The Need for Centralized Securities Regulations in the European Union

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Abstract: Developing a system of securities regulation in the European Union has been a difficult task. Currently, markets are regulated at the national level and are guided by certain minimum standards established by EU Directives. The Investment Services Directive, enacted in 1996, was heralded as the final piece of legislation required to complete a unified market for securities. This Note discusses the ISD’s failure to result in a fully integrated market and concludes that EU markets need supervision by a centralized regulatory body to allow them to become fully integrated.

INTRODUCTION

One prominent goal in the establishment of the European Union (EU) was the facilitation of economic growth and economic cooperation among European states. The European Commission (Commission) recognizes that financial services, which currently represent 6% of EU Gross Domestic Product (GDP) and 2.45% of employment, are an instrumental part of the European economy. It is apparent that the EU needs a system whereby business opportunities are accessible across borders and investors are protected. As a result, EU legislation seeking to achieve fair and equal access to capital markets has targeted the securities industry.


2 E. Waide Warner, Mutual Recognition and Cross-Border Financial Services in the European Community, 55 LAW & CONTEMP. PROBS. 7, 7 (1992) ("[I]ntegration of the Community's financial services markets . . . can be expected to spur competition among financial intermediaries, increase efficiency in the financial services industry, provide . . . securities investors with greater choice, and reduce the cost of capital for borrowers and issuers.").

Maintaining fairness and stability of markets in the EU is not an easy task.\textsuperscript{4} There are currently forty regulated securities markets throughout the twelve Member States that operate without the guidance of any kind of supranational regulatory body.\textsuperscript{5} Instead, each Member State’s national government regulates its securities markets in accordance with EU Directives.\textsuperscript{6} These Directives set baseline requirements and minimum standards in areas such as issuance of stock, prospectus requirements and, most recently, the ability of firms to provide investment services to cross-border customers once the firm has gained authorization to do business in its own Member State.\textsuperscript{7}

The most recent Directive, with which Member States were required to comply by January 1, 1996, is the Investment Services Directive (ISD). The ISD represents a significant progression toward market accessibility throughout the EU.\textsuperscript{8} Developments of the last few years, however, show that more rigid supranational regulation may be necessary before the markets of the EU are fully cooperative.\textsuperscript{9}

Part I of this Note provides a brief overview of earlier Directives in order to illustrate that the ISD does represent a major shift in the EU’s approach to regulating market accessibility. Part II outlines the ISD’s goals and its most important provisions. Part III explores recent developments in the financial services industry that call for updated regulation, and then points to the areas where the ISD falls short in dealing with those developments. Finally, Part IV concludes that the EU ultimately will need a centralized regulatory body to deal specifically with the securities industry because the current system simply cannot keep pace with developments in this area.

I. EARLY REGULATION OF SECURITIES IN THE EU

Historically, securities regulation has been noticeably absent throughout Europe’s markets, making the EU’s attempts at regulation

\textsuperscript{4} Id. at 185–86.
\textsuperscript{5} Id. at 191.
\textsuperscript{6} Id. at 187.
\textsuperscript{7} Id. at 187–92.
extremely challenging. Amid vague rules, self-interested weak regulatory bodies and, in some countries, cultures of non-disclosure, markets were easily manipulated and thus were easy targets for those who wanted to take advantage of them.

The EU’s effort to equalize market access has followed the same procedure as in other areas of legislation—the Council issues Directives setting standards for Member State legislation, and then allows each Member State to create its own laws that comply with these Directives. The last twenty years have seen significant legislation in the securities area. Initially, the Commission established rules that addressed specific issues such as how stock is issued and what information must be provided to investors to ensure fair dealing—that is, the rules of the game. In contrast, the most recent Directive, the ISD, focused more explicitly on accessibility—that is, who can play.

The earlier Directives merely required Member States to meet common standards within their own borders. For example, the 1979 Admissions Directive required Member State legislation to establish baseline listing requirements for companies issuing securities, including requirements that the issuer has published financial statements for the preceding three years, that the securities listed are freely negotiable, and that the securities are sufficiently distributed to permit a market.

Other Directives focused even more closely on disclosure requirements. For example, the Information Directive of 1980 required that companies listed on any EU exchange file certain “listing particulars.” These include the name of the person responsible for preparing the information required by the Directive and for auditing finan-

10 Warren, supra note 3, at 185–86.
11 Id. (“Insider trading in Europe has been regarded as a major tenet of trading strategy in the EU’s securities markets, and may explain why comparatively few Europeans are direct owners of equities.”).
12 Id. at 187.
13 See id. at 187–92.
14 Id.
15 Id. at 193.
cial statements, the capitalization of the issuer, the issuer’s principal business activities, the issuer’s assets and liabilities, its financial position, profits and losses, the issuer’s management, and its prospects for the coming year.\textsuperscript{19} Similarly, the Interim Reports Directive of 1982 required that all companies issuing stock publish biannual reports (with explanatory statements) on activities, profits, and losses.\textsuperscript{20} Finally, the Prospectus Directive of 1989 established requirements for what information companies must publish in a prospectus.\textsuperscript{21} These publication requirements include the terms of the offer, the nature of the securities, withholding taxes, underwriting arrangements, transfer restrictions and preemptive rights, issuer’s capitalization, issuer’s business activities, issuer’s material contracts, patents and licenses, legal proceedings, issuer’s annual and interim financial statements, issuer’s business trends, and prospects for the current year.\textsuperscript{22}

In 1985, similar standards were established for mutual funds. The Mutual Funds Directive set guidelines for supervision, structure, activities, and disclosure requirements for mutual funds, and also permitted marketing of mutual funds throughout the EU upon authorization by any one Member State.\textsuperscript{23} Other legislation included the Majority Shareholdings Directive of 1988 which ensured disclosure of the extent of shareholders’ voting rights,\textsuperscript{24} and the Insider Trading Directive of 1989 which prohibited trading on the basis of non-public material information.\textsuperscript{25}

All of these laws were helpful in beginning to structure a more uniform system of regulation. One commentator noted that they “established a far-reaching regulatory framework for implementation by

\textsuperscript{19} Id.; see also Warren, supra note 3, at 187; Harmonization, supra note 16, at 212 (noting exemptions for some information in certain situations).
\textsuperscript{22} Id.
the Member States, and ... an accessible, integrated marketplace."\textsuperscript{26} However, although demanding similarity of laws among the Member States, the Directives did not facilitate or encourage cross-border transactions.\textsuperscript{27} Member States regulated the securities industry solely at the national level, requiring firms to adhere to the national standards existing in the Member State where the firms chose to conduct business.\textsuperscript{28} These arrangements left firms vulnerable to discriminatory regulation in foreign countries, and subjected them to the high costs of obtaining authorization by several governments.\textsuperscript{29}

The Commission first sought to alleviate these problems by adopting the Mutual Recognition Directive, which represented a shift from commonality to reciprocity.\textsuperscript{30} This 1987 legislation applied to issuers of stock and mutual funds, and amended several existing Directives.\textsuperscript{31} It required that where an issuer complied with the laws established by one Member State pursuant to an amended Directive, that compliance would be sufficient to comply with the rules of other Member States.\textsuperscript{32} In other words, if an issuer's listing particulars were approved by a competent authority in one Member State, they must be recognized in all other Member States without additional scrutiny.\textsuperscript{33} The ISD goes one step further by granting investment firms, not just issuers, a "passport" to do business in foreign Member States.\textsuperscript{34}

\textsuperscript{26} Warren, supra note 3, at 190–91.

\textsuperscript{27} See Harmonization, supra note 16, at 190.

\textsuperscript{28} Id. at 194.

\textsuperscript{29} Warren, supra note 3, at 186.


\textsuperscript{32} Id.; Harmonization, supra note 16, at 213 (noting that "listing particulars approved by a competent authority in one Member State must be recognized in all other Member States without further action or information requirements ... even where more stringent disclosure requirements apply in the Member State where recognition is sought.").

II. THE INVESTMENT SERVICES DIRECTIVE (ISD)

A. Goals

The ISD was adopted to foster the freedom of capital movement among EU members permitted by Article 57 of the Treaty of Rome. The ISD "serves to protect investors and to facilitate the smooth functioning of capital markets" by requiring mutual recognition of minimum standards for the activity of investment firms across Member States' borders, rather than by requiring strict harmonization of laws. It is now possible for an investment firm to conduct business throughout the EU after obtaining authorization in just one Member State. The notion of the "Single Market" has been extended to the financial services arena.

An additional goal of the ISD was the prevention of protectionist regulatory discrimination against outsiders. Prior to the ISD, some Member States unfairly excluded foreign investment firms from competition. In E.C. Commission v. Italy, the European Court of Justice (ECJ) recognized that Italy's exclusion of firms not registered in Italy fell squarely within the bounds of the ISD. The court held that this exclusion was precisely the type of discrimination that the Directive was intended to prevent. Because the situation arose before implementation of the ISD, the ECJ decided in favor of the Commission on other grounds, namely that Italy had failed to fulfill its obligations under Articles 52 and 59 of the Maastricht Treaty. Thus, Italy was required to open its doors to foreign investment firms.

37 Warren, supra note 3, at 194.
38 Id.
40 Harmonization, supra note 16, at 189–90.
41 See generally Case C-101/94, EC Commission v. Italy (Re Restrictions on Foreign Securities Dealers), [1996] E.C.J. 6263, [1996] 3 C.M.L.R. 754, 783 (1996) (deciding that Italian laws unfairly restricted the activity of dealing in transferable securities to companies or firms whose registered offices were in Italy).
42 Id. at 757.
43 Id.
44 Id. at 778.
45 Id. at 780 (concluding that "the obligation for operators from other Member States to set up their principal establishment in Italy is the very negation of the freedom to pro-
The ISD also seeks to reduce compliance costs for investment firms operating in the EU by requiring authorization only in one Member State. Before the Directive, investment firms were subject to the unnecessary financial burden imposed by having to seek approval in every Member State in which they wanted to conduct business.

B. Provisions

The ISD applies generally to anyone in the business of providing investment services. Such services include "brokerage, dealing, market making, portfolio management, underwriting a distribution of securities, individual investment advice, and safekeeping and administration." The Directive's key provisions include Home State authorization, mutual recognition, prudential regulation, conduct-of-business rules, and exchange membership for foreign investment firms.

Home State authorization is the process by which an investment firm obtains permission to provide services in the Member State in which it principally conducts business (Home State). It requires that the firm have a main office located in the Member State where it is seeking authorization, and that the firm have sufficient initial capital. In addition, the firm's managers must show "sufficiently good repute" and "sufficient experience" in the securities industry. Finally, the firm must submit a business plan and disclose the identities of any shareholders or members who have "qualifying holdings."

Mutual recognition is the process by which firms receive permission to conduct business in Member States other than the ones that have granted them authorization (Host State). In order to conduct business in another Member State, a firm must notify its Home State...
that it wishes to do so.\textsuperscript{56} Within three months, the Home State must relay that information to the Host State.\textsuperscript{57} Within two months, the Host State must prepare for the supervision of the firm and then notify the firm of the conditions upon which it is authorized to conduct business.\textsuperscript{58} If, however, those two months pass without communication from the Host State to the firm, the firm can establish its branch office in the Host State and commence business.\textsuperscript{59}

The "prudential rules" established by the ISD prescribe specific safeguards that firms must have in place in order to ensure that they are complying with the regulations.\textsuperscript{60} These include sound administrative and accounting procedures, controls and safeguards over electronic data processing, adequate internal control mechanisms, segregation of accounts, records of all transactions, and procedures to minimize the risk of conflicts of interest.\textsuperscript{61} In addition, the conduct-of-business rules demand the following in day-to-day business: honesty and fairness, due skill, care and intelligence, and the employment of resources and procedures necessary for proper performance of business activities.\textsuperscript{62} Firms also must obtain information from clients about their financial positions and investment experiences and objectives, avoid conflicts of interest, and comply with all regulatory requirements.\textsuperscript{63}

Finally, the ISD requires that Member States allow investment firms to become members of their stock exchanges,\textsuperscript{64} and also provides for more transparency in stock trading.\textsuperscript{65} Transparency is achieved through publication at the open of the previous day's prices, as well as publication throughout the day of prices at no more than a one-hour delay.\textsuperscript{66}

III. HAS THE ISD BEEN EFFECTIVE?

Upon adoption, the ISD was hailed as the cornerstone of EU securities regulation and was said to complete "the final piece of frame-

\textsuperscript{57} Id.
\textsuperscript{58} Id.
\textsuperscript{59} Id.
\textsuperscript{60} Council Directive 93/22, \textit{supra} note 8, art. 10.
\textsuperscript{61} Id.
\textsuperscript{62} Council Directive 93/22, \textit{supra} note 8, art. 11.
\textsuperscript{63} Id.
\textsuperscript{64} Council Directive 93/22, \textit{supra} note 8, art. 15.
\textsuperscript{66} Id.
work legislation needed for a Single Market in financial services.\textsuperscript{67} However, there are reasons why the ISD has not resolved more completely the issue of EU-wide securities regulation.

The first problems encountered dealt with implementation.\textsuperscript{68} The ISD was adopted in 1993, and Member States had three years to tailor their own securities legislation to meet the new standards set by the Directive.\textsuperscript{69} At the original effective date of implementation, however, only four countries had fully implemented the Directive.\textsuperscript{70} As of August 1997, Germany, Spain, Luxembourg, and parts of the U.K. were still lagging.\textsuperscript{71} More recently, in June 1998, the U.K.’s failure to comply persisted.\textsuperscript{72} On June 19, 1998, EU Financial Services Commissioner Mario Monti announced that “the [ISD] is not yet fully implemented in all Member States, although considerable progress has been made.”\textsuperscript{73}

A second problem is that regulatory discrimination was not eradicated completely even where Member States seem to have complied with the ISD.\textsuperscript{74} In October 1999, for example, the Commission discovered that Italy had enacted a law in 1997 that granted reduced tax rates to issuers for the first three years that their securities were listed on Italian regulated markets.\textsuperscript{75} The Commission decided that


\textsuperscript{69} Council Directive 93/22, supra note 8, art. 31 (“No later than 1 July 1995 Member States shall adopt the laws, regulations and administrative provisions necessary for them to comply with this Directive. These provisions shall enter into force no later than 31 December 1995.”).

\textsuperscript{70} Wymeersch, supra note 68, at 30.

\textsuperscript{71} Commission Keeping a Wary Eye on Greek Stock Market Rules, supra note 68; Commission pursues infringement proceedings against Belgium, Spain, and the United Kingdom, supra note 68.

\textsuperscript{72} Commission pursues infringement proceedings against Belgium, Spain, and the United Kingdom, supra note 68.

\textsuperscript{73} Mario Monti, Completing the Single Market Legislation, INT’L MONEY MARKETING, June 19, 1999, available at 1999 WL 9958487; see Fifteenth Annual Report on Commission Monitoring of the Application of Community Law, COM(98)317 final at 219 (OJ C250) (identifying Austria, Germany, Luxembourg, Portugal, and Spain as the only Member States not to implement measures of 93/22).


\textsuperscript{75} Id.
such a “measure is likely to discourage issuers from having their securities listed on the stock markets in other Member States and moreover constitutes discrimination on the basis of nationality.”

Another shortcoming is that the ISD sets up the framework to allow investment firms to conduct business not in all Member States, but only in those Member States in which they have established branch offices. It does not take into account the potential for any increased cross-border business that may occur if firms were allowed to market themselves from a distance (that is, without setting up a branch office). The Commission has proposed an additional Directive to allow such transactions, highlighting the fact that the ISD is not the final answer. The impetus for this legislation is largely the development of electronic means, such as the Internet. However, the new laws would encompass marketing by telephone or mail as well.

The framework of EU securities regulation faces additional challenges such as the emergence of alternative trading systems, the uncertainty of redress for individual investors, the lack of uniformity of taxation, and large disparity in pricing. Each of these issues presents an obstacle to a fully integrated market, and each must be addressed quickly. The ISD, however, provides no resolution for any of them.

In October 1998, the Commission recognized that integration of the EU’s securities markets was not yet a reality. As a result, it published “Building a Framework for Action,” which outlined remaining challenges to a fully integrated market for securities. Among the is-

76 Id.
78 See id.
80 Id. The proposal seeks to facilitate the development of innovative forms of trade in financial services by guaranteeing: (1) a warming up period before a consumer agrees to a contract; (2) the consumer’s right of withdrawal under specified circumstances; (3) the supplier’s rights; (4) prohibition on providing services that have not been requested; and (5) limitations on “cold-calling.” See id.
81 Id.
82 Action Plan, supra note 9, at 6, 10, 15; Framework for Action, supra note 1, at 13. Commissions, the amount paid by investors to brokers per transaction, are extremely divergent among the Member States. Framework for Action, supra note 1, at 13. For instance, the commission on a purchase or sale worth 1,440 ECU (European Currency Units) in Ireland is just 3 ECU. Id. In Finland, the same transaction demands a commission of 51 ECU, seventeen times more. Id.
83 See generally Framework for Action, supra note 1.
84 See generally id.
sues discussed were the need for a "leaner and more effective regulatory apparatus," the persistent barriers to cross-border retail transactions, and the need for more cooperation among the EU's existing regulatory bodies. To address these issues, the Commission established the Financial Services Policy Group (FSPG) to develop a plan for attacking these issues.

From January 1999 through March 1999, the FSPG met to accomplish its dual goals of (1) identifying and prioritizing a set of actions, and (2) defining a number of immediate priorities. The Group was composed of representatives of EU Finance Ministers and was chaired by Mario Monti (the EU's Financial Services Commissioner). The Commission asked the FSPG to discuss four specific areas: (1) where new legal initiatives are required; (2) where existing provisions need to be adapted to new developments; (3) where existing provisions need simplification; and (4) where existing provisions need to be more coherent.

At its first meeting, the Group identified immediate priorities such as approving existing proposals and improving existing legislation. The second meeting focused on expediting the legislative process and on the issue of e-commerce in the financial services context. At its final meeting, the FSPG discussed the status of current supervisory structures and the international aspect of supervision.

The conclusions reached by the FSPG are detailed in the Commission's Financial Services Action Plan (Action Plan). This report describes a course of action that may resolve the remaining obstacles to full integration of the EU's securities markets. A projected timeline and delegation of duties are also outlined. The theme of the Action Plan is that the current system cannot keep pace with the de-

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85 Id. at 6–8, 13–17, and 18–20.
86 Id. at 3.
88 Id.
89 Id.
90 Id.
93 See generally Action Plan, supra note 9.
94 See generally id.
95 See generally id.
velopments in the financial services field. The bottom line of the group’s analysis is that “the ISD is in urgent need of upgrading if it is to serve as the cornerstone of an integrated securities market.” The present structure of securities regulation in the EU is not capable of responding to quickly evolving needs.

IV. MOVING TOWARDS STRICTER SUPRANATIONAL REGULATION

If the status quo is not strong enough to handle the demands of a rapidly-evolving marketplace, then it needs to change. The current state of securities regulation in the EU is insufficient. At the time of its adoption, the ISD seemed sufficient to introduce and encourage cross-border securities transactions. In reality, however, it is stagnant legislation that does not go far enough. The Commission plans to publish a Green Paper during 2000 as a “wide-ranging review of ISD as the basis for integrated and efficient market for investment services.” What the EU really needs is a strong supranational regulatory body to uniformly enforce securities laws throughout the Member States. The Commission’s recent actions, such as forming the FSPG, and further reliance in the Forum of European Securities Commissions (FESCO) indicate that it is beginning to recognize such a need.

Centralized securities regulation is necessary for two reasons. Foremost, the Commission needs to be able to act more quickly in response to changing markets. Second, absent centralized regulation, cooperation among several distinct regulatory bodies is nearly impossible to achieve.

The legislative process adopted by the EU is inefficient in the context of securities regulation because it moves too slowly. Currently, it can take three to four years for legislative procedures to be completed, and upon completion they often respond only to isolated

96 See generally id.
97 Id. at 5.
98 See Action Plan, supra note 9, at 16.
99 See id.
100 Id. at 23.
101 See id. at 16.
102 See generally id.
104 See Action Plan, supra note 9, at 4 (“Several proposals of immediate and significant relevance to the functioning of EU financial markets have fallen victim to protracted political deadlock.”).
issues. The Commission describes the current system as "piecemeal and reactive," an approach that will not suffice in the context of "financial services [that] are being steadily blurred." The EU needs a proactive authority that looks at the entire industry, rather than at particular problems, and is thus able to eliminate delays in responses to issues.

The second problem is merely one of too many cooks in the kitchen. Roberta Karmel, Professor of International Business Law at Brooklyn Law School and a former Commissioner of the Securities and Exchange Commission (SEC), notes that "transferring oversight of the self-regulatory process to fifteen different national securities regulators will not result in a pan-European securities market, but rather will compound the problems of a fragmented system for the trading and regulation of securities." By contrast, a single authority with the power to make decisions on an EU-wide basis would ensure uniformity of legislation, as well as consistent interpretation of laws.

Recently, the Commission has begun to ask for the help of securities regulators throughout the EU and has facilitated cooperation by different national regulators through groups such as the FSPG. The Commission also anticipates intensifying its collaboration with FESCO. Additionally, the Commission plans to develop a union-wide complaint network—a centralized forum where violations of securities laws can be reported.

These plans demonstrate that the EU needs a centralized regulatory system, not only to hear complaints but to act on them. The EU needs to establish a regulatory body that would address problems on a more permanent, continual basis, rather than by means of the ad hoc forums that are currently used.

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105 Id. at 17; see Karmel, supra note 103, at 33 ("Solving . . . problems through the process of formulating Directives is impractical. It takes too long for directives to be negotiated and then implemented. The capital markets are creative and dynamic.").
106 Action Plan, supra note 9, at 16.
107 See id.
108 See Karmel, supra note 103, at 34.
109 Id. (noting additionally that future dealings with non-EU securities regulators will be more likely if one regulatory body represents the entire EU).
110 See id.
111 See generally First Meeting of Financial Services Policy Group, supra note 87.
112 Action Plan, supra note 9, at 6.
113 Id. at 10.
114 See id.
115 See id.
The Commission has been reluctant to establish a permanent committee without regulatory authority to address securities issues, as has been created in the banking and insurance sectors.116 Similarly, its language regarding centralized regulation remains cautious.117 However, the Action Plan conceded that “[t]he EU has been hamstrung by the absence of a committee of appropriate standing to assist the EU institutions in the developing and implementing regulation for investment services and securities markets.”118 The EU needs to create such a structure that can more comprehensively and more efficiently oversee the securities markets of the EU.

CONCLUSION

The ISD represents a significant step towards a more accessible European securities market because it facilitates the cross-border activities of investment firms. However, it is merely a first step in integrating the securities markets and in achieving the goals of investor protection and efficient functioning of markets.

The cornerstone of securities regulation in the EU cannot be stagnant. It cannot rest on its laurels while the securities industry rapidly evolves. If the EU wants to reach full integration, it must develop a stronger foundation that encourages flexibility and a proactive approach to regulation. That foundation can be developed by creating a regulatory body that will address the needs of European securities markets and European investors.


117 See Action Plan, supra note 9, at 13. (“There are reasons to believe that the status quo may not be tenable over the longer-term. There is now a greater need and a willingness to engage in an open discussion on the structures that will be needed to ensure appropriate regulation and supervision of a single financial market. . . . In time, the option of a single authority to oversee securities markets supervision may emerge as a meaningful proposition in the light of changing market reality.”).

118 Id. at 14.