, central rulemaking may be required.[86] As it would make little sense for water pollution standards to vary mile by mile along a river, so it would make no sense for regulatory and supervisory standards to vary from country to country. Multinationals and other export-oriented investment firms tend to prefer European to national supervision not only to avoid the costs of meeting different and often inconsistent national standards, but also to avoid the risk of facing progressively more stringent regulations in some of the Member States.[87] This Section will make an effort to identify and discern the significant bearing of current supervisory structure on the costs of regulation and the benefits that may derive from a more centralised approach.

For the purposes of this discussion, it would be useful to examine all kinds of transaction costs after we endeavour to define them. In Coase's definition, transaction costs occur in order

'to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on'.[88]

By adapting this definition and by moving a little further one could divide transaction cost into three categories: *institutional* or *direct* cost, *compliance* cost and *indirect* cost.[89]

1.1 Institutional or direct cost

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[85] Scale economies may be defined generally as those benefits that result when the increased size of a single operating unit produces a single product and reduces the unit cost of production. The theory of scope economies, on the other hand, states that the average total cost decreases as a result of increasing the number of different goods produced. Although the empirical evidence on economies of scale and scope is elusive, it appears that with recent technological improvements, relatively small-scale financial firms are likely to improve their cost and revenue efficiency by consolidating and achieving a larger size and scope of activities and by decreasing their compliance costs. There is an extensive literature on economies of scale and scope. See, generally, Pratten, C., *Economies of scale in manufacturing industry* (Campridge: Cambridge University Press, 1971); Chandler, A., *Scale and scope: the dynamics of industrial capitalism* (Cambridge: Belkman Press, 1990). For their influence on the European Single Market, see Owen, N., *Economies of scale, competitiveness, and trade patterns within the European Community* (Oxford: OUP, 1983); Emerson, M. *et al, The economics of 1992: the European Commission's assessment of the economic effects of completing the internal market* (Oxford: OUP, 1988); Holmes, P., 'Economies of Scale, expectations and Europe 1992' (1989) 12 World Economy 525; European Commission, *Economies of Scale: Impact on Competition and Scale Effects* (London: Kogan Page, EarthScan, 1997).

[86] Schmidtchen, D. & R. Cooter (eds), *Constitutional Law and Economics of the European Union* (Cheltenham: Edward Elgar, 1997) 160.

[87] See Majone, *op.cit.,* note 84. It could, thus, be also alleged that centralisation eliminates the negative effects of supervisory arbitrage.

[88] Coase, R.H., 'The problem of social cost' (1960) 3 The Journal of Law and Economics 1, 15.

[89] For similar or different categorisations of transaction cost, see Goodhart *et al* , *op.cit*., note 1, 150; Majone, *op.cit*., note 84, 69-70; Alfon, I. & P. Andrews, *Cost-Benefit Analysis in Financial Regulation* (FSA Occasional Paper Series No 3, September 1999) 16-9.

First, *institutional* or *direct* cost is the cost of operation of the regulatory and supervisory agencies themselves. The smaller the number of regulators, the lower the institutional cost should be. Although the institutional cost of supervisors may be comparatively smaller than other kinds of cost, it may have a significant chain-effect on compliance and indirect cost. An ineffective institutional structure may raise overall cost on investment firms if it leads to inappropriate regulation and supervision.

Here is where the establishment of a single Securities Regulator would require particularly careful considerations and delicate actions. For instance, to the extent that multiple regulators have overlapping competencies – as is the case with the home country control regime –each regulator may impose costs on others. This lays the basis for what Scharpf has called the 'joint decision trap'.[90] The solution to avoid the overlapping 'trap' would be to provide a regime of clear allocation of responsibilities or to combine them in one body. In addition, given that the single Regulator would be responsible for a wider range of functions than national authorities, it would be more able to take advantage of economies of scale in their provision by allocating its resources in a more efficient way.

Naturally, the process of establishing a central European regulator means, by definition that most Member States and financial firms will have to alter their practices. Change costs time, money and effort. Of course creating a central body should not be entered into lightly. Nevertheless, the cost of centralisation should be balanced against the need for centralisation along the lines of the materiality and the benefits it will deliver for the entire Single Market.

1.2 Compliance cost and legal certainty

Secondly, *compliance* cost is the cost imposed on financial firms and consumers. It seems to be the most significant drawback created by the present home country control and mutual recognition regime. A recent survey suggests that companies could save an average of 15 per cent if current regulation were to be better designed.[91] Compliance cost refers to the incremental cost of compliance caused by regulation, but not to the total cost of activities that happen to contribute to regulatory compliance.[92] Although institutional structures may have an effect on compliance cost, the opposite (i.e. increase of the cost of the competent authority due to a specific regulatory measure) is unlikely to happen. Compliance cost may include information and research cost, legal cost and lobbying cost.

One of the main aims of financial services supervision should be the correction of information asymmetries between regulators and the regulated. Today, European citizens and companies are confronted with a system of regulation and supervision that is difficult to comprehend. Given that keener competition in financial services could tempt some institutions to expose themselves to higher risks, the problem of asymmetric information becomes especially acute. Investors would not easily be able to identify a heightening of such a risk situation.

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[90] See Scharph, F., 'The Joint Decision Trap: Lessons from German Federalism and European Integration' (1988) 66 Public Administration 239.

[91] This clearly supersedes any reduction in costs associated with home country control and mutual recognition, which may occur because of less conformity to technical regulations.

[92] See Alfon & Andrews, *op.cit*., note 89, 16.

Under uniform pan-European regulation and supervision, national supervisors, financial firms and consumers need not expend resources on information and research costs.[93] They do not have to inform themselves of the differences in the substantive law of Member States and the way, in which these rules are enforced. Nonetheless, the reduction of information and research cost constitutes only one part of any economic analysis; another part is the gains from legal certainty as an incentive for more efficient conduct.

Legal certainty is a very significant issue for lobby groups representing large industries. Large financial firms want to be informed as soon as possible about the legal validity of their cross-border transactions and the applicability of their supervision. Smaller firms, on the other hand, which would traditionally provide services only at national level, would also welcome cuts in research and legal cost as an incentive to expand their business and enter intra-Community trade.[94] To this end, supervisory fees of financial undertakings should decrease, insofar as they no longer need to comply with prudential rules or rules of conduct of both home and host Member States, and their overall lobbying costs may be reduced as they will have to deal with a single supervisory body. The assumed preference is for the minimisation of legal cost, consistent with ensuring the outcomes desired by those involved in the transaction.[95] A single Securities Supervisor could then operate a single database for the authorisation of financial firms, avoid unnecessary duplication or overlap across home and host country authorities and adopt a more effective and focused approach to areas of common interest to most regulated financial activities. This regime would enhance the production of more stable and predictable jurisprudence,[96] while it would also guarantee the legitimacy of the actions of the independent regulator.[97]

1.3 Indirect cost

Finally, *indirect* costs are those that are least obvious from a cash perspective. Although they are hard to gauge, they are not of minor importance. Indirect costs include those stemming from regulatory capture, regulatory escalation and moral hazard, reduced competition and public choice.

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[93] Information equilibrium may be also enhanced by the transparency that a centralised structure promises. See below Section C.2.3.

[94] For a different view, see Bergh, R., 'The Subsidiarity Principle and the EC Competition Rules: The Costs and Benefits of Decentralisation', in Schmidtchen & Cooter, *op.cit*, note 86, 168. Bergh argues that 'savings in search costs (thanks to legal certainty) accrue to export industry but are achieved at the expense of industries competing only in the home markets'.

[95] Although it would be wrong to assume that all market actors share the same preferences, it seems that the only ones that will not generate gains from decreased legal cost are those who gain from costly law, notably lawyers. See Ogus, A., 'Competition between National Legal Systems: a Contribution of Economic Analysis to Comparative Law' (1999) 48 ICLQ 405, 410.

[96] Rose-Ackerman, S., *Rethinking the Progressive Agenda: The Reform of the American Regulatory State* (New York: Free Press, 1993) 172.

[97] Firms and consumers will be more supportive of the central regulatory body when they receive cheaper information, less burdensome administrative handling and more legal certainty.

The issues of regulatory capture, regulatory escalation and public choice will be discussed later in Section 2.1. As far as moral hazard and competition is concerned, we shall make the following observations. The process of regulation and supervision is not simply one where the regulators command and the regulated obey. It involves a far more complex web of bureaucracy and bargaining, where regulated firms bargain for the rules that will be applied to them. Obviously, such a practice is encouraged by supervisors, who are reluctant, for political reasons, to impose excessive cost on industry.

Investors, particularly non-professionals, always feel closer to their national regulator. They tend to have a feeling of protection originating from the authority that monitors their national market and the financial firms that operate within that market. Research reveals that seatbelts encourage drivers to drive more aggressively. Similarly, that feeling of protection may more easily lead investors to take risky decisions, which will increase moral hazard. However, a radical change in the regulatory structure of European investment services market supervision would alter investors' psychological behaviour. A single Securities Regulator may deliver benefits in the reduction of moral hazard, especially among retail investors. Indeed, Goodhart asks whether under a single regulator 'a potential moral hazard would result from a public perception that the risk spectrum among financial institutions had disappeared or become blurred'.[98] In practice, the public's understanding of the new regulatory system is – regrettably – likely to be so low that this type of moral hazard should not arise.[99] On the other hand, for those consumers, who commence cross-border investment business, a single regulator would be a one-stop-shop for complaints handling, compensation schemes and information. This could facilitate the regulator's ability to enhance public awareness of the risks, costs and benefits of different investment services and to clarify the limitations of what regulation can deliver, thus reducing the potential moral hazard.

Finally, the cost from reduced or eliminated competition may have a severe impact on the free provision of investment services and on consumer protection. In a uniform market, different national regulators may have the effect of distorting competition, either because they interpret uniform regulations differently or because they react differently, or at different speeds, to new developments.[100] Domestic interests and protectionism also play a major role. When national authorities regulate and supervise in parallel in the Single Market, the principle of competitive neutrality[101] is at risk. Imagine, for instance, a situation, where a financial firm wished to provide cross-border services in a host country and offered a financial product or service that was innovating for the domestic market and was not provided by domestic firms. In order to protect their institutions, host authorities could easily impede or prohibit the provision of that product or service on the

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[98] Goodhart *et al, op.cit.*, note 1, 154.

[99] See Briault, C., *The Rationale for a Single National Financial Services Regulator* (FSA Occasional Paper Series No 2, May 1999) 26.

[100] See Deutsche Bank Research, *Regulation and banking supervision: Caught between the nation state and global financial markets* (Frankfurt: EMU Watch No 86, 29 June 2000) 4.

[101] 'Competitive neutrality' means designing a set of policies and legal arrangements ensuring that all individuals and organizations - public, for-profit, and non-profit - are treated in an equal manner in the bidding process. To the extent possible, all protections and special privileges that public units usually enjoy over private firms simply by virtue of public-sector ownership should be removed. The same should apply to the privileges that domestic firms usually enjoy over foreign ones.

grounds of the general good, so that domestic firms do not acquire an inherent disadvantage. It would take years for the foreign firm to bring the case to the ECJ, which would give enough time to domestic institutions to prepare and provide similar products or services. The home country control regime could give rise to several other similar impediments to competition, which could burden financial firms with additional and unjustified costs. Moreover, in contrast to the rhetoric associated with the launch of home country control,[102] consumers are not benefited either. Consumer choice is inhibited because consumers are not able to buy or, in some cases, even be informed about what may be available from foreign suppliers.

In a perfect Europe without borders and a financial environment with transaction costs equal to zero, there would be no reason for national authorities to transfer power to a federal pan-European body. Instead, investment firms and markets could be managed by intergovernmental agreements or even by means of non-cooperative mechanisms. However, this is not the case we currently witness in Europe. Costs involved in financial supervision are frequently quite easy to measure with some accuracy. The same, however, cannot be said for the benefits. More or less, the economic benefits of supervision lie in the prevention of disaster and in the constitutional free provision of investment services. As we shall see, there can be little doubt that a pan-European Securities Supervisor offers scope for significant efficiencies. At least in theory, a single supervisor ought to be able to generate a number of efficiency gains. Equally, however, it may be difficult to deliver these in practice, especially at the beginning of its function.

2. Independence and accountability

The potential delegation of prudential responsibilities to the European Securities Regulator raises significant questions of public control, independence and accountability, which justify the switch to centralisation. This Section endeavours to address these questions.

2.1 Public choice theory and independence

Any existence of multiple supervisory agencies and different regulatory regimes entails the possibility that powerful interest groups may impede any national or cooperative supranational developments. Public choice theory, which lies at the heart of the concern about regulatory failure, depicts the struggle over regulatory and supervisory action as a kind of competition between discrete groups and the general welfare, with information serving as the principal weapon. Financial firms, exchanges, issuers and investors have incentives to endeavour to influence the scope, content and enforcement of financial regulation in order to promote their private interests.[103] Furthermore, political

[102] See, for instance, ISD, Recital 2, which states: 'whereas firms that provide the investment services covered by this Directive must be subject to authorization by their home Member States in order to protect investors and the stability of the financial system'.

[103] Hertig, G., 'Regulatory Competition for EU Financial Services' (2000) 2 Journal of International Economic Law 349, 365. Generally speaking, the ability of pressure groups to influence decision-making

actors and interest groups are well aware that institutional choices have significant consequences for the context and direction of policy. This, of course, might seriously undermine the independence of various Member States' supervisory authorities or of the ESR. Accordingly, the elimination of political control and influences in this area is justified on the basis that it ensures an institutional environment conducive to the attainment of the supervisory objectives of financial stability, consumer protection and competition promotion.

Regretfully, data regarding the role of interest groups in influencing regulation is not sufficient enough to comparatively assess the influence at the national and EU level and thus to drive us to specific conclusions. Nevertheless, it may be possible to make certain speculations with regard to specific interest groups. Interest groups may be strong enough to influence supervisory authorities. Firms, for example, established in jurisdictions with more costly legal structures and which have already invested resources in complying with such regimes will not wish to lose the competitive advantage, which they thereby acquire over newcomers.[104] On the contrary, small and medium financial firms, which yet face difficulties in penetrating markets beyond their home country, will have a more growing interest in centralisation. Traditionally, these financial firms, which are increasingly lobbying for centralisation and additional harmonisation to further diminish existing barriers in intra-Community trade, have limited power and take slower steps.

Securities exchanges, for their part, have repeatedly lobbied for regulation at EU level to better incorporate tools allowing Member States to limit competition between them.[105] Although pan-European trading platforms consolidation plans have not been very successful in the past – with notable exceptions such as Euronext and Euro.NM - there is growing evidence that true pan-European exchanges will soon become common, chiefly owing to technological progress.[106] In this perspective, it is in the interest of major regulated markets to lobby to further diminish cross-border trading barriers and even campaign for a single European Securities Regulator.[107]

Finally, issuers and investors are initially unlikely to show much direct interest in the institutional supervisory structure, and, thus, have relatively less influencing power. They should be keener in harmonisation of Member States' laws with regard to accounting standards, disclosure, company law and consumer protection issues. It comes as no surprise that, for the very reason that these interest groups have limited powers in lobbying at the EU level, harmonisation efforts of these issues have been blocked for decades. However, being in favour of a European passport and in order to reduce transaction costs and increase liquidity, they may become more supportive of centralisation and consolidation of regulated markets as well as of real freedom of cross-

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differs across industries and subject matter. However, public choice teaches us that industrial groups will be more successful than investor groups. See Schmidtchen and Cooter, *op.cit*., note 86, 165-6.

[104] Ogus, *op.cit*, note 95, 411-2.

[105] Lee, R., 'Regulation of Capital Markets in the European Union' in P. Newman (ed), *3 The New Palgrave Dictionary of Economics and the Law* (London: Macmillan, 1998) 230.

[106] On the issue of securities exchanges' consolidation, see Section 4.

[107] Werner Seifert, for instance, chief executive of Deutsche Börse, is frustrated by the lack of progress so far; see The Economist, 'No SECs please, we're Europeans' (21 August 1999) 62. However, the formal approach of the Federation of European Securities Exchanges hardly moves in the same line; see *FESE Report, op.cit,* note 16.

border trading. In this respect, a centralised body could be seen as the only means of making the single financial market a reality.

In short, heterogeneous interest groups have different powers in influencing the content, the scope and enforcement of financial regulation and supervision. Since the power of issuers, investors and smaller financial undertakings is limited to their home competent authority, it is more likely that a single Securities Regulator will be under less pressure. Diverse interest group pressure means diverse financial regulatory and supervisory standards. A centralised body should tackle this problem by establishing a level playing field as far as supervision is concerned and by keeping itself far from regulatory capture efforts. However, this issue is examined below.

2.2 The problem of regulatory capture

A response to the issue whether regulatory and supervisory decisions should be taken at the national or EU level requires a comparison of the possibilities of decentralisation and centralisation to cope with the problem of regulatory capture.[108] Keeping national supervisors' knowledge up to date may require structured training in cooperation with industry or a system of inward and outward secondments between supervisors and the supervised. These steps would bring supervisors closer to the market, but carry the potential risk or perception of regulatory capture and conflict of interest.

Ogus suggests that large areas of law are 'interventionist' in that they protect defined interests and/or supersede voluntary transactions.[109] Such 'interventionist' law creates winners (the beneficiaries of protection) and losers (the subject of legal obligation), who, in a decentralised regime, will both attempt to exert pressure on lawmakers for more favourable law. National regulators, on the other hand, may also benefit from their close relationship with the market. They could, thus, allege that the closer a regulator physically is to the firm and the market that it regulates, the better and more efficient its supervision is. Nevertheless, any close relationship entails the risk of regulatory capture. But again one may ask: don't we always face the risk that market participants will try to capture their regulator in order to promote their own interests, irrespective of their distance with it? It should be argued that the possibilities of regulatory capture have their limits in the design of institutional structure. Although appropriate institutional architecture, such as a centralised supervisory body, will not prevent regulatory capture altogether, it may limit its scope. We elaborate below.

A centralised supervisory body should redress the imbalance. The risk of capture of a national regulator is higher compared to a supranational supervisor, which keeps itself at a safe distance from the financial institution it regulates. This may be depicted by the

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[108] See generally, Stigler, G., 'The Theory of Economic Regulation' (1971) 2 Bell Journal of Economics 3, Peacock, A. *et al., The Reguation Game* (Oxford: Basil Blackwell, 1984); Vickers, J. & Yarrow, G., *Privatization: An Economic Analysis* (Cambridge: MIT Press, 1988); Laffont, J. & Tirole, J., 'The politics of government decision-making: A theory of regulatory capture' (1991) 4 Quarterly Journal of Economics 1089.

[109] Ogus, *op.cit*., note 95, 412.

recent experience in many East Asian countries.[110] Also in Europe, incidents such as Crédit Lyonnais and Banco di Napoli suggest that domestic supervisors have sometimes been too close to the institutions they regulate, thus risking being captured, particularly when those institutions are state owned and supported by powerful political lobbies.[111] Because of their independence from electoral considerations and party political influences, supranational regulators are less likely to be captured by special interests than a national authority.[112] Hence, the natural distance, the pan-European Securities Regulator should keep, appears as a healthier solution.

Furthermore, the supervisory objectives of financial stability, consumer protection and competition promotion, can be used to control and to ensure the ESR's political independence. A central regulatory and supervisory body ought to observe supervisory objectives that underline its specific policy initiatives. The fact that a supervisor has been appointed with the responsibility of observing more than one supervisory objectives means that it has been granted goal independence.[113] Such independence is actually superior to simply having one ambiguous policy objective, for it guarantees the existence of democratic check and balances. Sticking, thus, to its objectives and policies and being less sensitive to external influence, a single regulator should respond with two different, but complementary characteristics: transparency and accountability.

2.3 Transparency and accountability

Under the current home country control regime, every regulator is and should be independent and accountable at an appropriate national level and subject to full judicial review of its implementing rules. It is certain that all Member States' legal systems contain rules, which try to promote and improve political accountability. Nonetheless, the often unclear distinction between national authorities' responsibilities may undermine such efforts. It is, thus, logical to assume that there is a great deal of accessibility asymmetry between market players that are close to the national regulator and other market participants – possibly from other Member States – that lack these advantageous contacts. Lack of clarity in the objectives of multiple regulators equals to lack of accountability, not only across themselves, but also across the institutions and markets they regulate. In addition, practical hurdles, such as language and distance foster the

[110] Before the crisis, 'lax prudential rules and financial oversight led to a sharp deterioration in the quality of banks' loan portfolios'; Fischer, S., *The Asian Crisis: A View from the IMF* (Paper presented at the Midwinter Conference of the Bankers' Association for Foreign Trade, Washington, 22 January 1998). There was excessive government ownership or involvement in banks, which resulted in too much 'connecting lending' with all the attendant dangers of concentration of credit risk and lack of arms-length credit decisions; Goldstein, M., *The Asian Financial Crisis: Causes, Cures, and Systemic Implications* (Washington: IIE, June 1998)

[111] Crédit Lyonnais and Banco di Napoli are recent examples of public support to individual insolvency problems.

[112] Majone, *op.cit.*, note 84, 71.

[113] Goal independence implies the unilateral ability of the regulator to set its own policy targets and goals.

problem.[114] As a result, Member States' supervisors are far away from producing an open, transparent and accountable regime.

On the other hand, if a single regulator is given a clear set of responsibilities, then it ought to be possible to increase transparency and accountability,[115] at least in terms of its performance against its statutory objectives, the regulatory regime, the cost of regulation, its disciplinary policies and the supervisory failures.[116] When the pan-European supervisory framework is clear, then it has the advantage of pinning appropriate accountability on the different actors in the system. In contrast to the home country control system, there is clearly no doubt who is responsible in the event of supervisory failure. Consequently, an open pan-European Regulator will be better accepted by individuals and undertakings. Edwards argues that Europeans need to have more than a minimum knowledge of the European institutions, procedures, norms and values in order to accept them.[117] This is the definition of legitimacy.[118] Transparency, thus, is an integral factor in the process of legitimisation and the single Regulator, as every other EU institution, must be seen as more efficient, democratic and effective, both in terms of policy-making and policy implementation. Sometimes, however, as a result of transfer of certain powers to a new organ some of the legitimacy may be lost. Legitimacy, for instance, may not automatically follow delegation of powers from the Commission or the Council to the ESR. According to a different view, it is also possible that transparency and legitimacy are enhanced. This is likely to be the case when powers are transferred from the less powerful national supervisory authorities to a central body. It is, thus, vital in this context that the new Securities Regulator creates and establishes its own legitimacy, which, as the establishment of the ECB has shown, may take a significant amount of time.

We must acknowledge that the creation of a pan-European Securities Regulator will result in a significant increase in concentration of supervisory powers to a single body. There is always a concern that a single regulator 'could potentially become an overmighty bully, a bureaucratic leviathan divorced from the industry it regulates'.[119] It is therefore vital that this body establishes a robust transparency and accountability framework, explicitly laid down in Article 1 EC Treaty, so that firms, individuals and markets approve and accept its competence. Right from the beginning, this major

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[114] Considerations of efficiency and cost have generally led national authorities to the usage of the home language only. It remains a fact that most supervisors' Internet Web Sites do not yet provide all documents and legal resources in English.

[115] See Taylor, M., *Twin Peaks: A regulatory structure for the new century* (London: Centre for the Study of Financial Innovation, 1995) 15; Goodhart *et al, op.cit*., note 1, 156.

[116] See Davies, H., *Building the Financial Services Authority; What's New?* (Travers Lecture, London Guildhall University Business School, 11 March 1999).

[117] Edwards, G., 'Legitimacy and Flexibility in post-Amsterdam Europe' in Boer *et al*, *Coping with Flexibility and Legitimacy after Amsterdam* (Maastricht: European Institute of Public Administration, 1998) 139.

[118] According to Snyder, legitimacy refers to the belief that a specific institution is widely recognised or at least accepted as being the appropriate institution to exercise specific powers; see Snyder, F., 'EMU Revisited: Are we making a Constitution? What Constitution are we making?' in Craig, P. & G. de Burca (eds), *The Evolution of EU Law* (Oxford: OUP, 1999) 463.

[119] Taylor, *op.cit*., note 115.

institutional reform ought to be based on the broadest possible debate, participation and consensus as the declaration appended to the Nice Treaty has called.

Transparency is further improved whenever the influence of considerations is made visible.[120] Of particular importance herein is the right of access of documents. It should be noted, however, that the new right of access, as introduced by Article 255 EC (former Article 191a), is limited to the documents of the three main institutions,[121] and hence does not seem to cover other bodies. Nonetheless, encouraged by recommendations of the European Ombudsman that agencies, too, should adopt rules on access to documents,[122] most institutions have adopted relevant decisions.[123] Regardless of the responsibilities undertaken, the single regulator should be obliged to undertake consultation on all rules and guidance that it adopts; it should publicise all responses received and explain the reasons that led to specific policy decisions; in making its proposals, it should include cost-benefit analyses of potential measures adopted; also, it should submit reports to the European Parliament and the ECOFIN Council on its work and publicise the records of its meetings;[124] finally, all measures adopted should be subject to judicial review.[125] At the same time, the accountability and legitimacy of regulation of the Securities Supervisor can be fostered by its relationship with the network of Member States' authorities. The better the relationship and interaction with existing national regulators, the more open and accountable its decision-making process will be.

To conclude, it is obvious that an open and easily accessible single regulator is more likely to reduce the information asymmetries for market participants by facilitating public access to financial market information and, thus, by coping with unequal costs of gathering information. On the other hand, it has by definition a significant advantage compared to a more fragmented supervisory structure: as soon as it keeps a clear distance with the industry it regulates, it will dramatically lessen the possibilities of being captured or pressured by private interest groupings. As long as it manages to incorporate an independent administrative structure and culture of open communication and clear lines of accountability, it will enhance decision-making and will maintain confidence in the European financial system.

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[120] Schmidtchen & Cooter, *op.cit.,* note 86, 173.

[121] Article 255 (1) states that 'any citizen of the Union, and any natural or legal person residing or having its registered office in a Member State, shall have a right of access to European Parliament, Council and Commission documents'.

[122] *Special report from the European Ombudsman to the European Parliament following the own-initiative inquiry into public access to documents* (OJ C44/9, 10 February 1998).

[123] For examples, see Vos, E., 'Reforming the European Commission: What Role to play for EU Agencies?' (2000) 5 CMLRev 1113, 1125.

[124] In this way, the Securities Regulator should avoid the criticism of lack of transparency often targeted at the ECB.

[125] In relation to judicial review, recent developments indicate that the ECJ would be prepared to loosen the strict *Meroni* requirements. In *Les Verts*, the Court had already elucidated that EU is based on the rule of law, thus permitting the Court to review the legality of all acts adopted by institutions. See Case 294/83 *Les Verts* [1986] ECR 1339, Paragraph 23. This decision should also apply to the Securities Regulator, irrespective of whether it would qualify as 'institution' or not. See Lenaerts, *op.cit*, note 69, 46.

3. Legislative delay and inflexibility: the Lamfalussy proposals and the harmonisation prerequisite

Another reason that justifies centralisation of EU securities supervision and regulation is the regulatory inflexibility of the current regime. It is argued herein that a single Securities Regulator will be in a better position to legislate fast and better, while complete harmonisation of European financial laws should not serve as a prerequisite for the establishment of the ESR.

3.1 Regulating after Lamfalussy

Until recently, there has been no structure in the European securities industry parallel to the legislative committees existing in the banking and insurance field.[126] Any technical adaptation of the core directives needed to take the form of a formal amendment, with the problems and delays this can imply. Has the recently established ESC, proposed by the Lamfalussy Group, been able to change the scenery? Whereas the goal of the Lamfalussy Report was to speed up EU securities regulation, it appears that Level 2 with its five-step procedure may actually delay it. Besides the problem of multi-institutional involvement, the very distinction of essential Level 1 and non-essential Level 2 measures raises significant theoretical and practical hurdles.[127] Mutual suspicion between national and EU institutions has complicated the enactment of investment services legislation. Criticism of the framework has come mostly from the European Parliament, which voted in favour of an appeals procedure or 'call-back' that would enable it to review and halt legislation proposed at Level 2 beyond the scope of the Lamfalussy Report.[128] The same concerns are shared by a number of market participants and academics. Moving a step further, the von Wogau Report has already limited the life of the ESC to four years, as an ultimate effort to provide the Parliament with leverage over the Commission and the Council to ensure that a 'call-back' mechanism is introduced in the next ICG. It becomes, thus, obvious that new institutional arrangements need to be addressed and adopted before that time lapses.

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[126] In banking, three committees are in place: the Banking Advisory Committee, the Groupe de Contact and the Banking Supervisory Committee of the ECB. In insurance, we have the Insurance Committee and the Groupe de Contact by the Conference of Insurance Supervisors. In securities, it should be noted that a High Level Securities Supervisors Committee was in place between 1992-2001. However, most of its functions have been undertaken by FESCO. Also, two Contact Committees, one for the listing and prospectus rules and one for UCITS, exist to facilitate harmonised implementation. Nevertheless, these committees have no comitology powers, which partially explains their weak influence. Recently, however, the Economic and Financial Committee proposed arrangements in line with the Lamfalussy framework for all financial sectors and the creation of separate Level 2 and 3 committees; see EFC, *Report on financial regulation, supervision and stability* (9 October 2002).

[127] See Avgerinos, Y., 'Essential and Non-Essential Measures: Delegation of Powers in EU Securities Regulation' (2002) 2 ELJ 269, 282.

[128] In its session of 14 March 2001, the Parliament voted by 410 to 25 against the regime. Criticism is also crystallised in the compromise reflected in the Von Wogau report, which was voted on 5 February 2002; see EP *Report on the implementation of financial services legislation* (A5-0011/2002 final, 23 January 2002).

Beyond the constitutional concerns, the current regulatory and supervisory regime has practical implications on how legislation is passed. Here, one should pay special attention to the lock-in problem that the home country control regime delivers. As admitted by the Commission and the Lamfalussy Group, the present functioning of the European legislative system cannot meet the challenge of regulating modern financial markets.[129] It is beyond evidence that every attempt to regulate at the EU level and to implement at Member State level is doomed to be lost in the vortex of severe delay and bureaucracy.[130] The problem unfolds beyond the financial services sector and has, thus, been one of the main concerns of the 2001 White Paper on European Governance and the 2001 Laeken Council. It takes time and effort to construct a pan-European regulatory regime, as each Member State negotiates both with its counterparts and with domestic lawmakers and interest groups. The current process for promulgating and amending Directives is inadequate to deal with fast-moving financial markets so that 'even new provisions for setting standards, by the time they are enacted, may very well be out of date'.[131] Directives end up being rather inflexible and almost impossible to alter once adopted. It seems, thus, likely that EU regulation runs the risk of becoming outmoded and anachronistic.[132] *A fortiori*, it also runs the greater risk of being less qualitative and efficient, since it will constitute the product of controversies and compromises.

The Lamfalussy fast-track agreement solution to speed up the legislative process does not seem likely to change the scenery. Although this procedure consists of only one reading for Commission proposals, the whole legislative process will not be actually shortened for the following reasons. First, the Lamfalussy approach is very much dependent on the political will of the Parliament and Council. It is up to these institutions to clearly define what is 'essential legislation' and what are 'technical issues' to be left to comitology.[133] Second, experience has proved very difficult for the Parliament and the

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[129] See European Commission, *Financial Services and Progress: 3rd Report* (COM(2000) 692/2 final, 8 November 2000, hereinafter '3rd Progress Report') 4. The Commission admits that 'there are a number of serious concerns and the worry that without more effort in next few months the FSAP will fail to maintain sufficient momentum to achieve the ambitious 2005 deadline'; European Commission, *'Working together to maintain momentum': 2001 Review of the Internal Market Strategy* (COM(2001) 198 final, 11 April 2001) 4. See also Initial Lamfalussy Report, 23. The Committee is indeed concerned that the present system will not be able to deliver the FSAP on time.

[130] The delay suffered in the genesis of the ISD, for example, illustrates the difficulties surrounding the liberalisation of financial markets in several Member States. The first proposal was submitted by the Commission in February 1989 and the Council finally adopted the Directive in May 1993.

[131] Davies, H., *Introductory remarks* (Speech at the Eurofi Conference, Paris, 15 September 2000).

[132] Directives' provisions can be divided in to two categories: a) provisions that leave considerable discretion to Member States and supervisors to set out the detailed regulatory requirements and b) provisions that allow less discretion. The disadvantage for the former is obvious; each Member State adopts its own standards and implementation methods. The problem with the latter is that, with the boom in securities market developments, the details of the Directives are often out-of-date and each Member State then needs to find its own legal solution. On the functions and the implementation process of directives, see Prechal, S., *Directives in European Community Law* (Oxford: Clarendon Press, 1995) 3 *et seq*.

[133] This may lead to significant delay. See Avgerinos, Y., *op.cit*., note 127. In order to assist in the definition and interpretation of essential and implementing measures, the Committee for Economic and Monetary Affairs of the European Parliament has established a panel of financial services experts to provide independent advice on the measures set out in the Financial Services Action Plan. The capacity of this group, however, is merely advisory.

Council to agree in the first reading, due to the technical nature of the legislative proposals in the financial sector.[134] Finally, it is likely that 'technical measures' will be more and more regarded as political issues and thus become part of the Level 1 'framework legislation'. Hence, this procedure could become a 'legal battlefield' and struggle between EU institutions and national regulators.

A further issue is that, even if adopted, EU laws – mostly in the form of Directives – are delegated to Member States to be implemented. The average delay in implementation of a Directive, once the deadline has passed, is thirteen months.[135] Moreover, since national securities markets regulation is often differently organised at Member States' level and national supervisors hardly share the same powers, it is inevitable that the principles of EU law will be turned into workable day to day rules in a way that they could be characterised as anything but uniform.[136] For example, the freedom left to Member States as to the choice of means and methods to attain the objectives prescribed by Article 11 of the ISD is reflected in the relative diversity of implementing rules with respect to both the substance of the rules and the legal instruments used.[137]

Subsidiarity constitutes a final major hurdle. As analysed before, subsidiarity is a principle of an essential political nature, implementation of which involves a considerable margin of discretion for the institutions. Therefore, monitoring of application and compliance with that principle should be of an essentially political nature and take place before the entry into force of an act in question. If, however, the *ex-ante* subsidiarity filter, proposed by the European Convention, is put into effect, two additional levels would be inserted into the Lamfalussy method, namely the subsidiarity filter for Level 1 legislation and the same filter for Level 2 legislation. As a result, under the Lamfalussy method and the subsidiarity filter, financial regulation would still require several burdensome layers before it becomes effective. What subsidiarity in this field may bring about is not the often alleged preservation of national identities, but the defence of the interests of the local market, i.e. sheer protectionism. This is not warranted in an integrated internal market. It may thus be considered that the subsidiarity filters should not apply in the areas of legislation covered by the Lamfalussy method, that is the financial markets and services.

The lock-in problem of inflexibility of the present regulatory system admits of two solutions. First, Member States may delegate substantial lawmaking and implementation power to a pan-European body to permit flexible responses to changes in the regulatory environment of investment services. Second, Member States could explore alternatives to regulatory cooperation at the EU level. With regard to the latter, however, it shall be

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[134] Characteristic is the paradigm of the new Market Abuse and Prospectuses Directives. In their first reading, the Parliament proposed 104 and 62 changes to the Commission proposal respectively. On the contrary, Council and Parliament agreed to the Regulation on IAS after a single reading.

[135] If the average time allowed for the implementation of a Directive is added (up to 3 years) one can understand why legislation is often out-of-date by the time it becomes effective; see the Commission *Internal Market Scoreboard* (No 9, 19 November 2001) 7.

[136] The recent 2001 Review of the Internal Market Strategy, *op.cit.*, note 129, 5, reveals that not only have key legislative proposals been delayed, but also progress in implementing existing Internal Market rules has been disappointing.

[137] See Tison, M., *Conduct of Business Rules and their Implementation in the EU Member States* (Financial Law Institute WP 2000-14, Gent University, 2000) 4.

shown below[138] that current coordination efforts between national supervisors have not been proved efficient enough. Nothing indicates that this situation is about to change in the near future.

At this stage, it is thus vital that investment services lawmaking and implementation is delegated to a single Securities Regulator. Presumably, reversing an assignment of regulatory power through Member States' negotiations would be as difficult and cumbersome a process as extending the authority in the first place. The very belief, however, that this will strongly contribute to the increase of the speed and efficiency of future legislation makes any such suggestion a minor issue. Flexibility is a structural attribute. Arguably, if the regulator is empowered to promulgate, repeal, amend and interpret regulation, then the system should be able to provide the right dose of flexibility. National authorities have to realise its significance on the one hand and to abandon the principle that the current allocation of responsibilities between them is sacrosanct on the other. Bearing in mind that, even with a fair wind, a new Directive scarcely ever takes less than three years between inception and delivery, decisions originating from the pan-European Regulator would speed up the legislative process in Europe.

3.2 Is there a need for further harmonisation before the creation of the ESR?

It is argued by many critics of centralisation that a further harmonisation of investment services rules is needed before a single European Securities Regulator can be established.[139] Should there be no harmonisation, a potential ESR would be ill equipped to function efficiently,[140] for it would have to operate across different legal and cultural structures. The Joint Forum Report on the role of coordination[141] stressed the importance of taking account of these factors in defining the role and responsibilities of a coordinator. These include the different legal frameworks of the countries where a financial firm operates, the different statutory responsibilities and powers of the individual supervisors concerned, the divergences of enforcement methods and the varying abilities of these regulators to share information across sectors and across borders. Hence, the deep differences in the legal tradition of the Member States will result in even more regulation, leading to even greater differences between national rules. The following paragraphs endeavour to analyse the scope of such an allegation and defend the view that *ex ante* full harmonisation cannot constitute a precondition for operational effectiveness of a pan-European regulator. Instead, the latter can better perform as the effective means of harmonisation of securities regulation within the EU. In any event, European market integration has, in fact, proceeded further than is commonly

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[138] See Section C.7.
[139] See, for instance, FESE Report, 12; Hopt, *op.cit.*, note 40; Levitt, M., 'Does Europe want a single market?' (2001) 4 The Financial Regulator 20, 24. Even standing against centralisation at the present stage, it is common belief that for the long term a European Securities Regulator is a leading vision, given that a far more harmonised regulatory and legislative framework is accomplished.
[140] See Avgouleas, *op.cit.*, note 40, 84.
[141] See Joint Forum, *Supervision of Financial Conglomerates* (February 1999) 106.

perceived so that Member States should be able to accept a supranational solution of this kind.[142]

Opponents of a pan-European Regulator argue that private market incentives will find and maintain an optimal level of investor protection.[143] None the less, the real question for the near future is whether the fragmented Member States supervisory authorities will be willing and able to establish a harmonised regulatory structure or whether a pan-European Securities Regulator would be better able to do the job. To rephrase the main thesis of subsidiarity, 'the functions handed over to the Union [should be] those which the Member States, at the various levels of decision-making, can no longer discharge satisfactorily'.[144] At the heart of its relation with subsidiarity, the home country control principle does not amount to maximising the number of tasks and responsibilities, which can be taken on at a Member State level, but to achieving an optimum distribution of such tasks and responsibilities.

In any harmonisation process, what is often examined is whether rules that result from harmonisation are better than those emerging from competition among national rules.[145] When the latter is the case, then many scholars contend that regulatory responses should follow market developments and not lead them.[146] This argument is not convincing for two reasons: first, regulation should keep pace with market developments and not lag behind, at least for the better achievement of the financial supervisory objectives. Second, the regulatory environment and the institutional structure of financial supervision is actually one key factor affecting harmonisation and market integration. As demonstrated before, the present regime of home country control is responsible for serious obstacles to achieving a truly integrated European market and free flow of cross-border investment services. Breuer rightly observes that this is not a 'chicken and egg' problem, so we should not waste time debating who should move first.[147]

Hence, harmonisation should not serve as a prerequisite for the establishment of a federal regulator. Complete harmonisation may be neither necessary nor wholly realistic at this point. Instead, a pan-European Securities Supervisor should serve as means of further harmonisation of EU financial services law. Just as the euro required the establishment of a European Central Bank, a pan-European securities market will require a European Securities Regulator. Given the difficulties in legislating at EU level and implementing at Member State level, we clearly need a uniform way of creating EU rules and an easy, efficient and unconditional way of transforming it to national legal systems.

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[142] See Deutsche Bank, *op.cit*., note 100; also Breuer, R., *Convergence of supervisory practices – a banker's view* (Paper presented at the Conference of European Banking Supervisors, Copenhagen, 20 November 2000)..

[143] See Dale, R., 'Reflections on the BCCI Affair: A United Kingdom Perspective' (1992) 26 International Law 949; Norton, J. & C. Olive, 'Globalization of Financial Risks and International Supervision of Banks and Securities Firms: Lessons from the Barings Debacle' (1996) 2 International Lawyer 301.

[144] European Commission, *The Principle of Subsidiarity* (SEC(92) 1990 final, 27 October 1992) 1.

[145] See, for instance, Kanda, H., 'Commentary 1 on Ruben Lee's Report No 1, Supervising EU Capital Markets: Do we need a European SEC?' in Buxbaum, R. *et al, European Economic and Business Law: Legal and Economic Analyses on Integration and Harmonisation* (New York: Walter de Gruyter, 1996) 206.

[146] See, for instance, Ogus, *op.cit*., note 95, 417.

[147] Breuer, *op.cit*, note 142.

As the following Section will show, rivalries between the London, Frankfurt, Euronext and other markets are too strong and there hardly exists a sufficient European tradition of investor protection to overcome the hurdles of cross-border investment services provision.

Solving the problem of harmonisation through implementation of Directives or Regulations formulated by Member States' regulators seems both time-consuming and impractical. Securities markets are far more creative and dynamic. This is the reason why self-regulation has functioned well for the investment services industry, despite its inherent limitations. Transferring supervision of the self-regulatory process to fifteen different national authorities will hardly result in a pan-European market. It would rather compound the problems of a fragmented system for the trading and regulation of securities. A central, flexible regulator that could deal directly with markets and financial operators could provide more appropriate and better oversight.

What is important is that, despite major delays, market integration and harmonisation in securities and other financial services legislature has proceeded further than is commonly perceived to support a federal institutional structure and a level-playing field for market participants and consumers. Although there remains a concern about the pace to deliver the FSAP in line with the agreed timeframe and political statements, there has been a certain degree of progress. The political agreement on the Distance Marketing Directive and the final adoption of the anti-Money Laundering Directive, the Statute for a European Company Regulation and the UCITS Directives have been considered as further steps towards integrating European financial markets. The final adoption of the Regulation on IAS and the proposed Directives on Distance Marketing, Insurance Intermediaries and Collateral took place before the end of the Danish Presidency (December 2002). Moreover, the Directives on Market Abuse and Pension Funds were adopted in January 2003 and May 2003 respectively. A common position on the Prospectuses Directive was reached in the Council in March 2003, with final adoption by July 2003 at the earliest. However, the most important updates of CAD and ISD are still under preparation.[148] The FSAP eighth report of 3 June 2003 urges the need for a final sustained effort to close the outstanding political discussions, but remains optimistic that the priorities and measures of the Action Plan will be in place by the end of the next IGC.

4. Securities exchanges consolidation and alliances

A further reason that demands centralisation of securities regulation and supervision is the consolidation and alliances between securities exchanges and trading platforms. Despite growing consolidation efforts between financial markets, a strong home bias persists in primary and secondary market activity in the EU. Partly, this situation reflects inertia in investment patterns. However, it is also the case that cross-border issuance, trading and settlement are beset by 'numerous outstanding legal and technical obstacles'.[149] On the other hand, it becomes now evident in Europe that the investment

[148] The European Commission presented its proposal for ISD II on 19 November 2002 after an instensive two-year consultation process. An ambitious timetable underpins the implementation of a revised capital framework for banks and investments firms by 2006/07, following discussions in the Basel Committee.

[149] See Initial Lamfalussy Report, 11.

horizons of funds and private investors are slowly becoming more European. Exchanges, traditionally organised and managed as national monopolies, are now competing for order flows between themselves and with new competitors that offer trading services, such as ATS. As a consequence, many of them are seeking European reach through organic growth, while others are looking to far-reaching alliances or fully-fledged mergers. It will be argued herein that this situation raises new consideration and challenges that are unlikely to be met by the existing financial institutional structure. Therefore, truly pan-European markets will soon require a real pan-European Regulator.

4.1 Exchanges

The higher cost of transacting cross-border deals in Europe compared to the US, means securities exchanges consolidation is necessary and inevitable. Once the traditional fragmentation of European markets has been resolved, the pan-European market will be able to respond in terms of cost, technological development, capacity to adapt and strategic vision. In the short to medium term, market developments' effects on the regulatory mechanisms for securities markets will gain substantial gravity.[150] But there is more. All this is happening at a time of unprecedented volatility in stock market indexes, driven in part by the behaviour of the 'new economy' and in part by the weak single currency and world financial situation.

New types of markets create new types of investors and new types of risks, which in turn require new types of solutions. Whatever the outcome of the market consolidation initiatives across Europe, there will be tough questions posed for national regulators. What will the role be for national regulators of undertakings operating as remote central exchanges? How can we ensure an adequate degree of harmonisation to allow an exchange to operate in a number of different Member States? Regulators will face a difficult task. A complex one: the challenge of progress. A challenge, which will imply overcoming the internal inefficiencies that stem directly from the desire to continue with local *status quo*.

The boom of telecommunications and EMU make securities markets more attractive. Twelve EU national markets have gone through a major structural change and have received a strong impetus to integrate into a single euro area market. This means that divergences purely related to the *locus* of market participants within the euro area become less and less relevant over time. In particular, the reduction in government debt securities owing to fiscal consolidation under the EMU, low inflation rates, elimination of exchange risk and the commitment of national governments towards improving the sustainability of public finances is expected to boost markets for securities issued by private entities.[151] This is also likely to be supported by the enhanced liquidity and less transactions cost of the private stock and bond markets resulting from the increase in the

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[150] For how market developments have influenced securities regulation and organisation in Member States, see Ferrarini, G., *Exchange Governance and Regulation: An Overview* in Ferrarini, *op.cit*, note 82, 245 *et seq*.

[151] See ECB, *Possible Effects of EMU on the EU Banking Systems in the Medium to Long Term* (February 1999) 12.

number of investors and issuers operating in the same currency.[152] A research conducted by Hardouvelis, Malliaropoulos and Priestley has shown that the average cumulative saving in the cost of capital from integration of stock exchanges over the period 1992-98 is estimated at around 2 per cent for the EU-12 countries.[153] It is also likely that a larger currency area, the eurozone, will attract new foreign investors and issuers to the European securities markets. In this context, the efforts already undertaken to set up alliances and mergers between stock exchanges will be facilitated.

Nevertheless, while joint ventures and mergers among exchanges are yet in the planning process, there are numerous obstacles to their successful fruition. European markets still compete with each other with regard to liquidity, transparency and cost.[154] Within euro, they also compete for listings and new products. Stock exchanges have already been privatised and now are demutualising. Some have and others may become listed companies, while their corporate structure differs. Take, for example, the collapse of the iX project, the once promising alliance plans between London and Frankfurt exchanges: what disclosure and accounting standards would apply to their listed companies? Which regulator should monitor trading and enforce insider dealing and similar laws? These problems were partly set out in a report issued by Merrill Lynch, advisers to the London exchange: 'UK regulators believe that Anglo-German attempts to harmonise share trading rules will be a "nightmare" if the London Stock Exchange and the Deutsche Börse merge to create iX. The report says that senior staff at the FSA have said privately that it will be difficult to achieve 'any practical level of harmonisation' of UK and German stock market regulations'.[155]Similar problems still torture the, otherwise successful, project of Euronext markets alliance.[156]

Vis-à-vis this evolving environment, regulators cannot remain still. Since present and future markets will soon have very little in common with the 'regulated markets' envisaged in the ISD, it becomes blurred as to who will regulate and supervise them. Under the ISD, for instance, home supervisors oblige 'regulated markets' to deal only in formally 'listed' stocks. As a result, it is completely unclear under the current regime whether a trading system operator designated as a 'regulated market' in one Member State will not be denied single passport rights in another jurisdiction on the basis that the particular operator does not itself 'list' the securities that it trades.[157] On the other hand, let us assume that an ATS, established in a home Member State, wishes to enter the

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[152] Between 1999 and 2002 only a core of operations had to be carried out in euro. The private sector will be convinced on purely economic grounds when the euro is available in physical form. The marginal cost of using a particular currency depends on how much it is used. Hence, a widely used currency has usually lower transactions cost.

[153] See Hardouvelis, G. *et al, EMU and European Stock Market Integration* (CEPR Discussion Paper 2124, April 1999) 33.

[154] See Onado, M., 'Competition Among Exchanges or Financial Systems?' in Ferrarini, *op.cit.*, note 82, 228.

[155] See Boland, V. & F. Guerrera, 'FSA staff brand iX plan a "nightmare"' (8 September 2000) FT 1.

[156] Investment firms licensed in one market do not automatically receive a passport to operate in another Euronext country as well. They still have to comply with the ISD notification requirement and they continue to be subject to the fragmented supervision and enforcement of the regulator of the home country; see Euronext, *Rule Book I* (30 July 2001) Chapters 2 and 9.

[157] ISD, Article 1(13).

market of another (host) Member State by use of its screen-based capacity. The ISD states that Article 15 'shall not affect the Member State's right to authorise or prohibit the creation of new markets within their territories'.[158] It seems that the intent of this provision was to furnish the host State with another escape clause from the European passport for screen-based electronic trading systems. By declaring a foreign trading system to be a 'new market', any host Member State could deny it European passport rights. The potential for abuse is now considerable. And the question arises: will national supervisory authorities be more capable than a pan-European regulator to deliver the job and offer solutions? A centralised supervisory regime will offer solutions at least in three fields, namely single passport for markets, competition and transmission effects.

First, under a centralised supervisory regime, any physical or electronic market, wishing to offer cross-border listing or trading services, would not need to face any EU authority's denial of its single passport rights on the grounds that it is seeking to create a 'new market' in its territory. After a single authorisation for operation and with a fully operational single passport, markets will be free to place screen trading facilities in partner Member States, so as to serve 'remote members' in other Member States. This will tackle the problem of fragmentation and will boost the potential for competition.[159]

Second, closer integration of securities markets increases the possibility that regulatory or supervisory differences influence competition between exchanges for trading volume. All aforementioned developments involve conflicts of interest between the commercial interests and regulatory responsibilities of exchanges that stand in the way of an integrated European regulatory system for a pan-European securities market. These conflicts could be best addressed and eliminated by an independent central authority, which would have no such commercial interests and would guarantee efficiency and stability in the function of European markets. On the other hand, a single authority will be needed in the near future to independently scrutinise the various inter-exchange cooperation agreements for their effects on competition between exchanges. To the extent that cooperation leads to substituting a single trading platform to competition for trading in specific securities, agreements may be considered to produce anti-competitive effects in the relevant market and may run contrary to Article 81 EC (former Article 85).[160] Although current securities markets' agreements are framed in a context of 'coopetition', in which inter-exchange competition and cooperation are said to coexist, the issue will remain crucial for future European financial market supervision structures.

Finally, developments in one regulated market may well have immediate and potentially major repercussions on the trading environment in other Member States. A central body would serve as a rapid response to transmission effects by upholding market integrity, confidence and stability. Regulatory or supervisory arrangements governing a large scale of European markets cannot be permitted to evolve on an *ad hoc* basis in

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[158] ISD, Article 15(5).

[159] It is a fact that some exchanges, such as Madrid and Athens, have no remote members; see European Commission, *Communication on upgrading the Investment Services Directive (93/22/EEC)*, (16 November 2000) 7.

[160] See Tison, M., *The Investment Services Directive and its Implementation in the EU Member States* (Financial Law Institute WP 1999-17, Gent University, 1999) 32.

response to the technical challenges presented by a particular merger or alliance. As it will be subsequently analysed,[161] building a mechanism of concentrated regulatory and supervisory power would offer legal certainty, stability and efficiency in a fast-evolving and so volatile European market.

4.2 Clearing and settlement

Relevant to the challenge of the ESR to ensure the proper function of the market is the need to eliminate undue and unnecessary risks and costs of inefficient and inadequate clearing and settlement systems within Europe.[162] According to the initial report of the Giovannini Group, which describes the current European clearing and settlement landscape, the existing arrangements within the EU are largely efficient in respect of domestic securities transactions.[163] These arrangements, however, are national-based and do not combine to provide respective post-trade processing for cross-border transactions. It has been calculated that as much as €1 billion a year of operating cost savings would be secured if cross-border equity settlement were conducted as efficiently as that in the US. As part of this saving, economies of scale could be created and the larger part of the cross-border clearing and settlement in Europe could be eliminated, greatly reducing risk, if a single European central counterparty (EuroCCP) were introduced in displacement of the present fragmented netting arrangements that operate mainly on Member State basis.[164] This would have the advantage of allowing netting of all national and cross-border transactions concluded on the same day and, ideally, compress all transactions of a trading participant into a single cash flow or obligation.[165]

Although further restructure of clearing and settlement systems seems necessary in the EU, Dalhuisen is right to assume that the unproblematic history of these systems does not call for their regulation *per se.*[166] Rightly, the securities industry and the Final

[161] See Section C.6.
[162] Clearing and settlement are the processes by which securities market transactions are finalised and are integral to the functioning of the financial system.
[163] Giovannini Group, *Cross-Border Clearing and Settlement Arrangements in the European Union* (November 2001). A further report, examining possible developments in the clearing and settlement architecture is scheduled to be produced by the end of 2002.
[164] Recent developments confirm the trend towards consolidation. At the beginning of 2000, Luxembourg-based Cedel and Deutsche Börse Clearing (DBC) merged to create Clearstream International, only to be followed next year by the Euroclear Clearance System, which emerged from the merger of Brussels-based Euroclear and Paris' SICOVAM. Both mergers, however, were functional and not legal, since the two pre-existing structures remain. See Sáinz de Vicuña, A., 'The Legal Integration of Financial Markets of the Euro Area', in Andenas & Avgerinos, *op.cit*, note 70. Nevertheless, there remain a very substantial number of different national and international providers of these services. For example, in Europe there are nineteen CSDs and two ICSDs providing various types of services and with various governance structures; see Giovannini Group, *ibid.,* 30.
[165] The Depositary Trust & Clearing Corporation, the US umbrella organisation that brings together clearing and settlement for the US securities markets, shows that a single provider can work in the case of certain brokerage operations, such as trade confirmation, settlement and regulatory compliance; see Rosen, R., 'Clearing up Europe's Exchanges' (9 February 2001) FT 19.
[166] Dalhuisen, J., 'What About a Single European Capital Market and its Regulation?' in Andenas & Avgerinos, *op.cit*, note 70, 14.

Lamfalussy Report accept that market forces should determine the contours of clearing and settlement in Europe.[167] This does not mean, however, that there are and there will be no public policy issues that have to be addresses and coped with by a central public body. Although the establishment of a EuroCCP seems an early target for the short-to-medium term, the benefits that this achievement would deliver, such as risk reduction at a member and systemic level, cost savings, reliability, scalability and integrity of services, call for a move towards this direction in the long term.[168]

In a recent Communication, the European Commission has identified two main policy objectives for the creation of an integrated clearing and settlement environment.[169] The first is to remove barriers to the finalisation of individual cross-border transactions in the form of Member States' differences in technical requirements/market practice, tax procedures and laws applying to securities. Although it is acknowledged that the removal of technical barriers will be primarily in the hands of the private sector, the remaining barriers will require public intervention, as in the case of defining the legal system that is applicable to securities transactions and holdings in the EU.[170] The second objective is to remove competitive distortions or unequal treatment of entities performing similar clearing and settlement activities. A fully integrated EU system requires that rights of access to systems be comprehensive, transparent, objective and, above all, effective.

These policy objectives go hand in hand with the general objectives of financial regulation and supervision: the maintenance of financial stability and consumer protection, the extension of consumer choice and the fostering of competition. Consolidation of exchanges and clearing systems in Europe will lead to an acute political question, for which the ESR will provide the only answer and solution. Even if the EuroCCP were to be governed and regulated by private market forces, there will ultimately be a need for oversight by the ESR with regard to prudential and competition implications in order to avoid duplication of compliance and shield its members from systemic risk.[171] Also, there are concerns about the actions of national regulators, who would have the right to object on grounds of adverse implications for the smooth

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[167] See FESE, *Second Report and Recommendations on European Regulatory Structures* (January 2001) 6; Final Lamfalussy Report, 16.

[168] See the Key Principles of the European Securities Forum at http://www.eurosf.com/key_principles.htm.

[169] European Commission, *Clearing and Settlement in the European Union: Main policy issues and future challenges* (COM(2002) 257, 28 May 2002).

[170] The Settlement Finality Directive (SFD) and the proposed Collateral Directive (CD) both contain provisions that represent an evolution from the principle that the applicable law should be that of the jurisdiction where a security is located. Instead, the security is to be treated as being located at the relevant register, account or system where it has been recorded; see SFD, Article 9(2) and draft CD, Article 10. However, the SFD and CD rules apply only in limited circumstances: the SFD only to securities offered as collateral to central banks and to payment and settlement systems, and the CD only to securities offered as collateral. In its Communication, the Commission states that the ultimate solution for the divergence in the legal treatment of securities across the EU would require achieving a uniform legal treatment with the creation of a 'uniform securities code'.

[171] As stated by the BIS, 'safe and reliable settlement systems are essential not only for the stability of securities markets they serve, but often also to payment systems, which may be used by an SSS or may themselves use an SSS to transfer collateral'; see BIS, *Recommendations for Securities Settlement Systems* (Consultative Report, January 2001) 7. Especially for risks in cross-border settlement, see Ferrarini, G., 'The European Regulation of Stock Exchanges: New Perspectives' (1999) 3 CMLRev 569, 592.

operation of the market. In the absence of agreed standards for the authorisation, oversight and supervision of SSS, national authorities may have concerns about the use of systems in other jurisdictions for the finalisation of transactions on their markets, or involving their institutions and investors. Central supervision, common standards and high-level principles should thus be sought given the pan-European character of an integrated financial market.[172] However, it is possible that common industry and/or regulatory standards may not be sufficient to provide a fair, efficient and stable framework for cross-border use of clearing and settlement systems. They may leave room for continued constraint on the exercise of rights of access and choice and on the stability of the system. In that case, a European regulator will have the most proper resources to carry out its oversight functions, such as authorisation, risk management techniques, gathering information on the participants' systems, assessing the operation and design of the systems and taking action to promote the systems' observance of European standards.

5. The euro as a catalyst

The introduction of a single currency within the eurozone calls for a single supervisory regime for EU investment services. One of the most significant economic effects of the EMU will be the achievement of an internal financial market as envisioned in Article 14(2) EC. The motto of the Maastricht Treaty has been 'one market, one currency'. The introduction of the euro in twelve EU Member States constitutes a 'quantum jump' which gives a new dimension to the internal financial market, brings economic agents closer together and has the effect of increasing and intensifying legal relationships across the euro area.[173]

5.1 EMU and supervisory concerns

It is true that European financial markets have not been automatically unified by the introduction of the euro. Nor has financial supervision. Local habits, regulations and vested interests will keep market segmented for some time.[174] Yet, it is also certain that competitive pressures will become irresistible in the medium to the long run. EMU has discerned the inadequacies of the Community internal market legislation as it exists at the

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[172] This need becomes now evident as the CESR and the ECB have joined forces to establish a working group, which will work on the drafting of common standards and recommendations for SSS and counterparties at European level; see CESR Press Release (25 October 2001) found at www.europefesco.org. In particular, they are considering the adoption of common standards for clearing and settlement entities in Europe, based on the G10 CPSS and IOSCO Recommendations and the standards of risk management developed by the European Association of Central Counterparty Clearing Houses (EACH). The CPSS-IOSCO Recommendations have been accepted globally by central banks and securities markets regulators as representing minimum standards for systems involved in the finalisation of transactions; see CPSS-IOSCO, *Recommendations for Securities Settlement Systems* (November 2001).

[173] See Sainz de Vicuña, A., *Legal Consequences of the Single Currency* (General Report at the FIDE Congress, Helsinki, 1-3 June 2000).

[174] The divergences between technical market issues is not within the scope of this book. For such an assessment, see the first paper issued by the Giovannini Group, *The Impact of the Introduction of the Euro on Capital Markets* (July 1997).

start of the third stage.[175] Moreover, the geographical domain of monetary policy and prudential supervision do not coincide anymore; monetary policy is now conducted at the euro area level, whereas supervision of markets and individual financial institutions has remained the responsibility of national authorities. By the same token, the Monetary Union is triggering a broad debate on the adequacy of the supervisory framework for financial institutions and markets.

This debate involves three concerns: first, the strong interpenetration of financial markets and the enlarged scope of systemic risk as a result of which the EMU poses a challenge to the limited integration and cooperation in the supervision of financial markets. Second, the trend towards conglomeration and competition in the financial services sector, partly caused by the single currency, raises the question of whether the current institutional structure for the supervision of financial intermediaries is adequate for the task. Finally, the transfer of monetary policy to the ECB raises the question of what role it will play in the area of prudential supervision and financial stability, which yet remain Member State responsibilities. This Section addresses the second issue, namely the consequences of the introduction of the single currency in the supervision of financial firms.[176] Its conclusions may be summarised in the motto 'one market, one currency, one regulator'.

5.2 Impact on financial institutions

5.2.1 Consolidation and competition

The impact of the euro on financial intermediaries providing financial services is not as direct as that on financial markets. Over the past few years, a favourable climate has prevailed across the entire European capital market, both in bonds and equities. Buoyant securities markets have stimulated new issues and helped to finance a wave of mergers and acquisitions (M&A). Of course, M&A historically preceded the EMU. However, an ongoing wave of mergers is occurring within the EU banking and investment systems after the EMU, which is expected to keep momentum at least in the short to the medium term.[177] Although most M&A at the EU level take place in the domestic area, two basic strategies are to be observed with reference to cross-border M&A: first, expansion into market niche abroad and, second, entering into foreign retail markets. The latter involves a need for access to an adequate distribution network, which is easier to achieve via strategic alliances or mergers. The introduction of the single currency and developments in electronic remote provision of investment services facilitate the cross-border conduct of financial services. This is likely to outweigh traditional hurdles of cross-border M&A, such as legal, fiscal and cultural differences with regard to management style and strategic goals.

[175] The diversity, for instance, in the national implementation of Community Directives appears now as a non-quantitative barrier to a single currency market.
[176] The first issue has been addressed by the previous Section, whereas the third is beyond the focus of this paper.
[177] In the euro area, M&A across sectors have accounted for roughly 30 per cent of all financial industry deals in terms of value over the past five years.

The single currency will also have a significant effect on the risk faced by financial firms when conducting cross-border business, which may give them an incentive for increasing their intra-Community trade and competition. European financial intermediaries already face increased competition after the introduction of the euro, as it has facilitated the comparison of the commissions charged and has led to cost reductions. Overall, credit, market, liquidity and market liquidity risks are generally expected to decrease, whereas legal and operational risks are likely to increase at least in the short term.[178] The positive macroeconomic effects of the EMU are expected to mitigate credit risk in European financial markets. In addition, market and liquidity risks will be positively affected by deeper and more liquid markets. On the other hand, while legal and operational risks are expected to increase in the short term owing to the major changes to the overall legal environment, they are likely to decrease in the long term.

The creation of mega pan-European financial institutions and holding companies of financial groups in the EMU brings the question of the division of responsibilities for such businesses into sharp focus. The post-BCCI Directive provides for a measure of financial firms holding supervision by the home competent authority. The new Conglomerates Directive has introduced specific prudential legislation for financial conglomerates and coordination arrangements between supervisors. [179] In these circumstances, the responsibility of home authorities in conducting efficient consolidated supervision will increase considerably.[180] On the other hand, host supervisors could find that they have insufficient information either to monitor the health of the financial system to anticipate a crisis or to be able to react to it rapidly and effectively.[181] In any event, the task of appointing one or two lead supervisors is not one without significant operational difficulties. These may include: a) acceptance of the leading role by the supervisor concerned and by all other authorities, b) ensuring that the supervisor concerned has all the necessary human and financial resources, c) securing full agreement on the precise conferred powers and responsibilities, ensuring comprehensive information collection, and d) agreement on the scope of supervision conducted and removal of any relevant jurisdictional difficulties.[182] The pan-European Securities Regulator or even a Single Financial Regulator may take an interest in the application of this Directive and study whether there is a need for further Community legislation to enable pan-European holding companies to be established and supervised on a European basis. Indeed, the emergence of large banking and investment groups requires an adequate legislative and supervisory response, which, in view of the size and the spread of the entities concerned,

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[178] See ECB, *op.cit,* note 151, 26.

[179] *Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC.*

[180] However, the coordinator may be composed by more than one authority and on the basis of more than one criteria, which may confuse instead of facilitating supervisory arrangements; *ibid*, Article 7.

[181] Mayes, D. *et al, Improving Banking Supervision* (Basingstoke: Palgrave, 2001) 61.

[182] See Walker, G., 'Conglomerate Law and International Financial Market Supervision' (1998) Annual Review of Banking Law 287, 330.

should come about at the EU level, instead of being confined to national competent authorities.[183]

5.2.2 The European Company (*Societas Europeae - SE*) Project

In the same line comes the resuscitation of the 30-years old project for the European company, the last legislative effort for which was made in 1991. When the bulk of the business of the financial undertakings is conducted domestically, the home authority has the least difficulty in carrying out consolidated supervision. But, will the solution of home country consolidated supervision apply to the case, where financial firms are established under European law? In October 2001, the Council of Ministers reached its final agreement on the Regulation to establish a European Company Statute.[184] The European Company will become a reality some 30 years after it was first proposed. As a result, financial firms and their subsidiaries will have the option of being established as a single company under Community and home country law and so able to operate throughout the Union with one set of rules and a unified management and reporting system. Indeed, consolidation of financial market participants, such as pan-European stock exchanges, banks and investment firms, multinational SSSs and EuroCCP for repo clearing houses, would benefit from a legal construction that is single and valid throughout the EU.

A further significant benefit of the SE is that it can easily transfer its registered and principal office to another Member State, which is generally not possible at present, as such a transfer is treated as a liquidation under applicable company and/or tax law.[185] This may substantially facilitate regulatory arbitrage, while it makes it obvious that placing European financial companies under the home country supervision system is extremely difficult, if not impossible. The European Company framework, when it will result in institutions having a substantial share or even the majority of their operations in other than their establishment countries, is bound to loosen the ties with their home supervisors.[186] Although European companies will still have to be registered in the Member State where they have their registered office, it is doubtful whether their supervisors will be able to efficiently keep under surveillance their whole pan-European business. Therefore, our supervisory concerns would be greatest.[187]

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[183] On the supervision of financial conglomerates in a global context, see the document released jointly by the Joint Forum on Financial Conglomerates, *op.cit*., note 141.

[184] European Council, *Regulation No 2157/2001 of 8 October 2001 on the Statute for a European company (SE)* (OJ L 294/1, 10 November 2001). The Regulation will enter into force on 8 October 2004.

[185] It remains to be seen whether many financial companies will be transformed into an SE merely for the purpose of transferring their principal office and, thus, shopping their forum.

[186] This means that, with growing cross-border exposures, failures in foreign activities constitute an increasing threat for the solvency of the entire financial firm and for the stability of the entire common market. See Mayes, D. & J. Vesala, *On the Problems of Home Country Control* (Bank of Finland Discussion Paper No. 20/98, 1998) 13.

[187] Interpretation of Recital 26 of Regulation 2157/2001 leads one to the conclusion that the host country rules are still applicable: ‘activities by financial institutions are regulated by specific directives and the national law implementing those directives and additional national rules regulating those activities apply in full to an SE’.

When this project becomes reality, it will radically change the concept of home country control, as we perceive it today. Just as national companies need national supervisors, European financial companies will need the supervision of a European Regulator. As European companies' activities will not be limited by Member States' borders and as the currency will be common in the whole eurozone, so should a central European Authority have surveillance powers beyond them.

On the whole, EU Member States have decided to abandon their national currencies and join a common money area in an attempt to integrate their financial markets. However, the main problem that financial services are not yet enjoying full free movement lies with national regulators themselves. Yet, governments remain answerable to their national electorates. Monetary union notwithstanding, Member States still defend their economic policies on the grounds of protection of the people within their jurisdiction. The road towards financial market integration is of an evolutionary nature, where each legal action is determined on case-by-case basis.[188] In order for investment services and markets to take full advantage of the introduction of the euro, we need an institutional convergence to complete the legal convergence and enhance the operational convergence. 'One regulator' should be added to the 'one currency' in order to deliver the 'one market' that will contribute to the smooth and efficient functioning of financial services.

6. Externalities and crisis management

Externalities constitute one of the most significant reasons that require the involvement of a federal pan-European body as the only means of ensuring financial stability. International securities swindles have undermined the global financial system from the time of the 1929 stock market crash to the 1998 collapse of the Russian and East Asian economies.[189] There is no need to assess the cost of such financial crises.[190] Although each crisis has a set of local explanatory factors, they all share common elements. Chaos theory teaches us that all results have a cause. In addition, the spill-over impact of such crises cannot be 'local'. The purpose of this Section is to explore the possibilities of effective crisis management by the current home country supervision regime and to examine whether a more centralised structure would execute a more successful pre-crisis assessment or rescue programme in the case of an emergency. In this regard, it is useful to consider the circumstances surrounding the bankruptcy of BCCI, once the fastest growing bank in the world, in 1991.

6.1 The BCCI

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[188] Duisenberg, W., *The euro as a catalyst for legal convergence in Europe* (Speech on the occasion of the Annual Conference of the International Bar Association, Amsterdam, 17 September 2000).

[189] For a description of recent financial crises in Europe, see Benink, H., *The Future of Banking Regulation in Developed Countries: Lessons from and for Europe* (mimeo) 6.

[190] For a comprehensive analysis, see Evans, H., *Plumbers and Architects: A Supervisory perspective on international financial architecture* (FSA Occasional Paper Series No 4, January 2000) 6.

The collapse of BCCI was the result of a massive fraud. It posed particular supervisory problems because the two companies, through which it carried out its international banking business, were registered in Luxembourg and the Cayman Island, its principal shareholders were latterly based in Abu Dhabi and the group was largely managed from London.

The Bank of England had been aware of some of the problems facing BCCI, but had judged that, on the information then available to it and in light of a commitment from its principal shareholders to re-capitalise the bank and to oversee changes to its management, systems and groups structure, the interests of depositors would be best served by dealing with the weakness within the on-going business.[191] The formal enquiry, conducted by Lord Justice Bingham after the BCCI failure,[192] criticised the Bank of England's supervisory approach, although it did not call for any radical changes to the basic system.[193] *Per contra*, in the *Three Rivers* case, the House of Lords did not accept that the Bank of England failed to provide continuous and effective supervision according to the provisions of Community law and, thus, it refused to recognise enforceable rights for depositors on the basis of the FBD.[194]

From a EU international standpoint, the most important legacy of the Bingham Report was the attention, which it drew to the prevailing shortcomings in the supervision of internationally-operating financial groups. [195] This has led to a tightening of international standards, as established by the Basel Committee, which have since given legislative backing in the EU. The post-BCCI Directive constitutes an emblematic paradigm. None the less, the Bingham Report stopped short of posing any major questions to national or international regulators with regard to the supervision of BCCI – and generally of pan-European or international financial firms. Was the Bank of England or the *Institut Monetaire Luxembourgeois* (IML) the principal supervisor of the BCCI?

The fragmentation and the tensions in reconciling domestic and international policies encourage the regulatory process to be primarily state-centred. In the case of the BCCI, its trading activities had considerable impact on the UK; accordingly, the UK should be obliged to accept major responsibility for regulating the BCCI empire and to cooperate with other regulators in a cross-border context. Here, an intersection of domestic and global interest was extremely significant. However, 'each regulator tended to focus on its

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[191] Latter, T., *Causes and Management of Banking Crises* (Centre for Central Banking Studies Handbook No 12, Bank of England, 1997) 36.

[192] Bingham, Lord Justice, *Inquiry into the supervision of Bank of Credit and Commerce International* (HMSO, October 1992, hereinafter 'Bingham Report').

[193] The Bank of England, however, accepted Bingham's recommendations and proceeded to the establishment of a legal unit and a special investigation unit within it.

[194] Namely, Articles 6-8; see *Three Rivers District Council v Governor and Company of the Bank of England* [2000] 2 WLR 1220, HL. The Court not only failed to refer the issue to the ECJ under Article 234 (former Article 177) EC Treaty, but also it failed to take sufficiently into account supervision developments in other jurisdictions. For an extensive and critical analysis of the comparative and community law aspects of the *Three Rivers* case, see Andenas, M., 'Liability for Supervisors and Depositors' Rights – the BCCI and the Bank of England in the House of Lords' (2001) Euredia 379.

[195] See Bingham Report, Paragraph 3.19 *et seq*.

own domestic concerns rather than accepting full collegiate responsibility'.[196] The Bank of England, for instance, could have closed BCCI at any time since its arrival in the UK, especially as it lacked a LLR and an effective supervisor, or as it was involved in money laundering activities. But, in its interest to encourage foreign investment in the UK, the Bank permitted BCCI to trade.

Certainly Luxembourg had a problem, because BCCI was registered and licensed there and the IML was the lead supervisor under the Basel Concordat. But it was also the Bank of England's problem because BCCI's effective base was in the UK, it was widely perceived as a British bank and UK depositors stood to lose much more than those of Luxembourg had things gone wrong.[197] Both Member States, however, refused to undertake the burden of consolidated supervision. Consequently, BCCI continued worldwide operation without being monitored on a concrete and consolidated basis.

Both the Bingham Report and the *Three Rivers* case raise questions about the adequacy of the decentralised framework based on minimum harmonised prudential standards and suggest a review of the effectiveness of the current EU supervisory arrangements. Especially the House of Lords case shows exactly what the FBD was meant to prevent: that regulators can claim non-responsibility because of the involvement of other Member States' regulators.[198]

Obviously, had a centralised pan-European supervisor existed at that time, it would have taken the aforementioned responsibility. The Treasury and Civil Service Committee, in its Report on BCCI,[199] noted that a number of parties involved considered the College[200] a second best solution when compared to a single supervisory authority. The Bingham Report suggests that if a single supervisor could have been designated, it might have been able at least to clarify responsibilities and to avoid the lack or deficient supervision of any of the BCCI's operating arms. Although it would not be safe to make assumptions of the likely course of events in that case, it is without doubt that a pan-European supervisor would be the best means of requiring a much more detailed independent examination of the group's worldwide business. What it might have discovered is speculative. But again, both the Bank of England and the IML failed to measure up the task.

6.2 Crisis management and pre-crisis analysis

The BCCI collapse represents without doubt a conflict between the domestic and international interest of supervisors. Both the UK and Luxembourg, Member States of a Union that was supposed to guarantee close avenues of collaborative work, were

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[196] House of Commons, *Banking Supervision and BCCI: International and National Regulation* (Treasury and Civil Service Select Committee, 4th Report, London, 1992) ix.
[197] See Bingham Report, Paragraph 2.70.
[198] See Panourgias, L. & M. Andenas, *Euro, EMU and the UK Law* (Report submitted for the Euro-Spectator Project, April 2001).
[199] House of Commons, *op.cit.*, note 196, 177.
[200] The 'college' refers to working relationships between more than two sets of national supervisors with regard to a particular institution. With regard to the use of supervisory colleges, see Walker, *op.cit*, note 182, 302.

reluctant to undertake their responsibilities. This leads us to four factors, which determine the appropriate structure and size of the supervisory domain and reveal the need for a single supervisory authority to protect consumers and retain financial stability.

The first factor, which has attracted a great deal of debate, is the timing for intervention in the event of a crisis. EU regulators agree that the objective of regulation is 'not to pre-judge where all market developments are heading to, but to ensure that, in the face of massive change, investors do not lose the protection that they can rightly expect to receive from the regulatory system'.[201] We do not share this proposition. Of course, prevention and cure are related, since the way in which each crisis is managed sends out powerful signals for the future. Nonetheless, incidents of the past clearly indicate that modern supervision must be forward looking. The lesson derived from failures of the past is that 'more important than crisis management is pre-crisis risk analysis and loss prevention'.[202] Almost all crises of the past – especially the latest Asian crisis, besides their weakness in the fundamentals, shared the element of panic. And panic cannot be an effective consultant is such circumstances. What was needed then was a stronger surveillance, which would be more focused on preventing policies that enabled a panic in financial markets. Similarly, European regulators must always be looking for trouble ahead instead of waiting for a crisis to occur. Prolepsis is the key in efficient crisis management and the European supervisor can be the key-holder.

The second factor is speed. When the principals of the hundred-billion-dollar hedge fund Long-Term Capital Management called the New York Fed in September 1998 and declared their inability to meet margin calls on the huge positions accumulated in several markets, they knew they were contacting an institution with unmatched clout. As a supervisor, the Fed had detailed information on the financial situation and relationship to LTCM of most major players on the worldwide financial scene. In a very short time, the Fed was able to congregate all the large creditors of LTCM and twist their arms into allotting US $3.6 billion in the recapitalisation of the failing hedge fund, thus reinstating its ability to meet outstanding obligations and preserving the financial stability of the US market.

On the morning of 24 September, the Fed in New York took a few hours to guarantee LTCM positions. Would such a swift and effective response be possible within the EMU if a similar situation were to arise? A similar intervention by the ESCB or the CESR would require agreement with each national authority. Every central bank would have an interest in not declaring the exposure of its own banks, hoping to limit its exposure to a rescue operation. The same applies to the investment services field. In a major emergency situation, there may be time to make some phone calls or call a meeting, but not to get involved in complex bureaucratic procedures. It is certain that the less the supervisory bodies involved in an emergency crisis, the faster and the more focused response they could achieve. In this respect, the existence of a single supervisor appears ideal. Only a single body would be able to guarantee prompt and efficient crisis management without

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[201] See FESCO, *Report 1999-2000* (15 November 2000) 9. Also Kanda would be surprised if the EU were seriously considering the establishment of a European Securities Commission in the absence of preceding scandals; See Kanda, *op.cit*., note 145, 205.
[202] Walker, *op.cit*., note 182, 327.

having to take into consideration micro-political issues of purely domestic Member State interest.

The third factor-query that arises is what kind of information supervisors will likely want to obtain during the course of an emergency situation and how feasible it is to obtain such information. In contrast to basic financial and operational information generally available to home authorities, the information that a supervisor will likely want to obtain from a supervised entity during an emergency would not necessarily be available to the supervisor prior to the emergency situation.[203] It would be the particulars of the emergency – the nature and scope of the problem – that would indicate what information would be required by supervisors. Moreover, it is the very scope and nature of the crisis that will usually point out to supervisors, which financial firms would likely be affected by the spill-over of the emergency. The europeanisation of investment business makes it extremely hard for the home supervisor to keep track of risk exposures of individual financial firms continuously. Centralisation of supervision, on the other hand, could enhance supervision practice by putting some emphasis on public disclosure and internal control mechanisms.

The fourth factor has to do with incentives and conflicts of interest. Under the home country control regime, home and host countries do merely share the same incentives for effective supervision. While home countries would be more interested for protecting financial institutions established within their territory, host supervisors' incentives to monitor foreign firms and deliver their input to the supervisory process may be blunted by the fact that they do not have the ultimate responsibility of overseeing the safety and soundness of these firms.[204] The early stages of the BCCI incident demonstrate that supervisors trying to protect their own investors, depositors and creditors can actually work against each other rather than cooperatively, when the appropriate crisis management mechanisms do not exist.[205] Whilst the UK, Luxembourg and other College authorities ultimately cooperated to close down BCCI in July 1991, they also remained sensitive to 'local' interests.[206] The differences between market sizes within the EU also play a role in incentives issues. It would be logical to assume that the provision of investment services by small financial firms in large financial centres may not receive so much attention from the host authorities.

Per contra, a supranational supervisor will not have any particular reason for not being equally interested in the effective monitoring of all EU firms and markets that will fall under its competency, irrespective of where they operate. The European Regulator could then be required to lay down a specific set of procedures, which it would follow in emergency circumstances, in advance so that its actions are predictable. It would also be easier for it to cooperate with other non-EU supervisors involved and avoid this 'tragedy

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[203] See Joint Forum, *op.cit,* note 141*,* 92.
[204] Mayes & Vesala, *op.cit.,* note 186, 18.
[205] *Ibid*, 26.
[206] For example, government efforts to restructure, rather than close down BCCI branch banks, were more extensive in countries, such as Pakistan, where BCCI dominated the market and was well linked with the political and economic establishment. Also, it seems that the UK's concern to protect depositors was secondary to the concern to safeguard the interests of the City of London as a citadel of finance capital.

of errors, misunderstandings and failures of communication',[207] which is often unavoidable in any network that tries to coordinate.

In light of these factors, coordination among fifteen or more supervisors runs two additional risks: first, it is unlikely that a rescue operation could be carried out without market participants being aware that such an operation is in progress. Second, national supervisory authorities have private information concerning the exposure of individual financial firms in their jurisdiction and they might be reluctant to reveal such information due to their interest to protect them. Coming to a decision for immediate action could thus involve a complex game: among the supervisors first and then between the supervisors and the financial firms. This may severely cause delays in the information exchange, which could undermine any rescue operation itself.

All these require the immediate action that only a pan-European centralised body could offer. The recurrence of financial failures calls for a combined preventive and remedial response.[208] Naturally, not only is it impossible to prevent all crises, but also crisis prevention comes at a cost.[209] It may involve gathering and updating of information from more than one financial undertaking and group in more than one jurisdiction in order to expedite the assessment of the emergency's impact. A supervisory authority, therefore, has to strike a balance between the costs of holding back the financial system and the costs of crises. Furthermore, the sheer existence of mechanisms to handle crises effectively may make their occurrence more likely – the well-known problem of moral hazard. Taking these drawbacks into consideration, a pan-European securities regulator will be compelled to act immediately when the signals of threat become traceable. Moreover, the host country's incentives problem could be overcome by placing the weight of the systemic and cross-border issues at the EU fora, where host supervisors could base their contribution on their expertise of local market conditions. *Per contra* it is unlikely that a network of fragmented supervisors – irrespective of how well organised and communicative it is – will be able to deliver the job. This issue is discussed in the following Section.

7. Imperfect information and deficient cooperation

It is widely accepted that the key issues of regulation and supervision of financial institutions are exchange of information between supervisors and coordination of effectives mechanisms for their supervision and intervention when problems arise.[210] However, problems of coordination will emerge in any structure of multiple agencies.[211] Beyond the doubtful competent and sufficient trust between national competent authorities, other factors, such as lack of loyal cooperation and imperfect flow of

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[207] Bingham Report, Paragraph 2.480.

[208] The problem is that 'the use of crisis management instruments has traditionally been confined to banks, because *they are the most relevant from the viewpoint of financial stability*' (emphasis added). See Economic and Financial Committee, *Report on Financial Stability* (EFC/ECFIN/240/00, 8 April 2000, 'Brouwer Report') 22.

[209] Mayes *et al, op.cit*., note 181, 3.

[210] See ISD, Article 23.

[211] Goodhart *et al*, *op.cit*., note 1, 155.

information, may undermine the efficiency of cooperation between multiple players. This Section supports the idea that, albeit the improvement of current coordination structures at the EU and international level, there are still not enough to prevent future crises and guarantee financial stability and consumer protection within the Single Market. This has clearly been the outcome of an assessment conducted by the Lamfalussy Group.[212] To assist our argument, this Section shall make use of the results and considerations that followed the collapse of Barings, the UK's oldest merchant bank, in February 1995.

7.1 Barings

Although the Barings incident exceeds the geographical borders of the European Union, the assessment of its causes may assist this discussion in assessing the weakness of national supervisory networks to supervise transnational investment business.

A general problem in financial supervision is that the jurisdiction of national regulators is smaller than the geographical business area of regulated financial institutions. In contrast to the BCCI case, the Barings collapse was brought about by the trading activities of a member of its Singapore Futures branch combined with a failure of oversight and compliance at every level of organisation.[213] Responsible for the consolidated supervision of the Barings Group was the Bank of England, which acted as the 'lead supervisor'.[214] The Bank received and considered data on Barings' consolidated capital ratios and consolidated large exposures, but was not responsible for the individual supervision of its subsidiary, Barings Futures Singapore (BFS). The Bank of England Report found that the Bank did not review Barings' overseas subsidiaries. Instead, it relied on the auditors and reporting accountants' statements regarding the existence of the connected lending limits of Barings' exposure to the overseas securities subsidiaries. Moreover, the Bank of England also relied on the supervision of BFS by the relevant overseas regulators.[215] The Bank Report clearly criticised the ineffective way the Bank of England was cooperating with overseas supervisors and recommended that it should clearly define its relationship with other regulators and effectively coordinate with them.[216] Moving a step forward, the Singapore Report surpassed the Bank of England Report in criticising the Singapore Monetary Exchange (SIMEX) for having concerns

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[212] 45 percent of the responses to the Lamfalussy questionnaire on the regulation of European securities markets stated that the current arrangements for cooperation and mutual assistance between national supervisors are not sufficient. The main perceived shortcomings are differences in supervisory powers and duties, duplication of supervisory control, deficient channels for cooperation, excessive cost and lack of expertise and transparency. See Initial Lamfalussy Report, 34.

[213] See the *Report by Singapore Inspectors on Baring Futures Singapore* (Financial Regulation Report, October 1995, hereinafter 'Singapore Report') On the contrary, the findings of the Bank of England Report were that the collapse was chiefly due to ineffective risk management and inadequate internal control. See Bank of England, *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings* (18 July 1995, hereinafter 'Bank of England Report') Chapter 13, Paragraphs 13.10-13.11.

[214] Although the Barings case falls outside the ambit of the EU home country control system and the relevant Directives, similar elements of supervisory structures can be traced to the international context. The concept of 'lead supervisor', for instance, is internationally recognised in the Basel Concordat of 1983.

[215] See Bank of England Report, Paragraph 13.58.

[216] *Ibid*, Paragraph 14.35.

about BFS' activities, not following up on them with urgency and not informing the central bank of Singapore and the Bank of England of these concerns.[217] In addition, the Report observed that the Singapore supervisors should diligently initiate enforcement actions against BFS rather than rely on the parent institution's reputation or on foreign authorities supervising the activities of the head office of such an institution.[218]

7.2 Is cooperation adequate?

The Barings collapse clearly represents a textbook example of the failure of respected national supervisory authorities to carry out their mission and to coordinate and exchange information on a cross-border basis to prevent the failure of a well-respected financial group.[219] Both Reports made clear that, just as in the BCCI incident, international coordination and cooperation were ineffective until true damage was complete.

As with transaction costs, given complete information between Member States' supervisors, there would be no need for sovereign states to delegate power to supranational bodies. Nevertheless, this is hardly the case in real life. The problem with national supervisors is that they are working in the context of national laws and regulations, whereas the core institutions of the EU financial system are now mainly pan-European in coverage. Coordination, for instance, of reporting standards is no small difficulty. As new issues arise, each supervisor will adopt its own reporting requirements to deal with them.[220]

A second problematic issue, especially acute within the EU context, is the institutional structure of financial services supervision. While some countries, such as the UK, Luxembourg and Denmark, have adopted the idea of a single regulator for their financial sector, different structures are in place elsewhere in Europe, some within finance ministries, some outside. These differences should have a practical impact on collaboration at cross-border level. Given the consolidation of financial services and their regulatory approaches, channels of cooperation may well require feedback from more than one supervisory institution in each Member State, which can easily jeopardise the reliability of communication.

A major issue in this debate is compliance, not in the sense of firms complying with the supervisors' standards, but in the sense of supervisors complying with their international and EU agreements and standards. 'Setting standards is the first step: maintaining them is the hard part', was an apt lecture title by Charles Goodhart.[221] IOSCO, for instance has issued a Report, which is hoped to serve as guidance on information sharing between national regulators during periods of crisis.[222] None the less, even in the unlikely case that all these recommendations are followed to the letter, certain

[217] See Singapore Report, Paragraph 15.41.
[218] *Ibid*, Paragraph 15.43.
[219] Norton & Olive, *op.cit*., note 143, 341.
[220] Goodhart *et al*, *op.cit*., note 1, 40.
[221] (Centre for Financial Research, Cambridge, 20 February 1998).
[222] IOSCO, *Guidance on information sharing* (November 1997); see also IOSCO, *Report on Cooperation between Market Authorities and Default Procedures* (March 1996).

problems may be impossible to overcome. First, authorities may be sensitive on giving information with an inherent significance for their domestic financial markets.[223] Second, the requested information may be in the possession of more than one authorities, which may complicate the cooperative mechanisms. Thirdly, there may be legal or practical reasons, which prevent the exchange of information in some jurisdictions, [224] confidentiality laws that accommodate access to and sharing of information or legal conditions that have first to be met.[225] Serious delays, therefore, are almost inevitable to occur.

In the EU context, FESCO (now CESR) members have agreed on a Multilateral Memorandum of Understanding, [226] which establishes a general framework for cooperation and consultation between supervisory authorities. Nevertheless, it is debatable whether the response to a potential emergency crisis will be facilitated by the time-consuming procedure described in this informal Memorandum (in as much as it is not legally binding) with regard to information exchange, investigations, compliance and enforcement assistance.[227] Although more information is available on MoUs between securities supervisors and regulated markets, cooperation through MoUs raises the questions of effective coordination of supervision, supervisory methods [228] and the content of information exchange. According to Mayes, MoUs do merely provide for regular transfer of routine information among supervisors, but only in the case where possible supervisory problems arise, including suspected misconduct.[229]

The BCCI and Barings crises taken together mandate that cross-border coordination and cooperation in the supervision of financial groups are equally as important as national supervisory efforts.[230] Cooperation mechanisms are indeed useful for specific objectives like discussion and issuing of recommendations and consultative documents to be implemented either by economic agents or by the various regulators. Nevertheless, their mandate is not equally powerful. The rather informal character and weak powers of

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[223] The home authority may be reluctant to reveal unfolding problems, because it might fear that widespread knowledge risks market reactions that could actually take the problem further. In the same way, the home supervisor will merely receive information about problems in the host market second-hand.

[224] National authorities maintain the right to refuse provision of information in instances where that transmission could violate public policy, sovereignty, national security or other essential interests.

[225] In some jurisdictions, information that discloses the positions and funds of individual customers may not be available under relevant bank secrecy and similar laws.

[226] FESCO, *Multilateral Memorandum of Understanding on the Exchange of Information and Surveillance of Securities Activities* (February 1999).

[227] Article 4(3), for instance, requires that any request addressed to a supervisory authority should specify, *inter alia*, the following: a) a description of the subject matter, the purpose for which the information is sought and the reason why this information will be of assistance, b) a description of the specific information requested and the relevant Community law pursuant to which the authority discharges its responsibilities, c) in case the request results from investigations of violations of any laws or regulations, a description of them and a list of the persons and institutions involved, and d) whether the requesting authority is in contact with any other authority or law enforcement agency in the country of the requested authority.

[228] According to Prati and Schinasi, supervisory practices vary considerably in the EU; see Prati, A. & G. Schinasi, *Will the ECB be the LLR in EMU*? (Paper presented at the SUERF Conference, Frankfurt, October 1998).

[229] Mayes & Vesala, *op.cit.*, note 186, 16.

[230] Norton & Olive, *op.cit*., note 143, 342.

these mechanisms, the lack of public report and accountability prevent them from being an effective administrative instrument.[231] In any given network, from IOSCO to Basel and CESR, all members-supervisors seek to operate by consensus. None has formal powers to censure let alone impose sanctions on members. No national supervisor has the power to intervene in a resolute manner in the event of cross-border financial problems or to undertake drastic actions to prevent distress becoming a major or system-wide crisis. After all, all these groups are composed of national representatives, who – unlike, for example, members of the European Commission or the ECB's Governing Council – do not have an explicit mandate to discard their national perspective in favour of a supranational or pan-European one.[232]

While these networks are mostly concerned with firms' ongoing business, it is doubtful whether their contacts and mutual trust built up are helpful if crises occur and information is sought at very short notice. The principles of home country control and mutual recognition are very demanding in terms of mutual trust, for trust is a basic social mechanism for coping with system complexity and for sustaining long-term cooperation.[233] If national authorities withhold information from each other and treat feedback as unwarranted criticism, conciliation to resolve conflicts is unlikely to be perceived as legitimate. Given that 'constituent organisations lack the capacities and incentives to overcome the obstacles to collective action posed by joint decision traps',[234] it may come as no surprise that networks, such as CESR, are often undermanaged. Since reliance on hierarchical authority is ruled out, capacity development depends on multilateral negotiations to define the terms of reliable regulatory and supervisory cooperation. Networks also entail a final risk: they may turn out to be a degeneration of the hub model, with the hub being not a multilateral institution, but one or two national authorities, dealing bilaterally with each peripheral supervisors. In the economists' jargon, it would be a hegemonic outcome, the hegemony being possibly assigned by the choice of location of an integrated securities market.

A European supervisory kingdom with fifteen kings and queens who frequently meet but do not elect an emperor, may in due course be difficult, if not impossible, to administer. Even an enhanced multilateral code of cooperation among EU securities supervisors should not work in practice. An alternative centralised institutional solution has to be sought and developed.[235] A centralised institution should not simply be a body that develops and imposes regulatory procedures. It should also be a forum, within which the objectives and rules of European financial cooperation are developed and implemented. Many of the goals of an efficient EU financial policy can be achieved by effective coordination of the activities of national authorities. The problem is that the

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[231] See Louis J.V. *et al, Banking Supervision in the European Community* (Brussels, University of Brussels, 1995) 60.
[232] See Breuer, *op.cit*., note 142.
[233] See Gambetta, D., *Trust: Making and Breaking Cooperative Relations* (Oxford: Blackwell, 1988).
[234] Metcalpe, L., 'Reforming the Commission: Will Organizational Efficiency Produce Effective Governance?' (2000) 5 JCMS 817, 829.
[235] This was also the opinion of a Group of experts back in 1995, which suggested that *'the system of cooperation between authorities cannot be maintained without the setting up of a higher authority at Community level'*; see Louis *et al, op.cit.,* note 231*,* 59.

means of achieving that coordination are, at the moment, quite limited. The European supervisor will fill that gap. Such a model should not preclude the establishment of an arrangement to assist or add value to the existing role of Member States' competent authorities and CESR. In particular, the European supervisor could play a constructive role in making CESR a viable and effective organisation for harmonising regulation and ensuring enforcement cooperation.

Of course, it is not argued herein that a perfect institutional structure is attainable. Also within a single regulator structure, there will always be potential problems of communication, information sharing and persistency. But, it is difficult to see how these problems could be more acute within a single regulator with a unified management structure and an effective internal decision-making process than across multiple authorities, each with its own individual and largely independent culture and decision-making structure.[236] What will the case be after the impending enlargement of the Union to CEEC, Cyprus and Malta? No matter how developed and enhanced cooperation is achieved, as a growing body of opinion now demands,[237] it will never substitute the timely access to information and the facilitation of coordination of a single regulator. Yet, outside observers are sceptical about how well such informal arrangements might work and tend to press for explicit pan-EEA arrangements.[238]

Speed is the 'A' and the 'Z' in responding to any fraudulent activity or default, especially when conducted within an electronic network.[239] A central regulatory system should seek out opportunities to leverage national supervisors' efforts to investigate transactions that they view as questionable. Acting as a neutral and independent coordinator, the single regulator will much easily achieve better flow of information, exchange of supervisory mechanisms and equivalence of regulatory capacities between national bodies. This is required, if not demanded, when problems involved are EU area-wide – because of the institutions and markets involved – or there are concerns of systemic problems spreading across borders. Moreover, centralisation enhances the quality of supervision by examining common trends in the financial system that may not be revealed from the national perspective only.

To conclude, despite existing enhanced cooperative efforts within the European supervisory regime, it is important that these be underpinned by a clear EU-wide coordinating authority, which will eliminate and substitute misunderstandings, institutional rivalry and excessive forbearance by national regulators. Managerial time is limited in the period before, and even more after a crisis, where response needs to be prompt and efficient. The gradually consolidating European markets simply cannot afford

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[236] Briault, *op.cit*., note 99, 19.

[237] See e.g. Duisenberg, W., *The future of banking supervision and the integration of financial markets* (Speech delivered at the conference 'Improving integration of financial markets in Europe', Turin, 22 May 2000); ESFRC, 'The European Shadow Financial Regulatory Committee: a new initiative' (1999) 2 JIBR 137, 140; Green, D., 'Enhanced Co-operation among Regulators and the Role of National Regulators in a Global Market' (2000) 2 JIFM 7, 12.

[238] Lannoo, for instance, advocates a 'European Board of Financial Supervisors'; Lannoo, K., *Challenges to the structure of financial supervision in the EU* (CEPS, 1999) 13.

[239] Perpetrators of Internet securities fraud, for instance, can easily move both the location of their web sites and the target location of their fraudulent scheme from one jurisdiction to another, when they encounter difficulties in a particular jurisdiction; see IOSCO, *Securities Activity on the Internet* (September 1998) 37.

a crisis to emerge in order to realise that current regulatory and supervisory arrangements are ill-adapted to deliver the job.

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8. Relationship with third non-EU countries

A final reason that asks for central regulatory and supervisory arrangements is the enhancement of the relationship between the EU and non-EU financial markets. In this critical period of time, where the Community moves towards its objective of a fully integrated financial services market, it is essential that our trade concerns emerge beyond the EU internal market as well. EU is not an island in financial markets. Financial transactions between EU markets and the rest of the world are as important as those within the Union. It is, therefore, equally important that both European financial institutions have unconditional access to the markets of the EU's competitors and foreign organisations have access to the Member States' markets.

Barriers, however, do remain in connection with many markets, including the large market of the United States. Many paradigms can be recalled here regarding investment services. Foreign financial firms do not 'benefit' from the European passport. The home country control and mutual recognition principles do not entitle non-EU financial firms to establish branches or offer services throughout the Community on the basis of one authorisation given by a Member State, and therefore arguably they are at a competitive disadvantage. On the other hand, EU securities markets cannot establish trading screen in countries such as the US, even though the core principles protecting investors and market integrity are similar in both jurisdictions. Although the US derivatives regulator has allowed Liffe and Eurex to install screens in America, Europe's equities exchanges find it harder to persuade regulators to let them in too. Furthermore, US stock exchanges cannot list companies that do not follow the US Generally Accepted Accounting Principles (GAAP). So, even if EU and US exchanges were to establish links, most listings brought in by the European side could not be traded in the US. Finally, even though US investment funds can be freely marketed in the EU, EU funds are required to establish 'mirror funds' in the US before they can market their products.[240]

With respect to supervision, there are at least fifteen governmental voices, besides the Commission, speaking today on regulatory and supervisory issues on behalf of Europe. Yet, the Union is not fully represented in international financial institutions or UN agencies. Even a regime for supervisory cooperation in external relations requires, at a minimum, that the Union 'speaks with one voice' and ensures that divergences of view among Member States are dealt with. Even this modest level of coordination will not work unless consultation and communication networks between the relevant national and EU actors are reliable. The problem will become more acute with the forthcoming enlargement of the EU. A Union of 25-plus countries will be more diverse, with a greater variety of economic and geo-political interests. It is certain that in core areas of the Single Market it will become difficult to establish consensus in an enlarged EU. The most pessimist scenario envisages a 'Europe in Shambles', which does not preclude the danger

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[240] Similar concerns exist for banking and insurance services regulation and supervision; see *3rd Progress Report,* 13.

of institutional deadlock and political chaos.[241] The process of integration may become deadlocked if current institutional arrangements and financial frameworks are not sufficiently changed. This is the nightmare of every thinking EU citizen.

This situation does not give Europe the effectiveness with respect to international issues that it would have if a single negotiator, a pan-European supervisor existed. This could be better understood in bilateral relations with powerful counterparties. The need, for instance, to harmonise US and European securities regulation [242] could be accomplished more easily by a single European regulator working with the SEC than by fifteen or later twenty-seven different negotiators. At the moment, the SEC remains the dominant regulator in Europe, as its rules are applied worldwide. This is a very compelling reason why the Union should bring into existence a regulator that can act as a counterweight to the SEC to represent Europe's interests in multilateral organisations. The size and power of an integrated pan-European market would make the single regulator an effective and reliable negotiator on issues of policy and law enforcement. Moreover, the ESR would be the perfect authority to maintain and foster these issues on the WTO/GATS agenda.

Given the fact that supervisory policies become increasingly important elements in international financial trade, developments in this field will become more rather than less important for international trade relation.[243] It has to be ensured that 'European markets are attractive to capital from outside the Union and that our regime is market-friendly'.[244] The establishment of a single supervisory authority in Europe constitutes an urgent need not only within the EU market, but also in the international context. With growing international economic interdependence, existing WTO principles of national treatment are reaching the limits of their effectiveness. Markets remain more integrated than their regulation and supervision. A pan-European authority, which could multiply existing integration efforts, could more easily export its work to the international multilateral system. Instead of importing standards and implementing them to fifteen different systems, the pan-European body could have the power and the impetus to find wider acceptance abroad. European financial governance will, therefore, have to be placed in a wider context.[245] Given the worldwide visibility of the euro and enlargement, the necessity has become obligation for the Union to reinforce its voice in the world.

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[241] See Bolkestein, F., *An uncertain Europe in the world of upheaval* (Rand Europe Public Policy Lecture, Societeit De Witte, The Hague, 14 June 2002).

[242] See Arlman, P., 'European Equity Markets after the euro: Competition and Cooperation across new Frontiers' (1999) 2 International Finance 139, 146-7. FESE also points out that modernisation of regulation in Europe has to be accompanied by rapid agreement with the US authorities aiming at full and immediate reciprocity of securities market access; see *FESE Second Report, op.cit.,* note 167, 6.

[243] See Woolcock, S., 'Competition Among Rules in the Single European Market' in Bratton *et al, op.cit*, note 69, 292.

[244] Davies*, op.cit*, note 131.

[245] See the Commission's *White Paper on European Governance, op.cit*, note 15, 26, advocating the EU's contribution to global governance. In June 2002 the Commission approved, as a follow-up to its White Paper, the consultation document: *Towards a reinforced culture of consultation and dialogue - Proposal for general principles and minimum standards for consultation of interested parties by the Commission* (COM(2002) 277, 5 June 2002). This document was, at the same time, a direct contribution to the *Action Plan for Better Regulation* (COM(2002) 278) and the Commission's new approach to impact assessment (COM(2002) 276), both of which the Commission adopted simultaneously.

D. THE POLITICAL CONUNDRUM: REAL DRAWBACKS OR POLITICAL UNWILLINGNESS?

Given the aforementioned rationale and the necessity and feasibility of transfer of certain regulatory and supervisory tasks from regional to centralised level, one may logically but also naively wonder: why is there still such an opposition to a pan-European Securities Regulator? It may be alleged that the logic of functional effectiveness is unable to fully explain current Community competences. This is encapsulated in the words of Majone,

'even in the case of economic regulation, where functional logic is most compelling, the timing and quality of many developments cannot be understood without taking into consideration other factors such as the policy entrepreneurship of the Commission or the activism of powerful actors who cannot wait for incremental task expansion to produce the policy outputs they want'.[246]

After assessing the pros and cons of the single Securities Regulator idea, the issue boils down to the political question, whether Member States would be ready and willing to give up their powers over the biggest, most sophisticated flagship. Therefore, one cannot really expect national supervisors to show a lot of enthusiasm for the prospect of being relegated to a local league and the role of junior partner to some remote super-body. This becomes evident when Professor Lamfalussy, the chairman of the Wise Men Committee, which concluded that a pan-European regulator is not yet feasible, explicitly admitted that he was given instructions by the Council to propose a solution only within the restrictions of the present Treaty.[247]

The principle of home country control has brought a negative effect on how Member States perceive 'home country' supervision. Member States today, do hardly look beyond their national markets and have less interest in how supervision is done in other countries. This is best illustrated by the Chairman of the FSA himself: 'While we have no formal responsibility for the prudential supervision of Deutsche Bank, it would be curious if we did not take an interest in what it got up to in the London market, where its presence is very considerable and even profitable on occasion'.[248] The notion of the phrase 'take an interest' is debatable.

Traditionally, the reluctance of European countries to entrust regulation and supervision to 'specialised, single-purpose commissions or administrative agencies' is reflected by the high degree of nationalisation of public-utility industries.[249] Indeed, major national regulatory authorities have their own domestic reasons for advocating

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[246] Majone, G., 'Functional Interests: European Agencies' in J. Peterson & M. Shackleton, *The Institutions of the European Union* (Oxford: OUP, 2002) 328.
[247] See Lamfalussy, A., *Presentation on the Special Roundtable on the findings of the Committee of Wise Men on the Regulation of European Securities Markets* (CEPS, 29 November 2000) (hereinafter 'CEPS Roundtable').
[248] Davies, H., *Convergence of Supervisory Practice* (Speech delivered at the Banking Supervision Conference, Copenhagen, 20 November 2000).
[249] Majone, G., 'Regulating Europe: Problems and Perspectives' (1989) 3 Jarhbuch zur Staats- und Verwaltungswissenschaft.

against the establishment of a centralised supervisory body. Up to now, the British have not believed it was in their national interest to have a European Securities regulator created.[250] The DG Internal Market of the Commission is British-dominated and London has the biggest capital market in Europe. In addition, members of the FSA play a major role in the decision-making process of CESR. Hence it is logical that the present institutional structure is more than satisfactory to them. On the other hand, the FSA considers the argument for a single EU supervisor as misplaced and counter to their philosophy of supervision. At a time, when the forces of consolidation are bringing together supervisors of all financial services in the UK, it would be odd to recreate at EU level a structure, which would divide securities supervision from other types of financial services regulation.[251] Also, Austria, Denmark, Germany, Finland and Sweden, which have already moved or are moving towards the consolidation of their financial services supervisory bodies, may have similar perceptions.

Conversely, although regulators acknowledge the deficiencies of the existing regime, they consider them relatively unimportant because they may not affect financial stability at the moment. A piece of the Brouwer Report deserves to be quoted in length:[252]

'The regulatory framework in Europe leaves some discretion to national authorities for interpretation and translation into national legislation. This could potentially result in regulatory arbitrage and an unlevel playing field. (…) However, this does not necessarily mean that the stability of the European financial system is negatively affected by remaining differences in national financial regulation.'

Although many believe that a single regulator in investment services is a necessity, steps cannot be implemented towards this end until the political patrons of the national authorities are persuaded that it is the right direction to take. A strong political will is needed, as it was the case with EMU. The Franco-German relationship, for instance, with its constant attempts to reconcile the very different interests of the two governments, drove monetary integration from 1969 onwards. It is striking that governments were willing then to pool their sovereignty as far as monetary policy was concerned – which after all is one of the most powerful instruments of national economic policy – but now shy away from taking the logical steps that follow.[253] It is as if 'Member States are suddenly afraid of their own daring'.[254] Now is the time. European financial market integration cannot be jeopardised by unnecessary national disputes and misunderstandings, while the international community is moving towards a single body to monitor the global financial architecture.[255]

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[250] See Whittaker, A., 'A European Law for Regulated Markets? Some Personal Views' in Ferrarini, *op.cit*, note 82, 270.
[251] See Green, *op.cit*., note 237, 10.
[252] Brouwer Report, 14-5.
[253] During the transition to the EMU, most governments, acting separately or through European institutions, showed a remarkable commitment to this goal, not only in words but also in deeds.
[254] Breuer, *op.cit,* note 142.
[255] This is evident in the March 2001 IMF's plans to establish an International Capital Markets Department to enhance its surveillance, crisis prevention and crisis management activities; see http://www.imf.org/external/np/sec/nb/2001/nb0124.htm. See, also, the proposal for a World Financial

E. Epilogue

This paper has presented the case for a European Securities Regulator and has raised the question: is what is being done or proposed enough? The answer lies far from an unequivocal yes. To date, the availability of the European passport and home country control has not produced the so desirable freedom of pan-European provision of investment services. Home country control and decentralisation have their limits. As a result, both major financial undertakings and investors have an interest in further supervisory centralisation supplemented or not by further harmonisation.

It is not disputed in this paper that, as far as systemic stability is concerned, the integration model of home country control may have worked well so far.[256] It has failed, nonetheless, in delivering the full application of the principle of the free movement of investment services within the Community. *A fortiori*, the European supervisory and regulatory system, as it exists at present, cannot continue to be adequate for an increasingly integrated European financial market, given its evident weaknesses. Whereas financial services and providers function and consolidate on a cross-border and cross-sector basis, their supervision cannot remain local. Home supervisors increasingly find their task more difficult, as they try to extend their power to financial business conducted beyond their country. Host supervisors, on the other hand, become less informed about the firms and the markets as a whole, which limits their ability to take *ex ante* action and successfully address crisis situations.

Although the proposals of the Lamfalussy Committee to speed up the legislative process may actually slow it down, they may be welcome for the time being as means of setting the stage for the creation of the ESR. Europe, however, cannot stop here. A strong trend towards a 'hard' single European Regulator is perceived. Although, as a first step, a pan-European Securities Supervisor could be solidly built on the current provisions of the Treaty, a more powerful body with decision-making and supervisory powers will need to become part of a new Intergovernmental Conference. Placing all central rules regulating the Regulator in the Treaty, will give the ESR a strong law-based status and will further strengthen its independence.

Rephrasing the theory of neo-functionalism, the functional needs of a single market in investment services would necessitate a considerable transfer of policy-making powers to the EU level. Regulatory economies of scale and scope for financial undertakings and securities markets call for efficiency gains that only a central regulator can deliver. The potential integration of financial markets and the europeanisation of investment and other financial services, which will be boomed as the introduction of the euro breaks down the

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Authority (WFA) in Eatwell, J. & L. Taylor, *International Markets and the Future of Economic Policy* (CEPA Working Paper No. 9, August 1998), 14. Finally, the Economist wonders who regulates firms like Citigroup, the world's largest and most diverse financial institution; see The Economist, 'The regulator who isn't there' (18 May 2002) 12.

[256] Padoa-Schioppa states that 'on the whole, (…) the legislative cum regulatory reform, although rather unusual and very diversified in comparison with those of most currency jurisdictions, does not seem to present loopholes or inconsistencies that may hamper the pursuit of systemic stability'; Padoa-Schioppa, T., *EMU and Banking Supervision* (Lecture at the London School of Economics, 24 February 1999).

barriers in Europe, will pose serious problems to the current fragmented multiplayer regulatory and supervisory structure.

The current supervisory regime has implications on the slow legislative process witnessed in Europe. Nobody argues against that but also nobody moves against it. Today comes the proposed regime by the Commission and the Lamfalussy Committee, which, nevertheless, is doubtful whether it will speed up securities markets and investment services integration. In any event, supervision remains untouched, while developments cannot wait. Home supervisors will find their task more difficult to extend their supervisory power to financial business conducted abroad. Host supervisors, on the other hand, are likely to become less informed about the firms and the market as a whole, which means that their ability to take *ex ante* action and resolve a crisis situation is limited.

Thoroughgoing 'enhanced cooperation' between members of CESR may ease the problem of information exchange but this is not adequate. National authorities tend to consider the financial industry as a sector that is entrusted with a 'national mission'. The need to act promptly, decisively and away from national political and socio-economic interests in emergencies supports a wider role for a pan-European supervisor with clear crisis management tasks. More important than crisis management, however, is pre-crisis risk analysis and loss prevention. One of the important lessons derived from crises of the past was that, although a number of indicators of potential exposure or collapse arose, they were not properly assessed on a coordinated basis. What has to be done in the event of cross-border crises within the EU? Who has to be informed? Where can regulators meet? The ECB is in charge of monetary stability, but not of financial stability, which remains a Member State responsibility, together with prudential supervision. The institution that could provide a *point d'appui* is lacking. More importantly, the nightmare of institutional deadlock or political chaos in decision-making may become inevitable.

A single regulator can be more flexible. Lawmaking in its hands will never follow market developments, while its flexibility will smooth national conflicts and provide an adequate forum for exchange of expertise and information, as a better shield to prevent or even repulse emergencies. Establishing a central authority will improve the way rules are decided, applied and enforced across the Union. Its advantages will include its ability to draw on highly technical, sectoral know-how, its increased visibility for the securities sector and the cost-savings it will offer to business. In addition, the pan-European Regulator will constitute the powerful counterparty that will negotiate and foster the European interests in the global financial arena and the WTO.

In light of its functions, it is important that the European Regulator remains immune to political pressure and regulatory capture. Its tasks and operation should be designed in such a clear way as to promote transparency and accountability. In turn, transparency will reduce information asymmetries within European markets and accountability will foster confidence, democracy and legitimacy. The establishing Treaty rules should set out the limits of its activities and powers, its responsibilities and requirements for openness. Moreover, such a major institutional reform ought to be based on the broadest possible consensus right from the beginning, as the declaration appended to the Nice Treaty called. The ESR will need a clear yardstick for the evaluation of its performance in the achievements of its objectives.

Although regulators acknowledge the deficiencies of the present regulatory and supervisory system, short-sighted perspectives and partial success of the past make them reluctant to move towards its radical reform. Complete harmonisation should not stand as a prerequisite to centralisation, as the necessary common European financial laws are already in place to justify and demand such a radical institutional shift. From what has been said, a need for action can be identified in a number of areas, including the removal of overlapping of jurisdictions to boost supervisory efficiency, the adoption of a more flexible response to innovations and the assumption of a united external stance. In the near future, the issue of a single EU regulator cannot be avoided by the markets and their participants. Acting in a single currency and unified securities market environment, the new regime would have the advantage of the *status quo* of a bigger body of common regulations, lower costs and greater flexibility. On the other hand, the lack of a single supervisor can impede competition and innovation beneficial to financial firms, issues and consumers. Europe has a responsibility to pursue financial institutional reform; not only for its own benefit, but also for the good of its neighbours – helping drive global economic growth, and promoting international cooperation beyond its own borders to ensure that globalisation works for the benefit of all.

At the end of the day, the rationale and the success of the ESR will heavily draw on its capacity to better serve and further promote the supervisory objectives of financial stability, competition and consumer protection. As put by Demarigny, the problem of European financial market regulation and supervision today is basically a lack of a 'bridge' between the upper level, the EU black-letter law written in stone, and the lower level, the day-to-day practical implementation, supervision and enforcement.[257] The European Securities Regulator could be seen as the constructor of the bridge, as soon as micro-political interests and national conflicts are left aside.

[257] Demarigny, F., Comment at the CEPS Roundtable.