

PART I

Introduction

I

Introduction

I.1 INTRODUCTION AND SCOPE

This book examines the EC's system of securities and investment-services market regulation or EC securities regulation. It is a system in transition, moving from a basic regulatory framework, which has had only limited success in integrating national markets to a considerably more sophisticated and extensive regime which is designed to complete the integration process. Market structures and regulatory regimes alike are evolving. This book examines the current regime and, reflecting this key phase in its evolution, assesses the new proposals and market forces which are changing the shape of EC securities regulation.

In writing this book, parameters had to be set for the scope of EC securities regulation. Indeed, one of the objectives of the book is to try to characterize EC securities regulation as a discrete subject, liberated from EC financial-services regulation and EC company law, in the interstices of both of which it is often to be found.¹ After a slow start, which can be traced back to 1977 and the Commission's Recommendation for a European Code of Conduct Relating to Transactions in Transferable Securities² and the early admission to official listing and issuer-disclosure measures adopted in the late 1970s and early 1980s, the subject matter of EC securities regulation has widened steadily since 1993 with the adoption of the cornerstone Investment Services Directive (the ISD).³ The adoption of the Financial Services Action Plan (the FSAP) in 1999 (see section 7 below) has accelerated the maturing process and, with the exhortation from the Stockholm European Council in 2001 that the key steps for achieving an integrated securities and investment-services market be implemented by 2003, EC securities regulation has now emerged as a fully fledged component of EC law and regulation.

This emergence of EC securities regulation as an independent subject tracks to some extent the development of securities regulation as a discrete discipline on this side of the Atlantic. Securities regulation is a long-established component of the US law-school curriculum while the foundation pillars of US

¹ For an analysis of the emergence of EC securities regulation from under the wing of EC company law see Davies, P, 'The European Community's Directive on Insider Dealing: From Company Law to Securities Market Regulation' (1991) 11 *OJLS* 92.

² Recommendation 77/534/EEC [1977] OJ L212/37 (the Code of Conduct).

³ Directive 93/22/EEC on investment services in the securities field. [1993] OJ L141/27.

securities regulation, the Securities Act, 1933 and the Securities Exchange Act, 1934, have produced not only a highly developed regulatory structure but a lively academic debate and voluminous literature on securities regulation. In recent years, securities regulation has begun to generate considerable interest and academic comment across the Atlantic as Member States of the EU have, often under the impetus of EC obligations, moved to introduce sophisticated systems of securities regulation.⁴

The subject matter of this book covers those EC measures which concern the regulation of securities market participants (issuers of securities, collective investment schemes, market intermediaries, and investors) and the operation of the markets themselves. It addresses the regulatory regimes which apply to issuer access to investors and to the securities markets and those which cover activities on the secondary markets in which transactions take place between investors after the initial issuer/investor transaction. After this introduction to EC securities regulation which forms Part I, Part II examines the regulation of issuer access to the securities markets and, in particular, the admission to official listing and issuer disclosure regime (Chapters II-IV) and collective investment schemes (Chapter V). As such, it is broadly concerned with investment products: securities and collective investment schemes. Part III concerns the secondary markets and, in particular, the regulation of investment intermediaries who provide investment services. The twin pillars of investment intermediary regulation, prudential and conduct regulation, are examined, as are compensation schemes (Chapters VI-X). Part IV concerns the securities trading markets on which issuers' securities are traded and investment intermediaries act as a market access channel for investors, particularly retail investors. It addresses the regulation of securities trading markets (Chapter XI) and post-trade settlement systems (Chapter XII). Part V (Chapter XIII) covers the pathology of securities regulation and examines the EC's market abuse regime while Part VI (Chapter XIV) concerns takeover regulation. Finally, Part VII (Chapter XV) examines the institutional structure of EC securities regulation. Those related regulatory areas which impact on the securities markets and their participants but which also have a wider reach, such as the EC's competition rules and money laundering regime, are not covered. Neither does this book cover, for the most part, the private law rights which arise in the interaction between issuers, investors, intermediaries, and markets, nor the EC's company law harmonization programme.⁵ Finally, this discussion is con-

⁴ For an overview of the early development of securities regulation or capital markets law across the EC see Buxbaum, R. and Hopt, K., *Legal Harmonisation and the Business Enterprise* (1988) 189-92.

⁵ Although the EC's accounting standards and financial reporting initiatives impact on securities regulation, in so far as they have implications for the type of disclosure which is made by issuers to the market-place, they are primarily concerned with the shareholder/company

cerned with the EC system of securities regulation. The main legislative device used to construct this regime, the directive (section 4 below), requires Member States to implement the rules contained in directives in their national systems. The implementation of EC securities regulation measures in the national systems is not discussed in detail, although reference is made to Member States' regimes to illustrate the difficulties and controversies in the EC framework.

EC securities regulation is at bedrock a device for integrating national securities and investment services markets. A by-product of that integration process has been, as can be seen from the scope of this book, the construction of a discrete system of securities market regulation. This system has, for certain Member States and in respect of particular regulatory areas, resulted not simply in the application of common EC standards but in the imposition of entirely new systems of regulation on national markets which were previously lightly regulated or unregulated; this was particularly the case with the ISD. In recent years, this system has deepened in scope and acquired regulatory sophistication to the extent that it can now be examined as an independent system of market regulation. This system responds to the traditional objectives of securities regulation, albeit, as discussed throughout, that these objectives are often not expressly articulated and must be examined through the sometimes distorting lens of the market integration priority. This priority means that EC securities regulation must also effectively integrate individual national securities markets which display different structural features and cultural approaches to regulation and grapple with the particular risks raised by an integrated securities and investment services market, all within the institutional, legal, and political constraints of that integrated market. This duality is examined throughout the book.

1.2 THE TREATY AND COMPETENCE TO REGULATE

EC securities regulation is based ultimately on the Treaty objective of constructing a common market (Article 2).⁶ More specifically, the internal market in securities and investment services, the construction of which has generated the rules of EC securities regulation, is part of a wider project to create a single market comprising 'an area without internal frontiers in

relationship and are usually considered as part of company law rather than securities regulation. The most important of these are the 4th (Directive 78/660/EEC [1978] OJ L222/1), 7th (Directive 83/349/EEC [1983] OJ L193/1) and 8th (Directive 84/253/EEC [1984] OJ L126/20) Company Law Directives which address, respectively, the presentation of annual accounts, consolidated accounts and the qualifications required of statutory auditors.

⁶ References to 'the Treaty' are to the EC Treaty as amended by the Treaty of Amsterdam. Art. numbering follows the Amsterdam Treaty. The reference is to EC rather than EU securities regulation, given that the discussion in this book concerns the EC pillar of the EU.

which the free movement of goods, persons, services and capital is ensured [Article 14(2) EC].’ A single or integrated investment services and securities market, within which investment services providers and investors can access national markets across the EC and issuers can raise capital, should generate broader and deeper capital markets. As a result, achievement of the Community’s market integration objectives should be enhanced by a reduction in the cost of capital for firms, particularly small and medium-sized enterprises, the promotion of growth and employment, and, more specifically, the achievement of greater choice for investors of investment services and investment products: this governing presumption of EC securities regulation can be traced back to 1966 and the seminal Segré Report (see section 6 below). It has received more attention in recent years when, as part of the renewed efforts to complete the single market in this area, the focus on the link between economic growth and investment services/securities market integration has intensified. The starting point for the EC securities regulation regime and the integration of markets, therefore, is that market finance (ie the raising of finance via the capital or securities markets) is a desirable financing mechanism.⁷ Indeed, in many respects the evolution of the integration project is a story of the movement of the EC from a predominantly bank-based finance system (as far as continental economies are concerned) to a market-based finance system, although, as discussed in Chapter II, this transformation is very far from complete.⁸ The rationales for the measures discussed in the following chapters which support integration can be traced back to these macro objectives, although these measures also have more immediate micro objectives, such as opening up market access across the EC, the efficient functioning of the market-place, market stability and integrity, and investor confidence, which are discussed in more detail in the relevant chapters.

The major obstruction to the internal market in securities and investment services markets and the primary preoccupation of EC securities regulation is the regulatory barrier to market access represented by obstructive and diverging national securities regulation regimes. Investment services and securities markets are traditionally subject to regulation in order to protect investors and the integrity and stability of the market-place itself; a number of factors such as market structures, investor profiles, the maturity of the market-place, saving patterns, and cultural attitudes towards regulation usually dictate the intensity of regulation. As is discussed in greater detail in the following chapters, securities regulation is generally based on the need to correct market failures (ie failures in the market’s self-regulatory mecha-

⁷ The alternative is bank finance, or the raising of finance via credit facilities provided by credit institutions. The relationship between the two and the EC’s position on market finance generally is discussed in Ch. II sect. 4.2 below.

⁸ Ch. II sect. 9 below.

nism which obstruct the efficient allocation of resources by an otherwise perfect market).⁹ Its major preoccupation is with market failures related to asymmetric information and externalities (ie wellbeing-influencing consequences which are visited on one party by the actions of another), such as the instability-generating effects which can be caused when a market participant fails. At the start of the harmonization programme, considerable variations existed across the EC as to how markets were regulated. Even where these rules were not actively obstructionist and designed to protect national markets from competition, the very existence of divergences between rules caused problems for the construction of the single market. Regulatory divergences and the duplication of rules can amount to non-tariff barriers given that the costs they represent for market participants can obstruct access to other Member States' markets and integration. They can distort competition between market participants and prevent the development of the level playing-field on which the internal market is dependent. More positively, uniform rules can generate investor confidence in the stability and efficient functioning of and level of investor protection in the integrated market-place and thus increase the likelihood of cross-border investment.

The Treaty free movement guarantees go some way to removing regulatory obstacles to the construction of the internal market in securities and investment services. In particular, the freedom to provide services (Articles 43–48 EC) and the freedom to establish (Articles 49–55 EC) are the Treaty cornerstones on which the internal market is based. They provide the basis for market access by virtue of the prohibition they place on discriminatory and free-movement-restrictive national rules and have been particularly important in the investment services sphere. They are, however, subject to exceptions which allow Member States to retain free-movement-restricting rules in certain circumstances.¹⁰ Although market regulation is the concern of this book, a single market in securities and investment services free of regulatory barriers cannot operate without the liberalization of capital controls or the free movement of capital. The Treaty capital movement rules are discussed in outline at the end of this introductory chapter.

Where the single market in securities and investment services cannot be achieved by means of the free-movement guarantees alone and regulatory barriers remain in place, the harmonization process steps in by providing for the adoption of harmonized securities regulation rules which are designed to remove the remaining regulatory obstacles to integration by putting common standards in place. Article 3(h) EC provides that the approximation of

⁹ The market failure doctrine is discussed further in Ch. VI sect. 2.2 below with respect to the investment services regime.

¹⁰ See Ch. VI sect 4 below.

Member States' laws to the extent required for the functioning of the common market is an activity of the Community. All EC measures, including harmonizing measures, must, however, be based on a Treaty provision that empowers the Community to act.¹¹ Lacking a competence independent of the single market, EC securities regulation is thus based on the single market legislative competences, both the general enabling clauses for the single market and the competence granted in respect of the free-movement guarantees which anchor the single market. For the most part, securities regulation rules have been based on the free movement and barrier removal-related competences set out in Article 44(2)(g) EC (directives designed to coordinate the safeguards required by Member States of companies or firms for the protection of members and others), Article 47(2) EC and Article 55 EC (directives designed to co-ordinate Member States' rules on the taking up and pursuit of activities as self-employed persons) and in the two general single market competences, Article 94 EC (directives for the approximation of Member States' rules which directly affect the establishment or functioning of the common market) and Article 95 EC (measures for the approximation of Member States' rules which have as their object the establishment and functioning of the internal market).¹²

The grip exerted by the single market on the securities regulation regime has had an enormous impact on the shape of EC securities regulation; other EC policy areas such as environmental law and, albeit to a limited extent, consumer protection enjoy an existence independent of the single market. On a general level, the overwhelming preoccupation with integration has resulted in a certain philosophical bankruptcy across the regime concerning the underlying regulatory objectives being pursued by the common standards which underpin the single market. While EC securities regulation serves primarily as a lever to open the market-place, it also serves as the regulatory basis for many activities on the market-place. As is discussed throughout, in the rush to harmonize it is not always clear what, for example, underlying regulatory objectives are pursued by the harmonized rules such as the issuer disclosure or capital adequacy controls or whether the common standards should only correct market failures or serve other objectives. In this regard, EC securities regulation is grounded in pragmatism and dictated by market-access requirements rather than by any particular

¹¹ Under Art. 5 EC the Community must act within the limits of the powers conferred upon it by the Treaty and of the objectives assigned to it therein. The choice of legal basis for a measure must be based on objective factors amenable to judicial review: Case 45/86 *Commission v Council (Generalized Tariff Preferences)* [1987] ECR 1493.

¹² The residual competence, Art. 308 EC (which activates when action by the Community is necessary to attain, in the course of the operation of the common market, one of the objectives of the Community when the Treaty has not provided the necessary powers) has not played a role in the development of the regime to date.

attachment to the rights and wrongs of market regulation or any particular regulatory philosophy.

The single market focus has also shaped the substantive content of the regime. This is particularly evident in the investment services area, where the single market objective has resulted in a focus on the free movement of the investment firm and its market-access rights and on the stability of the integrated market; limited attention has been given to the proactive protection of the investor who accesses the market-place. Indeed, as a regulatory priority, the investor as a focus for protection has generally been secondary to the investment firm as a beneficiary of liberalization and as an agent for the construction of the internal market. Moreover, one of the themes which emerges strongly from EC securities regulation and which is considered throughout is that it is not entirely clear whether the single market competences on which the regime is based allow for the adoption of measures which seek to raise the level of regulation in order to protect investors or the market-place rather than simply to remove those divergences which are obstructing integration. It appears, however, as discussed throughout this book, that harmonization is increasingly being used for what might be called 'second-generation' purposes and, in particular, to generate investor confidence in the single market and protect the market-place against post-integration risks.

Whether or not the Treaty can sustain the demands which the developing regime is placing on it is in the hands of the Court of Justice which presides over Treaty basis questions. Two important themes emerge from the Court's jurisprudence which are significant for the securities regulation regime. First, the Court has revealed in the past a tendency to defer to the judgement of the Community legislature in respect of the appropriate method for regulating economically complex situations.¹³ Secondly, in its seminal 2000 *Tobacco Advertising* ruling,¹⁴ a decision with potentially seismic effects for the development of the securities regulation regime, the Court indicated its intention more aggressively to assert its review powers over the Treaty basis chosen by the Community institutions and its scepticism about the extent to which Treaty competences can be manipulated to accommodate Community action which is deemed necessary. In particular, its finding that, in principle, the single market competences do not confer a general power to regulate the single market may represent a formidable obstacle to the continued development of the regime beyond a market construction device towards a single market regulatory regime.

In addition to being based on a Treaty competence, EC securities regulation must also comply with the Treaty's subsidiarity principle which has

¹³ Case C-233/94 *Germany v European Parliament and Council* [1997] ECR I-2405, para 56.

¹⁴ Case C-376/98 *Germany v Parliament and Council* [2000] ECR I-8419.

brought about a major shift in EC policy-making and law-making. Set out in Article 5 EC, it provides that, even if the EC has competence to act, before it does so it must assess whether the objectives of the proposed action cannot be sufficiently achieved by the Member States and whether, by reason of its scale or effects, the proposed action can be better achieved by the Community.¹⁵ Although the exact scope of the subsidiarity principle is shrouded in considerable obscurity, it is broadly designed to ensure that action is taken at the most appropriate level and that Community legislation is limited to what is essential.¹⁶ While the regulation of pan-EC actors such as financial conglomerates and pan-EC trading markets fits well with the subsidiarity principle, the principle has the potential to restrict the development of EC securities regulation in other areas, given that local markets tend to display particular cultural and structural features and that local regulators have an in-depth knowledge of their markets. Further, while on the supply side investment firms are increasingly operating on a pan-EC basis, the same is not true on the demand side, particularly with respect to retail investors. The principle has impacted on the form and content of legislation. The EC's currently defunct takeover regime, for example, started life as a detailed directive, but was recast as a framework, minimum standards directive in order, *inter alia*, to reflect the subsidiarity principle. Related to the subsidiarity principle, the proportionality principle (Article 5 EC) must also be respected. It provides that any action taken by the Community must not go beyond what is necessary to achieve the objectives of the Treaty.

Finally, the Charter of the Fundamental Rights of the European Union, adopted in 2000, is appearing as a nascent influence on securities regulation. Recent proposals for a public offer/admission to trading prospectus regime and for a market abuse regime state that their provisions respect the fundamental rights and principles set out in that document.¹⁷ Its influence is likely to grow, given that all the indications are that the reach of EC securities regulation is to extend and that its strengthened supervision and enforcement requirements, in particular, will increasingly have implications for market participants.¹⁸

¹⁵ The subsidiarity principle applies only to areas in which the Community does not exercise exclusive competence. On this question see Ch. IX sect. 12.2.2 below.

¹⁶ The Commission has expressed the view that: '[t]he aim of the subsidiarity principle is to see to it that decisions are taken as close as possible to the citizen, a constant watch being kept to ensure that action taken at Community level is justified in the light of the means available to national, regional or local authorities . . . [it aims] to regulate the exercise of powers and to justify their use in a particular case': Commission Report to the European Council on the Adaptation of Existing Legislation to the Subsidiarity Principle. COM(93)545, 1.

¹⁷ Proposal for a directive on the prospectus to be published when securities are offered to the public or admitted to trading: COM(2001)280, recital 32, and Proposal for a Directive on insider dealing and market manipulation: COM(2001)281, recital 24.

¹⁸ Ch. VI of the Charter concerns the administration of justice.

I.3 HARMONIZATION

I.3.1 *Harmonization and Regulatory Competition*¹⁹

EC securities regulation has as its underlying objective the construction of a single securities and investment services market via the harmonization of Member States' rules. In principle and outside the EC context, harmonization of rules is, from the economist's perspective, regarded as justified where it is necessary to correct a market failure which extends beyond national boundaries and cannot be corrected by action by individual States. Typical market failures include protectionist barriers, regulatory costs,²⁰ and externalities which are generated by wellbeing-influencing effects occurring in one State as a result of an activity which is regulated in another State. In the securities regulation sphere, harmonization is typically regarded as justified where markets interact such that intermediaries, investors, and transactions move between them, leading to the potential for cross-border externalities such as fraud²¹ and systemic risk.²² The cost and market-access obstructions generated by securities regulation barriers, as well as the regulatory concerns provoked by cross-border activity, have not only led the EC to take action but have also triggered international moves towards harmonization as participants in the international securities markets increasingly seek access to new markets.²³ While harmonization should deliver a clear regulatory environment in which economic actors can operate with a degree of certainty about which rules apply, harmonization of standards requires international agreement and can be a slow process which may result in the adoption of standards which, given the pace of developments in securities markets, rapidly become obsolete. It also has the potential to restrict regulatory developments which are typically incubated at national level and to limit the extent to which markets can tailor their regimes to reflect different market participant

¹⁹ There is a considerable literature on this question and on the relationship between harmonization and regulatory competition. See, eg, Bratton, W, McCahery, J, Picciotto, S, and Scott C (eds), *International Regulatory Competition and Coordination. Perspectives in Economic Regulation in Europe and the United States* (1996).

²⁰ See HM Treasury's 2000 Report, *Completing a Dynamic Single European Financial Services Market: A Catalyst for Economic Prosperity for Citizens and Business Across the EU* (HM Treasury, July 2000), para 7.

²¹ Bentson, G, 'Regulation of Stock Trading: Private Exchanges Versus Government Agencies' (1997) 83 *Va L Rev.* 1501, 1506.

²² Davis, E, 'Problems of Banking Regulation—An EC Perspective' in Goodhart, C (ed), *The Emerging Framework of Financial Regulation* (1998) 533, 547.

²³ IOSCO (the International Organization of Securities Commissions) is the primary actor in the international harmonization of standards process. The influential US Securities and Exchange Commission (the SEC) is also in favour of international harmonization between regulatory systems: Policy Statement of the Securities and Exchange Commission on the Regulation of International Securities Markets, SEC Exchange Act Release No 6807 (1988).

and transaction profiles. More generally, economic theory teaches that harmonization, like law-making, is vulnerable to regulatory capture or to the demands of the most vocal and influential interest groups. In the EC context, the problem of subsidiarity also arises. An alternative does exist. In principle, the barrier-removing objectives pursued by harmonization can also be achieved through a regulatory competition between States.²⁴ The regulatory competition model is premised on regulatory arbitrage. This is the assumption that, where regimes differ, consumers will choose products/services which meet their price and quality requirements, but which originate from a State with a regulatory regime that is more efficient and less costly than the domestic regime, over domestic products/services produced under the less efficient domestic regime. Firms may choose to relocate to another regime in response to these signals, while investors may choose to invest their capital in a State in which the regulatory regime reflects, from the investor's perspective, the optimal balance between risk and reward.²⁵ It has the advantages of easing the informational imbalance under which regulators labour (as compared to industry lobbying groups which benefit from inside knowledge) by allowing signals to be transmitted from the market-place to regulators, reducing the risk of regulatory capture and potentially resulting in the adoption of regulation which reflects a more diverse range of interests,²⁶ allowing regulatory innovation and the exercise of choice and checking the expansionist regulatory tendencies of government.²⁷ In the EC context it also appeals to the concept of subsidiarity by shifting the regulatory focus from the centre to the Member States. In the securities regulation sphere, support for regulatory competition²⁸ is often based on the assumption that it produces regulation which is more sensitive to investors' needs.

²⁴ See, eg, Kay, J, and Vickers, J, 'Regulatory Reform: An Appraisal' in Majone, G. (ed), *Deregulation or Re-regulation. Regulatory Reform in Europe and the United States* (1990) 242. Regulatory competition has been defined as 'the alteration of national regulation in response to the actual or expected impact of internationally mobile goods, services or factors of national economic activity': Sun, J-M, and Pelkmans, J, 'Regulatory Competition in the Single Market' (1995) 33 *JCMS* 67, 68.

²⁵ Snell, J, and Andenas, M, 'Exploring the Outer Limits—Restrictions on the Free Movement of Goods and Services' (1999) 10 *EBLRev* 252, 257.

²⁶ See Bratton, W, McCahery, J, Picciotto, S, and Scott, C, 'Introduction: Regulatory Competition and Institutional Evolution' in Bratton *et al.*, n 19 above, 1, 14: '[g]iven mobility of people and factors [of production], the imposition of costly and restrictive interest group legislation in one jurisdiction benefits a neighbouring jurisdiction with a less costly regime. Individuals and factors of production will vote with their feet, migrating to the less costly jurisdiction. They thereby affect lawmakers' incentives, making inefficient wealth transfers to favoured groups less attractive than regulations that enhance the wealth of the larger population' (references omitted).

²⁷ See Sun and Pelkmans n 24 above, 82.

²⁸ See Mahoney, P, 'The Exchange as Regulator' (1997) 83 *Va L Rev.* 1453, Romano, R, 'Empowering Investors: A Market Approach to Securities Regulation' (1998) 107 *YLJ* 2359 and Choi, S, and Guzman, A, 'Portable Reciprocity: Rethinking the International Reach of Securities Regulation' (1998) 71 *So. Cal. L Rev.* 903.

Among the problems generated by regulatory competition are the disadvantages of an uncertain regulatory environment, the risk that protectionist barriers will remain in place, and difficulties concerning the level to which competition drives regulation: the ‘race to the bottom’/‘race to the top’ conundrum. In general, it appears that securities regulation competition tends not to result in a race to the bottom or the setting of standards at an inadequate level, given that market participants tend to favour balanced systems of regulation which support market stability and do not deter investors.²⁹ It may be, however, that competition in this area is more likely to create a regulatory model which consists of different regimes which tailor their levels of regulation in order to attract different types of securities and investment services business.³⁰ Effective regulatory competition is, however, dependent on a number of factors, including the mobility of market participants and their ability to choose regulatory regimes, the extent to which regulators can decipher signals from market participants, and the absence of market failures which require intervention in the form of harmonized common standards. The respective merits and drawbacks of harmonization and regulatory competition as single market construction and barrier removal mechanisms vary according to the regulatory sector in question:³¹ regulatory competition in the investment services area, for example, raises market-wide systemic or system-wide stability concerns, given that market problems which arise in one Member State may spill over and destabilize the market-place in another. The implications of harmonization/regulatory competition for the different components of EC securities regulation are discussed further in the relevant chapters.³²

I.3.2 *Integration Devices*

The devices which the EC has used to remove regulatory obstacles via harmonization and the extent to which it has embraced regulatory competition also vary across the securities regulation regime as a whole.³³ The earliest

²⁹ See, eg, Ch. VI sect. 6.4 below on the investment services area.

³⁰ In the context of issuer disclosure see Choi and Guzman, n 28 above.

³¹ See the discussion in Hopt, K, ‘Company Law in the European Union: Harmonisation and/or Subsidiarity?’ (1999) 1 *ICCLJ* 41, 50–2.

³² For a broadly based critique of harmonization and regulatory competition in the EC context see Woolcock, S, ‘Competition Among Rules in the Single European Market’ in Bratton *et al.*, n 19, 289 and Sun and Pelkmans, n 24, both of which support a complementary rather than an antagonistic relationship between the two models.

³³ On the various harmonization methods which have been used in the construction of the single market see the analysis in Slot, P, ‘Harmonisation’ (1996) 21 *ELRev* 378, 382–7. Among the methods highlighted are: definition of law and policy at Community level; total harmonization (where no derogations from the harmonized rules are allowed); optional harmonization (in which an option is given whether the Member State applies its own rules or the harmonized rules domestically); partial harmonization (where the harmonized rules apply only

securities regulation measures (in the issuer disclosure area) harmonized at a high level of detail and sought to remove obstacles to integration by rendering Member States' regimes equivalent. As discussed further in Chapters II and IV, this approach was not successful largely due to the negotiating difficulties represented by detailed measures and the discretion given to the Member States in implementing the harmonized rules as a result of the derogations and options which these measures contained. A new approach to barrier removal was followed in the wake of the Court of Justice's groundbreaking judgment in *Cassis de Dijon*³⁴ in which it stated that products legally in circulation in one Member State were to be admitted to other Member States without being required to meet additional regulatory requirements. Member States were, in other words, subject to a 'mutual recognition' rule, or required to recognize the regulatory regimes of other Member States. Member States could, however, impose those requirements which could be classified as 'mandatory requirements', such as consumer protection rules. The single market harmonization project as a whole then switched to the harmonization of these mandatory requirements or public interest rules.

As far as EC securities regulation is concerned, mutual recognition, combined with harmonization of rules at a minimum level and the allocation of primary regulatory control for integrated market activities to the home Member State (very broadly the Member State in which the regulated party is resident or registered) is the touchstone.³⁵ In principle, mutual recognition levers open the single market once the regulated entity has complied with the minimum harmonized standards which are imposed by the entity's home Member State; costly duplications of regulation are thus avoided. These standards are designed to ensure the stability of the market-place, and, albeit to a lesser extent, the protection of investors and support mutual recognition as Member States can be confident in the regulatory standards applied by each other. While not imposing full harmonization, standards which are harmonized at a minimum level allow a degree of regulatory competition (as to the desirability of the Member State in question as a primary regulator or home Member State) above the minimum level and accommodate flexibility, innovation, and, of particular importance in the EC context,

to cross-border transactions); minimum harmonization (in which minimum rules are set at EC level but Member States may adopt more demanding requirements—market access is protected either by the free movement guarantees or by a mutual recognition clause in the directive); alternative harmonization which allows Member States to choose between alternative methods of harmonization; and mutual recognition of national rules and of national controls.

³⁴ Case 120/78 *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein (Cassis de Dijon)* [1979] ECR 649.

³⁵ The first example of this harmonization model is the 1985 Directive which harmonized the rules applicable to collective-investment schemes: Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities [1985] OJ L375/3.

local market sensitivity. This level of harmonization also places a limit on prejudicial regulatory competition. Regulatory competition is thus built into the harmonization regime which acknowledges, through the mutual recognition system, that national regimes can differ, but minimum standards and home country control place a brake on competition, while harmonization and mutual recognition prise open the single market. This structure and, in particular, the home Member State control anchor component demand considerable levels of co-operation and communication between supervisors across the single market; supervisory co-ordination requirements are thus built into the harmonizing directives in this area. This harmonization device has determined the shape of EC securities regulation, and its implications are discussed further throughout the book in the context of the specific areas of regulation in which it has been used. Indeed, a recurring theme of EC securities regulation is how the integration or harmonization device used has impacted on the substantive regulation adopted for the integrated market.

While the Commission initially promoted this highly influential integration device in its 1985 White Paper on the Internal Market,³⁶ it is, as outlined above, a creature and creation of the Court of Justice. As such, the mutual recognition of regulation principle applies across Member States' markets regardless of whether harmonization has occurred, and should, in theory, ensure that the securities and investment services market-place is always wedged open. In practice, notwithstanding the harmonization process and the mutual recognition principle, securities regulation in the EC is currently made up of a complex web of common EC rules and diverging national regimes, with the latter continuing to entangle market participants seeking access to the integrated market-place. Persistent obstructions to integration exist not only because EC securities regulation does not extend across the entire complex universe of securities regulation rules, with the result that home country control and mutual recognition are not possible in a number of areas. The mutual recognition principle which should support market access in the absence of harmonization is also subject to exceptions, in particular the ability of Member States to impose public interest legislation on non-national regulated entities.³⁷ As a result, in the absence of harmonization (or where the level of harmonization does not support full mutual recognition), regulatory obstructions and divergences can arise. Large areas of securities regulation remain unharmonized at present, and in those areas access to the integrated market remains vulnerable to obstructions caused by the imposition of general good or public interest rules by the Member States, whether driven by protectionist or innocent impulses. Even

³⁶ Completing the Internal Market. COM(85)310.

³⁷ See further Ch. VI sect. 4.6 below which discusses the general good doctrine which allows Member States to plead certain interests to justify the imposition of their rules on regulated entities from other Member States despite the mutual recognition principle.

in those areas which are harmonized divergences persist as Member States implement often opaque rules according to their own national traditions.³⁸ Accordingly, while EC securities regulation has developed sufficiently as a harmonized regime, such that it can be examined as a distinct market regulation system, the regulation of securities markets across the EC remains fragmented outside this central pillar. Major reforms are currently under way to accelerate the integration process and, in particular, to move the regime more completely towards home Member State control, driven in part by the development of the Internet and the impossibility of subjecting online activities to a host Member State system. The failure of EC securities regulation to date to integrate national securities and investment services markets and their regulatory systems more completely does not of itself condemn the regime as a failure. For certain Member States, the substantive regime which has emerged from the harmonization process has resulted in the adoption of new, enhanced regulatory standards.³⁹

I.4 FORMS OF LEGISLATION

Under Article 249 EC, binding EC rules can take three forms: regulations, directives, and decisions. Regulations are self-executing, in that they apply in the Member States once adopted and do not depend on further action at Member State level. In part due to their intrusive and prescriptive nature and the negotiating problems which they can generate, they have not featured widely in EC securities regulation.⁴⁰

Directives are binding as regards the result to be achieved but leave the choice of form and method of implementation to the national authorities. They will contain an implementation date, which will vary according to the severity of the changes required to existing rules or the new rules demanded and the degree of market upheaval which might be expected, by which the

³⁸ One leading commentator has observed that 'the overall picture of securities regulation at EU level is a partial body of common concepts and regulatory patterns, while a large part of the field remains uncovered, and considerable differences subsist in the rules ultimately applicable, each State having translated the European rules more or less according to its own fancy': Wymeersch, E, *The Harmonisation of Securities Trading in Europe in the New Trading Environment*, WP 2000-16, Working Paper Series of the Financial Law Institute, Universiteit Gent, 2.

³⁹ eg, before it adopted the national rules required to implement the ISD (the Stock Exchange Act, 1995 and the Investment Intermediaries Act, 1995), Ireland did not have a comprehensive system for the regulation of investment intermediaries. Insider-dealing and public offer disclosure rules have also been driven by harmonization. This outcome reflects the thesis put forward by Buxbaum and Hopt that 'harmonisation—if conceived broadly as an instrument of European legal and economic policy—gets its legitimation less from its results in integration than from the substantive content and effect of the Community law in which it results': n 4 above, 212.

⁴⁰ They do appear in EC company law. One high profile example would be the 2001 Council Regulation on a Statute for a European Company (the *Societas Europaea*), adopted on 8 Oct 2001.

obligations must be implemented by the Member States.⁴¹ The directive is the dominant legislative mechanism used in the securities regulation sphere. This reflects in part the Treaty competences on which EC securities regulation has been based, which mandate the use of directives in certain cases.⁴² More generally, however, directives allow for greater flexibility and for a degree of discretion to be conferred on Member States and can, as a result, more easily slot EC obligations into national regimes and structures. In the politically sensitive sphere of market regulation their split competence structure allows room for the exercise of Member State sovereignty.⁴³ In this respect, they respond well to the dictates of the subsidiarity principle. Conversely, as their effectiveness depends on implementation by Member States, their use has caused problems for the integration project. Harmonization via directives runs the risk that regulatory divergences will remain in place. This is particularly the case where directives give Member States discretion on how to apply provisions or grant options as regards which rules are to be implemented, albeit often in the interests of reaching agreement on contentious issues or in order to respond to particular Member States' market structures and regulatory cultures.⁴⁴ Serious divergences can also follow where their provisions are opaque or vague⁴⁵ and implementing measures vary as a result across the Member States.⁴⁶ This tendency

⁴¹ The implementation date of the proposed and now failed directive on takeovers, eg, emerged as a bone of contention, given that some of its provisions, notably the mandatory bid rule and the prohibition-on-defensive-action rule, required significant changes in certain Member States. One element of the doomed compromise on the measure which was hammered out just weeks before its final collapse in July 2001 was an extension of the implementation deadline to 4 years and the grant of an additional 5th year to implement the defensive-action prohibition. Implementation deadlines will often contain carve-outs for Member States which are thought to need additional time. It was feared that the liberalization of stock exchange access in the wake of the adoption of the ISD, eg, would generate overcapacity in certain Member States' markets. Those Member States that did not permit direct access to stock exchanges by credit institutions, but required them to use a specialized subsidiary and which, on adoption of the ISD, were required to remove this restriction were given additional time to implement the ban on direct access restrictions.

⁴² The original internal market competence, Art. 94 EC, for example, requires that harmonization be carried out via directives (Art. 95 EC which has now replaced Art. 94 EC in practice as the dominant internal market competence refers to the adoption of 'measures'), as does Art. 47(2) EC on which the investment services regime has been based. Similarly Art. 44(2)(g) EC which has served as the primary basis for the early official listing and disclosure measures requires that co-ordination of the safeguards required by Member States of companies for the protection of the interests of members and others be carried out via directives.

⁴³ Buxbaum and Hopt, n 4 above, 233.

⁴⁴ The public offers issuer-disclosure regime has been particularly problematic in this regard.

⁴⁵ Examples include the failure of the takeover regime to address the concept of 'control' and the omission of a definition of 'public offer' from the public offer prospectuses regime. In both cases, agreement proved impossible. See further Chs IV and XIV below.

⁴⁶ The Court of Justice is the final arbiter on the meaning of Community legislation. To date, it has had little opportunity to examine the securities regulation regime, although that situation may change, given that, as discussed in section 7 below, the regime is set to increase dramatically in scope.

towards divergences is exacerbated by the general lack of guiding principles in EC securities regulation; as is discussed further throughout this book EC securities regulation measures are often unclear about the objectives which they serve beyond market integration or the targets of the regulation which they impose, both of which have a bearing on how rules are transposed in practice.⁴⁷ Minimum standards directives, particularly those adopted or proposed in the wake of the institutionalization of the subsidiarity principle in the Maastricht Treaty can produce a degree of harmonization so limited that the need for the directive can be questioned. The charge of ineffective and inadequate harmonization was levelled by the UK at the proposed Takeover Directive, for example, which was recast in 1996 from its original incarnation as a detailed measure as a framework directive in light of the subsidiarity principle.⁴⁸ Difficulties have also arisen where directives are overly detailed and give Member States limited room as regards their implementation and become becalmed as a result in the negotiation process. Most seriously perhaps, Member States may simply fail to implement directives or implement them incorrectly.⁴⁹ Should this arise, the Commission, in its role as guardian of the Treaties, can take enforcement action against the erring Member State under Article 226 EC which can result in the imposition of fines on that Member State. In addition, the judicially created direct effect doctrine permits market participants who may be prejudiced by a Member State's action to rely on the rights contained in non-implemented or incorrectly implemented directives in their national courts once the implementation date has passed. Reliance on rights contained in directives is dependent, however, on the rights in question being clear, precise, and unconditional and on the rights being relied on against the State or part of the State (directives have direct effect only vertically and do not apply to horizontal relationships between individuals).⁵⁰ The enforcement structure has also been bolstered by the State liability doctrine which allows persons to sue a Member State in damages for failure to implement or incorrect implementa-

⁴⁷ Although the Lamfalussy law-making model (see section 7 below), which includes a 'conceptual framework of overarching principles' by reference to which EC securities regulation proposals should be measured, may improve matters in this regard: Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, Feb 2001 (the Lamfalussy Report), 22. Since the adoption of the FSAP in 1999 (section 7), a more considered approach to the objectives of securities regulation can be observed in new proposals and initiatives, with the Commission increasingly grappling with concepts such as the market failure doctrine, investor protection, differentiated protection between retail and professional investors, and interventionist versus disclosure-based regulation.

⁴⁸ See Ch. XIV below.

⁴⁹ This feature led the Lamfalussy Report to encourage greater reliance on regulations which are not subject to the risks of the implementation process: n 47 above, 26.

⁵⁰ Treaty provisions, by contrast, can have direct effect vertically and horizontally depending on the legal obligation imposed.

tion of a directive where damage has been sustained as a result.⁵¹ Notwithstanding these checks, Member States have a patchy record in implementing directives correctly and on time. Although reliance on directives for market regulation harmonization was recommended in the Code of Conduct,⁵² as the integration project gathered momentum, particularly after the adoption of the ISD, it became clear that inconsistencies and delays in the implementation process were contributing to the poor pace of market integration.⁵³ The extent to which directives provide for Member State discretion, however, is likely to change significantly in the future, following the adoption by the EC, in principle at least, of a new model for proposing and adopting securities regulation measures which will significantly increase the level of harmonization.⁵⁴

The final form of binding legislation, decisions, are binding on those to whom they are addressed, often individuals and legal persons, and have limited application in this area. Non-binding recommendations have been used on occasion in EC securities regulation, the most prominent example being the Code of Conduct which contains a comprehensive set of general principles governing activities in the securities markets, many of which have subsequently re-appeared in binding directives, but was, largely, ignored by the Member States.⁵⁵

The process by which these measures are adopted has exerted a decisive and often prejudicial influence on their content. Ultimately, securities regulation measures must pass through a legislative process which requires, to varying degrees depending on the procedures followed (which depend on the Treaty competence used), agreement between the Member States on the necessity for and scope of the measures. Differences in legal traditions and market structure (such as the extent to which universal banks or specialized investment firms operate on the market-place and the approaches markets take to the transparency of trading), varying emphases on the role of

⁵¹ Cases C-6, C-9/90 *Francovich and Others v Italy* [1991] ECR I-5357, Joined Cases C-46/93, C-48/93 *Brasserie du Pêcheur SA v Germany* and *R v Secretary of State for Transport ex parte Factortame Ltd and others* [1996] ECR I-1029.

⁵² It stated that harmonization via directives was the only method 'capable of attaining the objective of true European integration': n 2 above, Explanatory Memorandum, para I(4).

⁵³ It has been observed in the company law context that '[o]nly a small part of European company law is made up of genuine European company law. By far the larger part is derivatively European: it is European company law by virtue of transformation. This is true of all the company law directives.' Hopt, n 31 above, 43. A similar point can be made in respect of EC securities regulation, revealing the dependence of the market integration and barrier removing objectives of the regime on the implementation process.

⁵⁴ See the discussion of the Lamfalussy Report in section 7 below.

⁵⁵ See Hopt, K, 'The European Insider Dealing Directive' in Hopt, K, and Wymeersch, E (eds), *European Insider Dealing* (1991) 132. Recommendations have been relied on more extensively in the banking sphere. The Deposit Guarantee Directive (Directive 94/19/EC OJ (1994) L135/5), for example, originated in a 1987 Commission Recommendation, as did the large exposures regime.

market finance, the comparative competitive positions of national markets, varying perspectives on investor protection and corporate governance, as well as old-fashioned political tensions and rivalries, can stymie the progress of legislation or produce legislation which is overly complex.⁵⁶ Chapter XV discusses the complex inter-institutional procedures under which EC securities regulation measures are adopted and describes how the delays, political tensions, inertia, and compromises to which they can be subject have weakened the securities regulation regime.

I.5 REGULATORY DEVICES

The regulatory devices traditionally employed by securities regulation appear in the EC regime, even if their use must be looked at through the lens of harmonization and market integration. As discussed throughout, disclosure is the dominant information-based regulatory mechanism for many securities regulation regimes and appears across EC securities regulation. Its *locus classicus* is in the issuer-disclosure sphere, but it is also relied on in the collective investment schemes, investment services, securities-trading markets, market abuse, and (now defunct) takeover regimes. It is likely to increase in importance given that the regime as a whole appears to be moving towards greater reliance on market discipline as a form of control.⁵⁷ The regime also relies on more interventionist controls, however, particularly in the investment services regime, in order to set the foundations for market integration via mutual recognition of investment services providers.⁵⁸ The emphasis to date has been on the imposition of prudential standards, notably capital adequacy standards and organizational requirements, which safe-

⁵⁶ The Lamfalussy Report laid part of the blame for the delays in adopting securities regulation measures at the door of the Council ‘where there is far too often a tendency to add unnecessary levels of complexity to straightforward Commission proposals (often in an attempt to try to fit 15 sets of national legislation into one Community framework’: n 47 above, 14.

⁵⁷ eg, the combination of disclosure and market discipline has been canvassed as a supplementary device for managing and monitoring the soundness and risk management policies of investment firms (Commission Services’ *Second Consultative Document on Review of Regulatory Capital for Credit Institutions and Investment Firms* (the 2001 Regulatory Capital Review), MARKET/1000/01) while disclosure of transgressions to the market-place has been relied on as a form of deterrent in the Commission’s 2001 Market Abuse Proposal, n 17 above.

⁵⁸ In this regard the regime differs from US securities regulation which is largely based on disclosure devices (although it does impose more interventionist controls via the Securities Exchange Act, 1934 and the Investment Company Act, 1940 in particular) in that it does not give disclosure the same totemic status. For a comparison of the regulatory devices used in the EC and the USA see Austin, R, ‘Commentary 2 on Report on Supervising EU Capital Markets’ in Hopt, K, Buxbaum, R, Hertig, G, and Hirsch, A (eds), *European Economic and Business Law* (1996) 209–10 who has noted that the SEC regards itself as a ‘disclosure regulator’. The same focus is not apparent in the EC regime; neither is the US level of sophistication as to the objectives of disclosure, particularly in the issuer disclosure sphere, reflected in the EC regime as is discussed further in Ch. IV below.

guard the stability of the integrated market-place. Protective mechanisms (such as conduct-of-business rules), directed to the relationship between the investment firm and the investor, have been less in evidence, in a reflection of the focus on market integration via the free movement of the investment firm and the stability of the new market-place.

A number of trends can be observed in this area. Protection of the retail investor who accesses the integrated market-place and is an agent for integration is emerging, after many years in the doldrums, as a major preoccupation of EC securities regulation. Protection of the integrated market-place against post-integration stability risks such as those posed by increased cross-border activity, and the development of financial conglomerates can also be identified as an influence on the regulatory devices used across the regime.

I.6 THE ROOTS OF EC SECURITIES REGULATION

Broadly speaking, EC securities regulation has evolved in three stages.

In phase 1, efforts were directed towards the construction of a single deep and liquid securities market which issuers across the EC could access for their financing needs. The regulatory focus was on harmonization (via detailed, equivalence-promoting directives initially and subsequently via minimum harmonization and mutual recognition) of Member States' rules on the admission to official listing process and on the disclosure required when an issuer makes a public offer or officially lists securities. In phase 2, attention shifted to the construction of a single market in investment services. The regulatory touchstones here are mutual recognition, minimum standards, and home country control, mediated by the subsidiarity principle which encouraged the use of framework measures, while the preoccupation of the common standards adopted is prudential regulation and the stability of the integrated market-place. A number of core areas were not addressed, however, and others were not subject to harmonization at a level sufficient to support home country control and mutual recognition. Phase 3, which is currently unfolding, is dramatically increasing the scope and sophistication of EC securities regulation as concerted and urgent efforts are being made to complete the single market in securities and investment services. In this phase, securities regulation has assumed a priority it has hitherto not enjoyed on the EC's agenda. This is evidenced not only by a series of path-breaking reports but also by its regular appearance in the conclusions of the biannual European Council meetings which have prioritized the completion of the single market in financial services generally and in investment services and securities in particular. Phase 3 is also distinguished from the earlier phases in that regulatory change is being dictated in many cases by

dramatic market practice, technological, and industry-structure developments. In this phase, the considerable gaps in the harmonized rule structure are being filled and earlier measures which have not had the hoped-for success in removing regulatory barriers are being revised. The form in which harmonization is achieved is still evolving: it does seem clear that a more complete transition to home country control will be the outcome of this phase and that mutual recognition will be more fully realized across the single market. The outstanding feature of this phase, however, is the focus on the manner in which common standards are adopted; the new approach, based on a hierarchy of norms principle involving harmonization occurring at two levels (general framework principles and detailed technical measures), amounts to a sea change from the earlier phases, as significant as the initial move towards mutual recognition. Finally, in terms of substantive regulation, the focus has become broader in this phase. In particular, investor protection and protective regulation generally have moved up the agenda to assume the position previously enjoyed by prudential regulation in phase 2. Market integrity, or the protection of the market against abusive practices or a lack of transparency, is also receiving considerably greater attention.

The 1966 Segré Report⁵⁹ marks the first significant foray by the EC into securities regulation. It highlighted the poor condition of the EC capital or securities market⁶⁰ and the benefits which could follow from the integration of capital markets, identified the obstacles to integration, chief among them the imposition by Member States of diverging and duplicative rules on market participants and proposed remedial measures, notably with respect to the capital-raising process and the harmonization of disclosure standards.⁶¹ Subsequent developments took place on two fronts: the liberalization of capital movements (section I.8) and the harmonization of Member State rules.⁶² Although the first securities regulation proposal was presented in 1972 (the proposal which became the listing particulars regime as late as 1980),⁶³ the Code of Conduct represents the EC's first legislative attempt at setting common standards for an integrated securities and investment ser-

⁵⁹ Report by a Group of Experts Appointed by the EEC Commission, *The Development of a European Capital Market* (1966). The findings of the Report are discussed throughout this book.

⁶⁰ '[Community] savers generally prefer to hold cash or short term assets and it would be difficult to alter that liquidity preference radically in the short term' and '[i]n several Community countries, the equity markets are suffering from a shortage of available capital and from a rather unsatisfactory pattern of business demand for capital . . . business firms often find it hard to obtain risk capital and at the same time the investing public does not always find attractive opportunities on the market': *ibid*, 17 and 27.

⁶¹ For an overview see Dalhuisen, J, *The New UK Securities Legislation and the EC 1992 Program* (1989) 55.

⁶² See Wouters, J, 'EC Harmonisation of National Rules Concerning Securities Offerings, Stock Exchange Listing and Investment Services: An Overview' 4 (1993) *EBLRev.* 199.

⁶³ [1972] OJ C131/61.

vices market-place. It was followed by the first generation of admission to official listing and disclosure directives, adopted between 1979 and 1982,⁶⁴ which sought to construct a single securities market in which issuers could raise capital. This regime focused on stock exchanges and, in particular, on the official listing process, and did not cover public offers of securities.

1985 saw the presentation of the Commission's White Paper on the internal market which set out a programme of measures designed to deliver the single market by 1992 and the Commission's intention to accelerate the harmonization process by means of the mutual recognition/minimum harmonization/home Member State control device. The White Paper's discussion of the investment services and securities sector was linked to a general examination of the financial services area in which the Commission found that 'liberalisation of financial services, linked to capital movements, will represent a major step towards Community financial integration and the widening of the Internal Market'.⁶⁵ In the securities/investment services sector the Commission called for the completion of the work which 'still remains to be done to ensure that securities markets operate satisfactorily and in the best interests of investors' and, specifically, for the development of a 'European securities market system' which would provide a Community-wide trading system for securities of international interest.⁶⁶ It also broadened the focus of EC securities regulation from its concentration on issuers and the official listing process by including in its 1992 programme the adoption of four measures, two of which took the regime beyond the issuer market access context: the collective investment scheme regime (by 1985, adopted on schedule); a public offer prospectus regime (by 1988, adopted in 1989); a regime concerning the information to be published on the acquisition of major holdings (by 1988, adopted on schedule); and an investment advisers regime (by 1989, adopted as the ISD in 1993). 1985 thus also saw the adoption of the framework for the single market in collective investment schemes. With this regime, the EC gave the passport device, which has come to dominate EC securities regulation, its first airing. The collective investment scheme regime was based on authorization of the collective investment scheme by the home Member State in accordance with the regime's common standards and the conferral of a regulatory passport on the authorized scheme to operate across the EC. It was followed by the second generation of disclosure directives (adopted between 1986 and 1994) which grafted the mutual recognition concept on to the harmonization via

⁶⁴ A measure harmonizing the disclosure required on the acquisition or disposal of major shareholdings was adopted in 1988.

⁶⁵ White Paper on the Internal Market, n 36 above, 27. The White Paper is discussed further in Ch. VI sect. 5.1.3 below.

⁶⁶ *Ibid*, n 36 above, para 197. The evolution of the EC towards a single securities trading market is discussed in Ch. XI sect. 8 below.

the equivalence of standards approach of the first generation measures and introduced harmonized disclosure rules concerning the public offer of securities. These developments moved the issuer disclosure regime closer to becoming a common disclosure system that would enable an issuer to raise capital across the EC in reliance on one integrated disclosure document that could be used in official listing applications and public offers.⁶⁷ The scope of EC securities regulation expanded to include the pathology of securities regulation in 1989 with the adoption of an insider dealing regime which was designed to protect the integrity of and confidence in the new market-place. In 1993, after protracted negotiations, EC securities regulation took a major step forward with the adoption of the cornerstone investment services regime. In 1997 this regime was bolstered by the adoption of a directive which required that investor compensation schemes be established in all Member States and setting out common rules. By 1997, which can be seen as the approximate end of phase 2, the harmonized structure contained the basic elements of securities regulation such that a common core of basic rules applied in most Member States. A network of competent authorities had also been established, designed to supervise the harmonized rules and to provide a pan-EC co-operation system on which the supervision of the integrated market could be based. Nonetheless, the regulatory structure supporting the integration process was inadequate: large areas of regulation remained unharmonized (market manipulation, conduct-of-business regulation, and a more detailed consideration of the regulation of securities trading markets, to name but three areas); the existing regimes were deficient in a number of respects (for example, the disclosure regime's mutual recognition structure which was shot through with exceptions and derogations and never worked properly in practice, leaving issuers exposed to the costs represented by varying national regimes); implementation of directives was inconsistent and often badly delayed; and supervisory co-operation was underdeveloped. All in all, the signs were already there that the regime would be ill-equipped to cope with the enormous demands which would be placed on it imminently, notably: the arrival of monetary union, the Internet explosion, and the upsurge in cross-border activity which followed in the wake of these two developments and which was aided by technological developments in the securities-trading environment and market restructuring (best evidenced by the growth of financial conglomerates and the arrival of competition in the securities-trading market environment).

The internal market in securities and investment services is now developing organically at a rate that poses significant challenges for the securities regulation structure. Clearly, the euro removes currency risk and enhances price transparency within the euro zone. It is also leading to

⁶⁷ As discussed in Ch. IV below, this objective has not been achieved.

changes in investment patterns as investors shift to pan-EC sectoral rather than Member State-based investment patterns. New technologies, particularly the Internet, are increasing the ease with which cross-border investment services can be offered and are also enhancing the dissemination of market information and access to trading, bringing greater numbers of investors to their own national markets and, increasingly, to the integrated market-place. In a related development, technological developments with respect to alternative trading systems (or ATs) are changing the shape of Community trading by carrying out functions previously the preserve of traditional exchanges, thereby generating competition, reducing transaction costs, and facilitating cross-border trading. Consolidation in the investment services industry on an intra- and inter-Member State basis is continuing, as is the growth of financial conglomerates which offer investment services and securities services along with banking or insurance services. The most high-profile consolidation is arguably taking place between stock exchanges where pan-EC alliances and mergers are taking place on a dramatic scale. Demographic developments and changes in how State-supported pensions schemes are funded are provoking massive growth in the collective investment scheme or investment fund industry and increasing retail investor activity on the market-place. Finally, and perhaps most significantly, market-based finance is beginning to reverse the traditional dominance of bank-based finance in the EC as issuers turn to the securities markets for their financing needs to a much greater extent than previously. All of these developments are discussed further in the following chapters with respect to the different areas of EC securities regulation with which they are most closely implicated.

I.7 THE FSAP AND THE LAMFALUSSY REPORT

Whether the regulatory structure that was in place after phases 1 and 2 would be able to support these greater levels of cross-border activity, respond to the regulatory challenges raised by market developments, and deliver securities and investment services market integration, or whether it would instead hamper integration and frustrate market developments began to come under increasingly closer scrutiny from the end of the 1990s. This period has also produced a considerably more sophisticated articulation from the EC institutions of why the integration of securities and investment services markets should be promoted; the market integration measures adopted up to this stage have tended not to engage in an analysis of why market integration (or the market finance model, support for which is implicit in the securities market integration process) should be encouraged.

In recent years it has become clear that the single market in investment services and securities, which, as part of the single market for financial services generally, was regarded as being critical for growth and job creation, was incomplete. The immediate catalyst for what would be prove to be a tidal wave of reforms and consultations and for a focus of attention on securities regulation and EC securities markets at the highest policy-setting levels appears to have been the then imminent introduction of the euro, which was identified as creating a unique opportunity to equip the EU with a modern and efficient financial infrastructure and as posing new challenges for the regulatory structure of the internal market. Reflecting the UK's focus on financial services market integration as a mechanism for economic reform, the 1998 Cardiff European Council requested the Commission to prepare a framework for action for financial services which would ensure that the full benefits of the euro were realized with respect to financial services generally and that the stability and competitiveness of EU financial markets were ensured. The Commission duly issued a Communication later in 1998 on 'Financial Services Building a Framework for Action'.⁶⁸ The Communication emphasized the importance of integrating financial services markets generally, given the employment-generating potential of the financial services industry and the wider choices which would be made available to consumers and investors. More specifically, it found that efficient and transparent markets would optimize the allocation of capital and, by facilitating access to equity financing, would allow small and medium-sized companies to generate growth and employment opportunities. It found, however, that while some progress had been made, financial services markets generally remained segmented and cross-border provision of financial services, particularly in the retail sector, remained low. It highlighted a range of issues which needed to be addressed in order to 'equip the EU with financial markets capable of sustaining competitiveness and weathering financial instability'.⁶⁹ Two aspects of financial services market integration were highlighted: the construction of deep and liquid EC capital markets which would serve issuers and investors better and the removal of the remaining barriers to the cross-border supply of retail financial services in order to ensure consumer choice while maintaining consumer confidence and a high level of consumer protection.⁷⁰ Five areas were identified for further action: an overhauling of the legislative apparatus in order to ensure more effective responses to regulatory challenges; a market-driven modernization of wholesale markets in order, in particular, to remove the remaining barriers (legal, administrative, and fiscal) to cross-border initial public offers and investment-related activities; completion on an incremental basis of the single

⁶⁸ COM(1998) 625 (the 1998 Communication).

⁶⁹ *Ibid*, p. 1b.

⁷⁰ *Ibid*, p. 1a.

market for retail financial products in which consumers would benefit from high levels of consumer protection as well as from increased competition and choice; review and clarification of the mechanisms for supervisory and regulatory co-operation; and creation of the general conditions for a fully integrated financial market including construction of an integrated infrastructure with respect to payments, stricter application of the Treaty rules on competition and State aid and progress on tax harmonization. Later in 1998, the Vienna European Council called for the translation of these objectives into a specific work programme. Construction of the work programme was undertaken by the newly constituted Financial Services Policy Group, which is comprised of representatives of the Ecofin Council ministers, the European Central Bank, and the Commission, and it was presented by the Commission in its 1999 Communication, 'Implementing the Financial Services Action Plan'.⁷¹ The work programme, or Financial Services Action Plan (FSAP), which should be completed with respect to securities and investment services markets by 2003, sets out a programme of forty-two measures which, if adopted, will radically change the shape of EC financial services and securities regulation. It is as significant for the single market in investment services and securities as the 1992 programme was for the single market generally. The FSAP's proposals recognize that deficiencies in the harmonized regime are blocking greater integration and are designed to plug the major gaps; in its discussion of the FSAP the Commission noted that although the single market in financial services generally had been under construction since the early 1960s, markets remained fragmented. It also found, however, that the introduction of the euro provided a 'unique window of opportunity' to provide the EC with a modern financial structure in which the cost of capital and intermediation were kept at a minimum.⁷² A second theme of the FSAP is the need to protect the market-place against the risks posed by greater integration, to meet the regulatory challenges posed by market developments and to ensure the protection of retail investors in the integrated market-place. The FSAP's investment services- and securities-related proposals (the FSAP generally is designed to serve as 'an aspirational programme for rapid progress towards a single financial market')⁷³ are grouped around four categories (wholesale markets, retail markets; prudential rules and supervision; and wider conditions for an optimal single financial market). They include: revising the ISD to ensure that its mutual recognition principles work more effectively, clarifying the conduct of business regime which at present is unsatisfactory and results in duplications of regulation, and updating its securities trading market provisions to take into account market developments such as the growth of competition between markets and the arrival of ATSS; revising the disclosure

⁷¹ COM(1999)232 (the FSAP).

⁷² *Ibid.*, 1.

⁷³ *Ibid.*, 2.

regime so that a single prospectus can be used in cross-border capital raising; adopting a market abuse regime; revising the collective investment scheme in order to update the investment restrictions rules; adopting a takeover regime; adopting a common set of international accounting standards; addressing investor protection in the cross-border provision of investment services via measures covering, *inter alia*, the distance selling of financial services; and enhancing co-operation between supervisors. Together with the 1998 Communication, the FSAP is discussed in greater detail throughout the text in relation to the specific impact of its proposals on the various discrete components of EC securities regulation. Progress on the FSAP is monitored regularly by the Commission in consultation with the Financial Services Policy Group which issues a series of progress reports. The 2000 Lisbon European Council, the conclusions of which have been described as bringing about a 'step change' in the movement towards greater integration,⁷⁴ highlighted, in particular, the need for action on the wholesale markets side, given the contribution they can make to economic growth, and identified the widest possible access to investment capital on an EU basis, elimination of barriers to investment in pension funds, further integration of government bond markets, enhancing comparability of companies' financial statements, and intensifying co-operation by regulators as priority action areas. It also called for action on Internet-related measures, such as the proposal on the distance selling of financial services.

The Lisbon European Council also emphasized the crucial role played by securities markets in generating growth and employment and identified integration, efficiency, and stability as the benchmarks against which the performance of EC securities markets should be assessed.⁷⁵ As outlined above with respect to the FSAP and Commission's 1998 pre-FSAP Communication, the link between economic growth and the integration of securities and investment services markets regularly appears as the driving factor behind the push to integrate securities and investment services markets. In 2000, the Commission elaborated on the benefits of integration, stating that the pooling of national liquidity in an integrated market would allow private-sector savings to be put to their most productive use and, in particular, to serve as a complement to statutory pension schemes, provide companies with a flexible and competitive alternative to bank borrowing, ensure that the potential for the competitive pricing of capital is optimized by widening the pool of investors available and minimizing inter-

⁷⁴ Report from the Commission, Progress on *Financial Services. Second Report* (COM(2000)336) (the Second Progress Report), 2.

⁷⁵ For a summary of the Presidency Conclusions see *ibid*, 1 and the Commission's Communication on Upgrading the Investment Services Directive (the ISD Communication) COM(2000)729, 5.

mediation and transaction costs, and, ultimately stimulate growth and job creation.⁷⁶

While the FSAP sets out the substantive measures which must be adopted in order to complete the internal market in securities and investment services and respond to market developments and their related regulatory challenges in the internal market context, its fate, as far as its securities regulation measures are concerned, is bound up with the seminal Lamfalussy Report which was delivered in February 2001⁷⁷ and which is a landmark in the history of EC securities regulation. In July 2000 a Committee of Wise Men on the Regulation of European Securities Markets, chaired by Baron Alexandre Lamfalussy, was constituted by the Council in order to assess the current state of integration in the securities and investment services markets and the harmonized structure supporting it, to examine how the mechanisms for regulating the securities markets can best respond to developments such as stock exchange alliances and technological developments and to suggest proposals for adapting current practices in order to ensure greater convergence and co-operation on the markets. Its findings, which are discussed throughout this book, were a searing indictment of the inadequacy of the harmonized structure, its inability to cope with market developments and support greater integration, and the failure of EC legislative procedures to deliver regulation quickly and effectively. It warned that unless steps were taken to complete the regulatory structure and open the market-place and to revise the law-making process, 'economic growth, employment and prosperity will be lower, and competitive advantage will be lost to those outside the European Union. And the opportunity to complement and strengthen the role of the euro and to deepen European integration will be lost.'⁷⁸ By contrast, an integrated financial market would, subject to proper prudential safeguards and investor protection, allow capital and financial services to move freely across the single market, with the result on a micro-economic level that European businesses would be in a position to tap deep pools of capital for their financing activities, supplies of capital from EC savings would be matched by demand for capital

⁷⁶ *Ibid.*, 5 and Second Progress Report, n 74 above, 3. See also the Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets, Nov 2000 (the Initial Lamfalussy Report), which stated at 2 that '[a]n efficient regulatory process for financial services and capital markets is crucial . . . for successful economic reform, for boosting economic growth. Crucial for helping channel the high rate of European savings towards the corporate sector. Crucial for strengthening both the international competitiveness of the European Union in the global economy and for releasing its entrepreneurial potential. Crucial also for job creation and consumer protection'. More specifically, it identified at 4–7 the following benefits: higher returns on ordinary investors' savings in securities, whether directly or via collective investment schemes; enhanced financing opportunities for small and medium-sized companies, and the growth of venture capital funding; lower costs of capital for large companies; and a strengthening of competition and innovation.

⁷⁷ N 47 above.

⁷⁸ *Ibid.*, 8.

from EC businesses, and consumers would be better able to purchase financial services and securities from the best suppliers. On a macro-economic level, the Report pointed to the potential for an increase in the productivity of capital and labour, stronger GDP growth, and enhanced job creation. The Report found that the development of an integrated securities market was being held back by a number of factors including: gaps in the harmonized regulatory regime which were preventing the operation of mutual recognition; an inefficient regulatory system; inconsistent implementation of rules; inefficiencies in clearing and settlement systems; differences in legal systems (such as divergences in how bankruptcy proceedings are dealt with); taxation differences; political barriers in the form of creative techniques designed to assist local suppliers and national markets; external trade barriers; and cultural barriers such as different entrepreneurial cultures and different attitudes to regulation such as variations in approaches to corporate governance, disclosure, and the importance of competition. Its main concern was the inability of the law-making process (which is discussed in Chapter XV) to deliver the required reforms. The Report found that while there was a strong consensus on the need to deliver the FSAP as soon as possible, the current regulatory framework was 'too slow, too rigid, complex and ill-adapted to the pace of global financial market change'.⁷⁹ The heavy reliance on directives, under subsidiarity pressures, was leading to implementation problems, while consultations with regulators and markets were inadequate. Its proposed solution was to revise the law-making process such that level 1 principles, or basic political choices, would be adopted in framework measures (in the form of directives or regulations) in accordance with normal legislative procedures. Level 2 measures, or detailed technical measures, would be adopted by the Commission under a streamlined and accelerated law-making procedure, supervised and assisted by two new committees. Level 3 concerns the implementation process and requires enhanced co-operation between securities regulators across the EC in order to ensure consistent implementation of level 1 and 2 measures. Level 4 addresses enforcement and calls for more aggressive enforcement by the Commission of EC rules.

The Lamfalussy model is discussed in detail in Chapter XV below. Its implications for EC securities regulation are enormous. On a procedural level, the law-making procedure should become considerably more transparent and sensitive to market requirements, given the new model's emphasis on pre-consultation. More generally, it has the potential not only to accelerate the adoption of securities regulation measures and to enhance dramatically the ability of the EC to respond to developments in the integrated market-place, but also, by allowing for the adoption of more detailed

⁷⁹ *Ibid*, 7.

technical measures, to transform EC securities regulation from a market integration device based on mutual recognition to a regime which intervenes much more aggressively in national regimes and, in effect, regulates the single market. It may yet prove to be a staging post towards greater centralization of market regulation.⁸⁰

The 2001 Stockholm European Council supported the Lamfalussy Report, noting the ‘crucial role’ played by financial markets in the overall economy of the EC and emphasizing the importance of creating a ‘dynamic and efficient European Securities Market’. In addition to endorsing the Lamfalussy law-making model, it called for every effort to be made to implement the key steps necessary to achieve an integrated securities market by the end of 2003 and called for further convergence of supervisory practices and regulatory standards.⁸¹ Over the summer of 2001, the first package of reforms designed to finalize the integration of the securities market was unveiled and prepared in accordance with the Lamfalussy model, with the Commission presenting proposals for the control of market abuse and for a new prospectus disclosure regime and making two decisions establishing the committees which will streamline the cumbersome legislative process. Overall, it appears from the measures already presented and the consultations being carried out by the Commission on future proposals, that while they are designed to break down the remaining barriers to integration this new generation of measures will also, unlike their precursors, seek to regulate the integrated market to a significantly greater extent.

The FSAP and the Lamfalussy model are the critical influences on the future of EC securities regulation, but the regime will also be shaped by a number of extra-EC influences. Market developments are influencing regulation to a greater extent than ever before; the growth in e-commerce, to take one example, has accelerated the push towards home country control of investment business while the development of ATs and securities-trading markets alliances and mergers, to take another, is forcing the EC to address sophisticated problems such as how to preserve market transparency in a fragmented trading environment and how best to prevent market manipulation. The extent to which markets and market participants converge in their standards and practices in non-harmonized areas is also likely to play a large part in the evolution of the integrated market. Convergence outside the institutional structures of the EC is already occurring at the level of market regulators. Prior to its incorporation within the EC institutional structure as the

⁸⁰ One of the favourite preoccupations of securities regulation commentators is to comment on the legal possibility and political likelihood of the establishment of a Euro-SEC wielding powers over the integrated market. This question is discussed in Ch. XV below.

⁸¹ Annexes to the Presidency Conclusion, Stockholm European Council, 23 and 24 Mar 2001, Annex I. Resolution of the European Council on More Effective Securities Market Regulation.

Committee of European Securities Regulators (the CESR), FESCO (the Federation of European Securities Commissions) played a major role in encouraging convergence (see Chapter XV below). EC securities regulation does not take place in a hermetically sealed market-place; in order to ensure the competitiveness of EC market participants and to reflect the global nature of investment services and securities markets, account must be taken of international developments. In particular, the work currently being undertaken by the Basle Committee on Banking Supervision will determine, to a large extent, how the EC's capital adequacy regime will evolve while proposals adopted by IOSCO, the Basle Committee, and the International Association of Insurance Supervisors on the regulation of financial conglomerates have influenced the EC's proposals in this area. In the disclosure sphere, IOSCO and the International Accounting Standards Board are exerting considerable influence on the shape of the new disclosure regime.

As is discussed in Chapter II the full development of an integrated securities and investment services market is, however, dependent on an alteration in patterns of investment behaviour across the Community. Unlike the position in the USA, bank finance remains the predominant source of funding for Community companies.⁸² Personal investment in the markets through pension funds and collective investment schemes is also much less developed than in the USA due to the greater embrace of the welfare state in Europe. Where the securities markets are accessed, however, it is not entirely clear that investors will move away from an oft-observed bias towards domestic investment in spite of the benefits of diversification in foreign investments. The retail investor, in particular, has been shown to be reluctant to venture beyond the home market.⁸³ It seems clear, however, that the internal market in securities and investment services will continue to mature and deepen. The ability of EC securities regulation to respond to this process will be critical.

I.8 CAPITAL CONTROLS

I.8.1 *The Road to Liberalization*

The abolition of capital controls or, more specifically, the removal of restrictions on cross-border financial transactions⁸⁴ is a critical horizontal require-

⁸² Gros, D, and Lannoo, K, *The Euro Capital Market* (2000) 39.

⁸³ 'Europe is likely to become the home market for institutional investors, but not yet for households': *ibid*, 163. See also the Initial Lamfalussy Report which noted that while the investment horizons of retail investors (and funds) are becoming more European, 'a strong home bias persists in primary and secondary market activity in the EU markets': n 76 above, 11.

⁸⁴ See generally, Bakker, A, *The Liberalisation of Capital Movements in Europe* (1996), Mohamed, S, *European Community Law on the Free Movement of Capital and the EMU* (1999) and